

ECONOMIC GOVERNANCE

*The Impact of the European Union
on the Regulation of Fiscal and Monetary Policy
in Central European Countries*

Studies of the Central European Professors' Network
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*The Impact of the European Union
on the Regulation of Fiscal and Monetary Policy
in Central European Countries*

EDITED BY
ZOLTÁN NAGY

*On the occasion of the Hungarian Presidency
of the Council of the European Union*



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on the Regulation of Fiscal and Monetary Policy
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FOREWORD

This book is the result of a year of research, during which some eminent experts and academics from the featured countries worked on the subject and wrote chapters on the EU and individual countries. In organising the research, we sought to ensure that the subject was presented by local researchers with expertise in the legal systems of each country while also drawing on the literature of the country concerned. The focus was naturally on EU economic governance, providing a coherent framework for analysing national legislation. In addition to Member States, the book examines the legal system of Serbia, a country that is about to join the EU, and describes how an applicant country sees the problems and challenges of EU regulation.

The European Union (EU) has faced a series of major challenges in recent years, which have increased the importance of fiscal and monetary policies. Economic governance at the EU and member-state levels deviated from the traditional framework, leading to extraordinary measures. However, after extraordinary governance, a return to normality is required. However, the question remains whether the traditional economic governance framework is appropriate for dealing with new situations or whether policymakers need to consider new solutions.

It is in the interests of the European Union and its member states to have competitive, economically, and socially balanced countries. Economically developed states should ensure a high standard of living and maintain the conditions required for the welfare state to function. One challenge is defining a single set of standards for states with different levels of development. A sustainable, economically developed European Union can only be built from a balanced group of Member States, which requires a defined framework. However, the responsibility for achieving the objectives of economic governance and tackling the problems lies with the Member States. This situation is a source of conflict in the short term, even if the objectives of the Member States and the Union coincide in the long term.

This book aims to present and analyse the regulatory models of some Member States in the area of fiscal and monetary policy based on the economic governance of the European Union. The book focuses on eight Central European countries, describing their economic governance, and consists of two main sections: fiscal and monetary policies. The fiscal section comprises three sub-chapters: public finance

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budgeting, aid policy, and taxation. These were considered key areas within the fiscal policy for EU regulation.

The chapter on public finances presents the application of EU standards on budget deficits and public debt to domestic regulations, alongside EU legislation. The framework, regulation level, and stringency of sustainable fiscal management vary across Member States. Furthermore, despite many similarities, handling exceptional situations (economic and pandemic crises) is subject to different rules at the member-state level. The solutions and results of this crisis serve as examples for future regulations.

The second chapter in the fiscal section deals with aid policy issues. The EU chapter focuses on EU State aid law, its main areas of analysis, and the Commission's recent position in relation to State aid procedures. The country chapters present Member States' aid policies and the relationship between these policies and EU aid rules, focusing on areas of conflict.

The third chapter in the fiscal section addresses taxation issues, showing the balance between Member States' fiscal sovereignty and various EU legal principles. The country chapters focus on tax sovereignty, tax harmonisation, and the fight against tax evasion. Of particular interest are the positions of Member States in the global minimum tax and the relationship between tax sovereignty and tax competition. The chapters also provide insights into Member States' views on tax harmonisation at the EU level. The fight against tax evasion is a key interest of Member States and is facilitated by implementing EU rules.

The second major section deals with monetary policy issues. This chapter analyses the issue of joining the Euro area, presenting the advantages and disadvantages and the reasons for some Member States' insistence on independent monetary policy. The experience with banking union arrangements is presented, as well as the issues of the division of powers between the Union and the Member States. The chapter also covers the monetary aspects of crisis management, analysing monetary policy instruments and their effectiveness in EU and non-euro countries.

We hope the reader will gain a comprehensive analysis of economic governance in Central European countries and a better understanding of the economic policies and legal regimes that underpin them in countries that have historically followed similar development paths.

By researching this topic, we also contribute to the Presidency of the Council of the European Union in 2024. The possibilities and conditions for this research were provided by the Professorial Network Program of the Central European Academy at the University of Miskolc.

Budapest, 14 May 2024

Prof. Dr. János Ede Szilágyi
Series Editor

Prof. Dr. Zoltán Nagy
Editor

PART I

FISCAL POLICY

CHAPTER 1

EU LAW ON PUBLIC FINANCE RULES



LÁSZLÓ SZEGEDI – BÁLINT TELEKI

Abstract

This chapter discusses the public finances of the European Union (EU). The first subchapter covers the history of the EU public finances, examining the basic regulatory framework pursuant to the Maastricht Treaty and the Stability and Growth Pact and analysing in detail the connection with the 2008 crisis and its aftermath. The most important developments in the control over EU public finances are also discussed in this subchapter. The second subchapter introduces a critical approach to the current framework of the EU public finances, exploring the impact of the Stability and Growth Pact and its reforms, and discussing the possibility of the establishment of an Economic and Monetary Union 2.0 from multiple perspectives. The third subchapter focuses on contemporary challenges, in particular the COVID-19 pandemic and its impacts, as well as the effects of climate change and digitalisation on EU public finances.

Keywords: *2008 financial-economic crisis, 2021-2027 Multiannual Financial Framework, climate finance, digital finance, Economic and Monetary Union 2.0, European Central Bank, European Commission, NextGenerationEU, Recovery and Resilience Facility, Stability and Growth Pact*

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1. History of the EU public finances

1.1. Public finances pursuant to the Maastricht Treaty

It is undebatable that the Maastricht Treaty (1993) was a crucial milestone that provided the agenda and tools that made it possible for the Economic and Monetary Union (EMU) to set off with its full potential. The previous amending Treaty, the Single European Act (1987), completely ignored the whole issue, and there was no consensus on what a few years later became dogma, that the EMU is a prerequisite of a united Europe.¹ The Delors III package, which a short time afterwards tried to compensate for this deficiency and brought about relevant innovations, did not have the necessary legal status and, therefore, the legal effects of an amending Treaty. As such, its innovations did not become part of the primary law of the then-so-called European Communities (known as the European Union (EU) since the Maastricht Treaty).²

The Maastricht Treaty established a three-stage agenda for introducing the euro and realising the related financial institutions, such as the European Central Bank (ECB), the European System of Central Banks, and the Eurozone. The EU still adheres to these criteria today, although this issue is not discussed in detail in this chapter.³

The Maastricht Treaty also introduced the *convergence criteria* for joining the Eurozone, which are still in effect today. The official website of the European Union⁴ summarises these criteria as follows (although, of course, in reality, the criteria comprise a detailed and complicated set of rules): price stability, sound and sustainable public finances, exchange rate stability, and rules related to long-term interest rates. This chapter discusses the second of the criteria listed above, public finances.

1.2. The Stability and Growth Pact

As Warin mentions, the Maastricht Treaty introduced the concept of ‘excessive deficits’. While the three monetary entry criteria – low inflation, low interest rates, and exchange rate stability – become moot once a country has joined the monetary union, the two budget entry criteria – public deficit and debt – remain a live issue. To that effect, the Treaty calls for the adoption of an excessive deficit procedure (EDP) that makes fiscal discipline a permanent requirement. The Stability and Growth Pact (SGP) defines and implements this procedure.⁵

1 Arató and Koller, 2015, pp. 197–198.

2 Chang, 2016, pp. 9–34; Horváth and Szalai, 2004, pp. 15–27.

3 Chang, 2016, pp. 9–34; Horváth and Szalai, 2004, pp. 15–27.

4 See: *Conditions for joining the euro area: Convergence criteria* [Online]. Available at: <https://www.consilium.europa.eu/en/policies/joining-the-euro-area/convergence-criteria/> (Accessed: 30 August 2023).

5 Warin, 2008, p. 4050.

The SGP, adopted in Amsterdam on 16-17 June 1997,⁶ involves three main elements.⁷ The first is a *political commitment* to a budget surveillance process, with the desired effect being that ‘effective peer pressure is exerted on a Member State failing to live up to its commitments’. The second comprises *preventive elements* to stop countries from exceeding the 3% reference value, with Member States submitting stability and convergence programmes to the Council of the European Union. On the recommendation of the European Commission, the Council (acting by a qualified majority) can issue an early warning to Member States before an excessive deficit occurs, with the expectation being that the transgressing state will take steps to rectify its budgetary situation. The third are *dissuasive elements* in the form of the EDP, which demands immediate action on the part of the Member State and can entail the imposition of monetary fines. Such sanctions begin as a non-interest bearing deposit with the Commission that is equal to 0.2% of the Member State’s gross domestic product (GDP) plus a figure linked to the size of the deficit. The Council may intensify these sanctions each subsequent year with the imposition of additional fines that may not exceed 0.5% of the Member State’s GDP on an annual basis. The deposit becomes a fine if the excessive deficit remains after two years. Exceptions can be made if an unusual event beyond the Member State’s control impacts its financial situation or if the country experiences a severe economic downturn that causes its real GDP to drop by at least 2%.

The *Lisbon Treaty* regulates this point as follows. The general legal basis of the convergence criteria is Art. 140 of the Treaty on the Functioning of the EU (TFEU). In accordance with Art. 1 of Protocol (No 12) on the EDP (attached to the Treaties), the reference values referred to in Art. 126 para. (2) of the TFEU are (i) 3% for the ratio of the planned or actual government deficit to the GDP at market prices; and (ii) 60% for the ratio of government debt to the GDP at market prices.

Protocol (No 13) on the convergence criteria also refers to this issue. Art. 2 states:

The criterion on the government budgetary position referred to in the second indent of Article 140(1) of the said Treaty shall mean that at the time of the examination, the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists.

The SGP is based on a two-pillar system, including a so-called ‘preventive arm’ and a ‘corrective arm’.⁸ The SGP’s preventive arm aims to prevent excessive deficits from occurring in the first place. Member States are required to maintain their budget deficits within the 3% limit. If a Member State’s deficit is approaching the limit, the European Commission monitors the situation and may issue warnings

⁶ Mongay, 2022, p. 4.

⁷ Coricelli, 2005, pp. 6–7.

⁸ Ferrán, 2012; Coricelli, 2005.

or recommendations to take corrective measures. The SGP's corrective arm comes into play when a Member State exceeds the 3% deficit or breaches the 60% debt threshold. The EDP is activated, which involves the following series of steps:⁹ (i) the European Commission assesses the situation and presents recommendations to the Council of the EU; (ii) based on the Commission's assessment, the Council can issue recommendations for the Member State to take corrective actions; and (iii) the Member State is then required to submit a plan outlining how it intends to correct the excessive deficit or reduce debt.

The SGP has faced criticism for its perceived lack of enforcement mechanisms. While theoretically, Member States that repeatedly fail to comply with the rules could face financial penalties, in practice, such penalties have rarely been imposed. The SGP also allows for some flexibility during economic downturns or exceptional circumstances, and Member States facing severe financial challenges can be granted leeway in meeting the deficit and debt targets.¹⁰

1.3. The consequences of the 2008 global financial crisis and the subsequent Euro crisis

What do market failures mean? Economics points out that the market can only work efficiently under certain conditions, however, there are some conditions under which such efficiency will not occur. An excellent example of this is the 2008 economic crisis.¹¹ This crisis began with the busting of the United States housing bubble in 2007, which led to a collapse in the subprime mortgage market. As financial institutions faced massive losses, a chain reaction was triggered, causing a severe liquidity crisis and loss of confidence in the global financial system.¹² The financial crises (2008-2012) significantly affected the EU owing to its strong financial ties with the United States. European banks had invested heavily in US mortgage-backed securities and complex financial products, resulting in significant losses when those investments plummeted in value. Consequently, European banks faced a liquidity crunch and a loss of trust among lenders, resulting in a freeze in interbank lending. This made it difficult for banks to access funds and led to a credit squeeze, impacting businesses and consumers.

In terms of European fiscal/budgetary issues, the sovereign debt crisis is perhaps the most relevant impact of the financial crises. Some EU countries, particularly the so-called 'GIIPS' countries (i.e. Greece, Italy, Ireland, Portugal, and Spain), and others such as Cyprus and Hungary, faced escalating levels of public debt and deteriorating

9 Ferrán, 2012; Coricelli, 2005.

10 Ferrán, 2012; Boonstra, 2005; Chang, 2006; Ferrán, 2012; Halmai, 2021a; Halmai, 2021b; Mérand, 2022; Sigl-Glöckner et al., 2022; Mongay, 2023.

11 Ferrán, 2012; Nagy, 2019, p. 291.

12 Ferrán, 2012; Lentner, 2015, pp. 24–35; Urbanovics and Teleki, 2021.

economic conditions.¹³ The 2008 financial crisis had long-lasting effects on the EU. It revealed the vulnerabilities in the Eurozone's structure and highlighted the need for deeper economic and fiscal integration.¹⁴ Unfortunately, the crisis also contributed to the rise of anti-EU sentiments and populist movements in some Member States.¹⁵ Some EU countries implemented austerity measures involving spending cuts and tax hikes to address the sovereign debt crisis. However, these measures faced backlash due to their impact on social welfare and public services as the crisis exposed the need for stronger financial regulations and supervision. The EU responded by implementing reforms such as creating the European Supervisory Authorities and, later, the European Banking Union.¹⁶

Regarding the responses in the field of fiscal policy, many new measures were introduced. The European Semester promotes economic stability, structural reforms, and fiscal responsibility across the EU. It fosters coordination and ensures that Member States align their policies with EU priorities to enhance the overall economic performance and resilience of the EU. This process is critical to the EU's efforts to prevent economic imbalances like those experienced during the Eurozone crisis.¹⁷

The EU Fiscal Pact, also known as the 'Fiscal Compact' or the 'Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union', is an intergovernmental Treaty adopted in response to the Eurozone crisis. It was signed by 25 EU Member States in March 2012, aiming to strengthen fiscal discipline and coordination within the Eurozone and ensure the stability of the euro currency.¹⁸ It is important to note that the EU Fiscal Pact operates in parallel with the existing EU framework for economic governance, which includes the SGP and the European Semester process. While the Fiscal Pact is intergovernmental and applies to a subset of EU Member States (those in the Eurozone that have adopted the euro as their currency), the SGP and the European Semester involve all EU Member States.¹⁹

13 This exposed weaknesses in the Eurozone's design as it rendered its three inherent denials questionable. These denials are: (i) No state bankruptcy can occur within the Eurozone; (ii) No bail out is allowed for Member States within the Eurozone; and (iii) No Member State can leave the Eurozone. Moreover, the crisis resulted in an economic recession, with the EU experiencing a severe economic downturn, GDP contracting, and unemployment rising. Export-oriented economies suffered due to decreased global demand, and consumer spending and business investment declined. See: Arató and Koller, 2015.

14 Halmai, 2020.

15 Ágh, 2020, pp. 30–32.

16 Moloney, 2012; Imre, 2013; Imre, 2019; Lastra, 2019; Van Cleynenbreugel, 2019; Szegedi, 2020; Szegedi, 2022; Vértesy, 2022.

17 See: *The European semester* [Online]. Available at: https://commission.europa.eu/business-economy-euro/economic-and-fiscal-policy-coordination/european-semester_en (Accessed: 30 September 2023); Arató and Koller, 2015, pp. 269–280.

18 See: European Central Bank, 2012, pp. 101–102; Arató and Koller, 2015, pp. 269–280.

19 Arató and Koller, 2015, pp. 269–280.

Since the crisis, the EU's economic governance rules have been strengthened through eight EU regulations and one international Treaty: the Six Pack,²⁰ which introduced a system to monitor broader economic policies for the early detection of problems like real estate bubbles or falling competitiveness; the Two Pack,²¹ a new cycle of monitoring for the euro area, with countries – except those with macroeconomic adjustment programmes – submitting their draft budgetary plans to the European Commission every autumn; and the 2012 Fiscal Pact, which introduced stricter fiscal provisions than the SGP.²²

It should be briefly mentioned that after the initial years of the 2007-2008 crisis, monetary policy institutions, national banks, and the ECB played a decisive role in meeting public finance targets. Some of the literature, though, suggests that there should not be too close a connection between fiscal and monetary areas. According to Canzoneri et al., legislative processes are too slow for the discretionary component of fiscal policy to interact strategically with monetary policy at business cycle frequencies.²³ Meanwhile, Darvas and Merler argue that there are three main constraints on monetary policy: fiscal dominance, financial repercussions, and regional divergences.²⁴ In accordance with its secondary mandate set out in Art. 127 para. (1) of the TFEU,²⁵ the ECB supports EU economic policies: along with the Commission, the ECB participates in the monitoring of financial assistance programmes and in macroeconomic surveillance missions.²⁶

It is worth summarising the situation in certain GIIPS countries pursuant to the 2008 crisis and the Eurocrisis. As Pagoulatos and Triantopoulos mention, Greece's performance was found lacking when compared with other EU Member States, exhibiting relatively conservative credit policy stances and a limited integration of

20 The 'Six Pack' is a package of five regulations and one directive adopted in December 2011. The regulations are designed to strengthen the EU's economic governance framework, particularly for Eurozone countries. Key components of the Six Pack include rules on fiscal discipline, public expenditure, and economic policy coordination. It introduces the EDP, which establishes a framework to address Member States with excessive deficits and imbalances. The Six Pack aims to enhance fiscal surveillance and enforcement mechanisms, ensuring that Member States maintain sound fiscal policies and avoid excessive debt.

21 The 'Two Pack' consists of two regulations adopted in 2013, which are designed to complement the Six Pack and further strengthen economic governance within the Eurozone. The Two Pack focuses on the surveillance and coordination of economic policies in Eurozone Member States. It establishes the European Semester, a process that allows for closer scrutiny of national budgets, economic policies, and structural reforms. The Two Pack aims to enhance the coordination of economic and fiscal policies among Eurozone members to promote greater convergence and stability within the currency union.

22 See: *Stability and Growth Pact* [Online]. Available at: <https://eur-lex.europa.eu/EN/legal-content/glossary/stability-and-growth-pact.html> (Accessed: 19 September 2023).

23 Canzoneri et al., 2002, p. 334.

24 Darvas and Merler, 2013, p. 1.

25 'Without prejudice to the objective of price stability, the ESCB [European System of Central Banks] shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union'.

26 Darvas and Merler, 2013, pp. 3–5.

the Greek banking system with international financial markets.²⁷ Greece had been running large budget deficits for years, accumulating significant levels of public debt.²⁸ The true extent of these deficits was often hidden or understated, leading to a loss of investor confidence. In October 2009, Greece's public debt reached unsustainable levels, exceeding the country's GDP. This high debt burden made it difficult to attract investors and maintain financial stability.²⁹ Greece's membership in the Eurozone limited its ability to devalue its currency to boost exports and stimulate economic growth. It also complicated negotiations with international creditors. Greece implemented harsh austerity measures in exchange for financial assistance from international institutions like the International Monetary Fund and the ECB. These measures included tax increases, public spending cuts, and structural reforms, which had significant social and economic impacts.³⁰ When considering Greece, perhaps the largest problem with the Maastricht Treaty system was the *de facto* prohibition of bail-outs.³¹ Another problem was that in the early phase of the crisis, Greece did not ask for help and later falsified data regarding its economy.³²

In addition, the economic crisis led to political instability in Italy, with frequent changes in government leadership and a lack of consensus on addressing economic challenges. However, according to Di Quirico, political turmoil was also a problem before the crisis.³³ This made it difficult to enact and sustain economic reforms. Italy's fiscal situation raised concerns among EU authorities and the ECB. As Quaglia puts it, Italy suffers from 'a financial system that does not speak English'.³⁴ Italy faced pressure to adhere to the EU fiscal rules and reduce its budget deficit, further complicating the country's ability to stimulate economic growth. Italy's high public debt levels led to concerns about a potential sovereign debt crisis as rising yields on Italian government bonds made borrowing more expensive and raised doubts about the country's ability to meet its debt obligations.³⁵ In response to the economic challenges, the Italian government implemented austerity measures to control public spending, reduce the budget deficit, and stabilise public finances. These measures included tax increases and public expenditure cuts.³⁶ In reality, Italy has always been unfit for the conditions of the Maastricht convergence criteria: even at the time of the Maastricht Treaty in 1993, when the criteria for entry into the Eurozone was set, the Italian government's debt hovered at around 108% to 120% of GDP.³⁷

27 Pagoulatos and Triantopoulos, 2009, p. 39.

28 Hausken and Welburn, 2020, pp. 26–27.

29 Pagoulatos and Triantopoulos, 2009, pp. 35–36.

30 Pagoulatos and Triantopoulos, 2009, pp. 35–36; Hausken and Welburn, 2020.

31 Nelson et al., 2010, p. 10.

32 Arató and Koller, 2015, pp. 270–272.

33 Di Quirico, 2010, pp. 3–4.

34 Quaglia, 2009.

35 Quaglia, 2009.

36 Di Quirico, 2010, pp. 4–6.

37 Mascitelli, 2011.

Murphy and O'Brennan argue that Ireland should be considered one of the more compelling case studies during this period of protracted EU crises. They compare the 2008 financial crisis to the Brexit crisis in terms of crisis management.³⁸ 2008, Irish banks had overextended themselves in the property market, and their balance sheets were severely affected when property prices plummeted. The government had to intervene with significant financial support to prevent a complete collapse of the banking system.³⁹ The banking crisis put immense pressure on Ireland's public finances, leading to a severe sovereign debt crisis. The government's deficit soared, and the country faced increasing borrowing costs in the international bond markets. The Irish government implemented austerity measures to address the fiscal challenges, including tax hikes and spending cuts. These measures aimed to control the budget deficit and stabilize the country's finances but had significant social and economic consequences. Ireland ultimately sought a bailout from the International Monetary Fund, the European Union, and the European Central Bank to stabilize its economy and banking sector. This bailout came with conditions, including implementing further austerity measures and financial sector reforms.⁴⁰ As Ireland emerged from the worst effects of the financial crisis, the UK's decision to leave the EU in June 2016 precipitated a political, economic, and constitutional crisis for the Irish state. However, the EU's solidarity with Ireland throughout the Brexit⁴¹ negotiations resulted in an entirely different political dynamic than that which prevailed during the financial crisis.⁴² Similarly to Italy, Ireland was also a victim of private sector indebtedness, mainly due to the financial sector. According to Karsai, the lesson here is that the significance of the current account balance and the outstanding private loans indicate that macroeconomic variables regarding the private sector should also be included in the Maastricht convergence criteria and the Stability and Growth Pact.⁴³

As the examples of Greece, Italy, and Ireland demonstrate, the peripheral Member States, especially those in the Mediterranean, suffered huge losses as a combined consequence of the financial crisis and the vulnerability of their own economic and financial systems. This underlines the need for a more flexible approach toward the Member States when it comes to expectations around public finances. The idea of the EMU 2.0 (see below) intends to move in this direction.

1.4. Control over EU public finances

This subchapter briefly discusses European control over public finances. Although the Cohesion Policy funds are part of the Union budget, the way they are spent is based on a system of shared responsibility between the *European Commission*

38 Murphy and O'Brennan, 2019, p. 472.

39 Honohan, 2009, pp. 2–3.

40 Murphy and O'Brennan, 2019, pp. 473–478.

41 Halmai, 2020.

42 Murphy and O'Brennan, 2019, p. 484; Honohan, 2009; Halmai, 2020.

43 Karsai, 2012, pp. 111–112.

and *national authorities*.⁴⁴ In general, the European Commission shall implement the budget in cooperation with the Member States.⁴⁵

The *European Court of Auditors* helps the other EU institutions and the Member States to better manage and supervise the use of the EU funds, which is particularly important to the European Parliament when deciding whether the EU's accounts for the previous year are accurate and the funds are properly spent, a process known as 'granting discharge'.⁴⁶

In post-2008 European practice, the role of *fiscal councils* as a means of control has become increasingly important. As the ECB puts it, fiscal councils are generally defined as independent public institutions that are aimed at strengthening commitments to sustainable public finances. According to the Two Pack, Eurozone countries should have in place an independent body, such as a fiscal council, that is in charge of monitoring compliance with numerical fiscal rules and, where appropriate, assessing the need to activate the correction mechanism foreseen under the Fiscal Compact.⁴⁷ According to Wildowicz-Giegiel – to use the OECD terminology – fiscal councils can be defined as independent institutions financed by public funds that have a mandate (established mainly by constitutional or organic laws) to produce independent analyses, forecasts, and advice on fiscal policy.⁴⁸ Georgescu and Căpraru point out that though the mandates with which fiscal councils are invested at the EU level differ from country to country, common responsibilities can be identified for making, approving, and analysing macroeconomic and budgetary forecasts, as well as monitoring compliance with established fiscal rules.⁴⁹ Their main advantage is that the continuous monitoring by these independent institutions raises the level of transparency and accountability in the budgetary process. At the same time, information asymmetry diminishes, and the quality of the debates on fiscal policy increases.⁵⁰ Debrun et al. argue that, where they exist, the influence of independent fiscal institutions playing a role in fiscal policy (e.g. fiscal councils) is more ambiguous: they might or might not favour the presence of rules, depending on whether numerical rules and the institutions themselves complement or substitute each other.⁵¹

Although it is not the topic of this particular chapter, it should be briefly mentioned that there are three levels of public financial control at the level of the Member States, which are also involved in the control over EU funds: (i) the audit

44 See: *European Commission: Financial management* [Online]. Available at: https://ec.europa.eu/regional_policy/funding/financial-management_en (Accessed: 26 January 2024).

45 Nyikos, 2021, p. 211; Art. 317 of the TFEU.

46 See: *European Court of Auditors: What we do* [Online]. Available at: <https://www.eca.europa.eu/en/what-we-do> (Accessed: 26 January 2024); Nyikos, 2021, p. 214.

47 European Central Bank, 2014, p. 96.

48 Wildowicz-Giegiel, 2019, p. 615.

49 Georgescu and Căpraru, 2020, p. 7.

50 Ibid.

51 Debrun et al., 2008, p. 325.

bodies under parliamentary authority; (ii) the government; and (iii) the internal audit control in the budget holders.⁵²

2. A critical approach

2.1. Impact of the Stability and Growth Pact – partial success

As mentioned above, the SGP is a set of rules designed to ensure fiscal discipline among EU Member States and maintain stability in the Eurozone. However, a considerable portion of the literature suggests that the SGP has only partially achieved its goals, highlighting some key points and relationships related to fiscal policy and economic growth. Consequently, there have been questions about the SGP's effectiveness since its inception. This discussion intensified during the post-2008 European financial crises. There were several waves of criticism, among which that after 2008 was perhaps the most vivid; however, there were also serious concerns before the crisis. These concerns resulted in the reform of the SGP – the 'new' SGP – which was accepted in March 2005.⁵³

Shortly before the aforementioned reform, some voices suggested that the SGP should be abolished, as Boonstra submitted in his article, 'Should we just forget the Pact?' in early 2005. Boonstra questioned whether it would be impossible to imagine what we consider doing without budgetary standards. He argued that by improving the transparency of national budgets and regular monitoring by the European Commission, the market can be supplied with even better information. Rating agencies could also play a part in this. With the 'no bail out' clause of the Maastricht Treaty, the financial markets would put pressure on the countries with poor budgetary policy.⁵⁴ Nevertheless, the SGP was, of course, not abolished. The 2008 crisis and its consequences strongly disproved this way of thinking, that is, the neoliberal dogma of the sufficiency of the self-regulatory market. It has quickly become clear that strong regulatory institutions must be established in order to make financial markets safe.⁵⁵

⁵² Lentner, 2013, pp. 255–258.

⁵³ See: Boonstra, 2005; Chang, 2006; Ferrán, 2012; Mérand, 2022; Sigl-Glöckner et al., 2022; Mongay, 2023.

⁵⁴ Boonstra, 2005.

⁵⁵ 'Neoliberalism is the concept according to [which] problems and developments of human nature are bound to be solved through market competition. In other words, all problems can only be interpreted in a market context, and the belief in the self-regulating capacity of markets and their nature of fulfilling the possibility of free choice is unquestionable, and therefore basically, from any point of view, the market is a higher-order distribution mechanism than any of its alternatives'. See: Patomäki, 2009; Lentner, 2013, pp. 48–50.

In addition, as a pre-2008 critic of the SGP, Chang raised concerns about the differences of interest between the larger and smaller Member States. Interestingly, the reason behind these concerns is that the smaller Member States (such as Austria, the Netherlands, Greece, and Portugal) were those that insisted on maintaining the SGP in its original form. The larger Member States, including Germany and France, pushed toward a reform driven by the will to make the SGP more flexible. In line with this, before the reform of March 2005, it was the smaller states that were more rigorous about adhering to the SGP, while Germany and France occasionally ignored the rules that were disadvantageous to them.⁵⁶

As for post-2008 criticism of the SGP, Mérand examines three Member States with budgetary issues (Italy, Spain, and Portugal) and concludes that although these countries were subject to the EDP in 2014, they were out of trouble by 2019. Moreover, the Commission did not have to impose any sanctions on these governments.⁵⁷ Unfortunately, these accommodative strategies led to the politicisation of the SGP. According to Mérand, this was a direct, unintended consequence of strengthening the SGP after the Eurozone crisis.⁵⁸

Mongay draws attention to the fact that a central issue regarding the reform of the corrective arm is the extent to which the thresholds established in the abovementioned Protocol 12 of the TEU-TFEU should have been changed to introduce higher thresholds. However, although such higher thresholds could give some temporary leeway to high-debt countries, the need to establish deficit and debt caps and the constraints they impose on fiscal policy would not be fundamentally affected. The Commission's orientations (see below) do not veer toward amending Protocol 12.⁵⁹

Sigl-Glöckner et al. propose a reform that – according to them – should lead to a more effective reduction in debt ratios and a clearer division of tasks between fiscal and monetary policy.⁶⁰ They posit that if the Member States' majority cannot comply with the 3% deficit limit, a higher deficit limit could be acceptable, with the restriction that it must be a previously communicated and, therefore, publicly known primary deficit threshold. In Sigl-Glöckner et al.'s proposed reform, only if Member States cannot comply with the latter should the European Union deem their deficit 'excessive'.⁶¹

2.2. The idea of an Economic and Monetary Union 2.0

In addition to the rules of the SGP being highly debated, another deficiency is that, owing to certain political realities, the fiscal pillar of the EMU is way behind the monetary pillar in terms of development. These issues have already inspired the idea of the so-called EMU 2.0, which would be a different approach with a partially

⁵⁶ Chang, 2006.

⁵⁷ See: European Commission, 2014.

⁵⁸ Mérand, 2022.

⁵⁹ Mongay, 2023, p. 5.

⁶⁰ Sigl-Glöckner et al., 2023, p. 2.

⁶¹ Sigl-Glöckner et al., 2023, p. 2.

different toolset to help further integration within the fiscal pillar. Regarding the incomplete parts of the EMU, there may be a chance to create a Fiscal Union, but it is quite uncertain that it could really happen within a reasonable time (Moreover, the Banking Union exists but remains incomplete, and currently there is no significant discussion of the Capital Markets Union or the deeper Political Union).⁶²

The EMU 2.0 would have to include the aforementioned. The Fiscal Union should consist of, among other things, a stricter Macroeconomic Imbalance Procedure; more integrated, or at least coordinated, national budgets among Member States; and more integrated policies for competitiveness. There is a good chance that many Member States will not be willing to relinquish their budgetary autonomy to this extent.

2.2.1. *The Five Presidents' Report (2015)*

The introduction of the Five Presidents' Report (hereinafter: the 'Report')⁶³ is considered the beginning of the second wave of the EMU reforms pursuant to the 2008 crisis and the Eurocrisis (the former was discussed above as the direct consequence and crisis management of the crises).

The Report begins with the following declaration:

The Euro Summit of October 2014 underlined that “closer coordination of economic policies is essential to ensure the smooth functioning of the Economic and Monetary Union” (EMU). It called for work to continue to “develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity” and “to prepare next steps on better economic governance in the euro area”.⁶⁴

In the context of the Report, Begg et al. note that to make the EMU economically sustainable, the first imperative is to acknowledge that it had been left incomplete at Maastricht due to *divergent Member State preferences*.⁶⁵ The main consequence is the need for the development of a certain '*resilience*' in the EMU in the context of the economic and social structures in Member States. This is an absolute prerequisite to the long-term success of the *coordination of national economic policies* and the coordination of national development procedures with EU funds.⁶⁶

Perhaps the most crucial point recommended by the Report is a stronger Macroeconomic Imbalance Procedure: 'It should be used not just to detect imbalances but also to encourage structural reforms through the European Semester. Its corrective arm should be used forcefully. It should be triggered as soon as excessive imbalances

62 Langenbucher, 2020; Halmai, 2021a; Halmai, 2021b.

63 The five presidents concerned, who were in office at the time, were Jean-Claude Juncker (European Commission), Donald Tusk (European Council), Mario Draghi (European Central Bank), Martin Schulz (European Parliament) and Jeroen Dijsselbloem (Eurogroup).

64 European Commission, 2015.

65 Begg et al., 2015, p. 804.

66 Halmai, 2021a, p. 43.

are identified and be used to monitor reform implementation'.⁶⁷ Beyond that, this strengthened procedure should bring adequate reforms for re-balancing the whole euro area and the EMU.⁶⁸

Under the Report, several key features must be implemented to create the EMU 2.0. Established in the 2017 roadmap of the European Commission⁶⁹ and summarised by Halmai,⁷⁰ these features include: (i) the development of the *European Monetary Fund* (EMF); (ii) the integration of the Fiscal Pact into the framework of EU law; (iii) new budgetary instruments for a stable euro area within the Union framework; (iv) for the 2018-2020 period: (iva) targeted changes in the Common Provisions Regulation to mobilise funds to support national reforms, and (ivb) strengthening the Structural Reform Support Programme; and (v) communication regarding a *European Minister of Economy and Finance*.

Schweigl notes that the EMF is a step toward further integrating the EMU as a financial assistance fund that existed out of the EU legal framework and is being brought within the realm of EU law. The main advantage this tool brings is realised within the Banking Union through providing financial assistance/loans to EMF member countries in need and securing the functioning of the Single Resolution Fund by operating as a common backstop.⁷¹

The creation of the *European Fiscal Board* is also a consequence of this package. The European Fiscal Board was realised in 2017 as an independent advisory body of the European Commission. Its main responsibilities are: (i) to evaluate the *implementation of the Union's fiscal framework* and the appropriateness of the actual fiscal stance in the euro area and at the national level; (ii) to make *suggestions for the future evolution* of the Union's fiscal framework; (iii) to *assess the prospective fiscal stance appropriate for the euro area* as a whole based on an economic judgement, as well as the appropriate national fiscal stances, within the rules of the SGP; (iv) to cooperate with the *National Independent Fiscal Councils*; and (v) to *provide ad-hoc advice* to the President of the Commission.⁷²

2.2.2. The 10 points of the Commission (2022)

The 10 points of the *Commission's Orientations for Reforming the EU Economic Governance Framework* determine the main features of the new wave of the reform of the EMU. The proposed orientations⁷³ aim to strengthen debt sustainability, promote sustainable and inclusive growth through investments and reforms, and improve national ownership and the simplification of the framework.

⁶⁷ Ibid.

⁶⁸ European Commission, 2015, p. 8.

⁶⁹ European Commission, 2017.

⁷⁰ Halmai, 2021a, pp. 51–54; Halmai, 2021b, pp. 253–260; Teleki and Szegedi, 2023.

⁷¹ Schweigl, 2019, pp. 522–523.

⁷² Schweigl, 2019, pp. 522–523; Halmai, 2021a.

⁷³ Markakis, 2023; Sigl-Glückner et al., 2022; Halmai 2022.

The main features of these proposed orientations include: (i) moving toward a *more risk-based surveillance framework* focusing on debt sustainability and differentiating between countries based on their public debt challenges; (ii) *retaining the current reference values* for deficit and debt criteria (3% and 60% rules) but adapting the ‘debt reduction benchmark’ to country-specific debt ratios; (iii) introducing *national medium-term fiscal-structural plans* that integrate fiscal, reform, and investment objectives, merging stability and convergence programmes; (iv) allowing Member States *greater flexibility* in setting their fiscal adjustment paths based on the Commission’s reference budgetary adjustment path; (v) establishing a *common EU framework for assessing Member States’ medium-term fiscal-structural plans*, with the Council adopting the plans based on Commission assessments; (vi) monitoring the implementation of the plans through *annual progress reports* and allowing for plan revisions under certain circumstances; (vii) maintaining *escape clauses* for severe economic downturns and exceptional circumstances; (viii) *strengthening EU enforcement* through various available sanctions, including financial, reputational, and macroeconomic conditionality measures; (ix) increasing the *role of independent fiscal institutions* in monitoring and implementing fiscal rules and improving the setup and performance of these institutions; and (x) addressing the *relationship between fiscal rules and the Macroeconomic Imbalances Procedure*.

Perhaps the most essential reform plan is to give Member States greater flexibility in determining their budgetary correction path. The revised EU budgetary framework would define the requirements to ensure a reduction in debt ratio or its sustainability and keep the budget deficit below 3% of GDP in the medium term. Meanwhile, Member States would develop country-specific budgetary paths and priority public finance and reform commitments.⁷⁴

The Commission, therefore, stands ready to propose country-specific recommendations on fiscal policy for 2024 that are:⁷⁵ (1) in line with the fiscal targets Member States set out in their stability and convergence programmes, so long as those targets are consistent with ensuring that the public debt ratio is set on a downward path or stays at a prudent level and that the budget deficit is below the 3% of GDP reference value over the medium term; (2) quantified and differentiated based on Member States’ public debt challenges; and (3) formulated based on net primary expenditure, as proposed in the Commission’s reform orientations.

As Pench notes regarding this latest reform:⁷⁶

The Commission’s EU fiscal governance reform proposals revolve around the principles of fiscal sustainability and national ownership. [...] Political concerns lay behind the demand for additional safeguards, but these should be addressed through institutional rather than rule-based solutions. Implementation and enforcement will be critical.

⁷⁴ Markakis, 2023; Sigl-Glöckner et al., 2022.

⁷⁵ See: European Commission, 2023b.

⁷⁶ Pench, 2023.

3. Challenges of today and outlook for the future

3.1. The COVID-19 pandemic and its effects

The COVID-19 pandemic presented a formidable challenge for the EU; however, it also proved to be an opportunity. The EU's crisis management included a massive injection of extra resources under the umbrella of *NextGenerationEU*, almost doubling the original budget of the 2021-2027 Multiannual Financial Framework (MFF)⁷⁷ and adding some additional resources for 'National Resources and Environment' – although this particular field received only around 5% extra compared to the original budget. The total value of the *NextGenerationEU* is EUR 806.9 billion, of which EUR 723.8 billion is designated to the *Recovery and Resilience Facility* – EUR 338.0 billion is provided as grants, and another EUR 358.8 billion is provided in the form of loans.⁷⁸

The priorities of the 2021-2027 MFF and the *NextGenerationEU* emphasise environmental and climate issues, along with digitalisation. In total, 50 % of the resources are allocated to (i) research and innovation, (ii) climate and digital transition via the Just Transition Mechanism, and (iii) recovery, preparedness, and health issues – another type of resilience of which the EU is in desperate need. Another 30% will entirely be spent on fighting climate change – the highest share this field has ever received in any EU budget. The remaining 20% is allocated for digital transformation. Additionally, in 2026 and 2027, 10% of the annual budgets will be spent on preserving biodiversity.⁷⁹

In 2021, Darvas et al. wrote that in the framework of recovery from COVID-19, 'a review of the European fiscal framework is needed to achieve the EU's green goals more rapidly'. The quality of public finances, how policy-makers spend resources, and the associated reforms are of central importance. Improving the efficiency of insolvency procedures will be crucial for speedy and effective recovery, and it will be essential to adapt social security and taxation systems in the context of the single market for labour, and especially to tailor them to teleworking.⁸⁰ Research undertaken in 2020 by McKinsey & Co. emphasises that the recovery from the economic crisis associated with the COVID-19 pandemic coincides with a pivotal time in the fight against climate change; in other words, the post-pandemic recovery will be a decisive period for fending off climate change.⁸¹

77 European Commission, 2020a; European Commission, 2021; *About Climate-ADAPT* [Online]. Available at: <https://climate-adapt.eea.europa.eu/about> (Accessed: 23 August 2023).

78 European Commission, 2021b.

79 European Commission, 2021b.

80 Darvas et al., 2021.

81 McKinsey & Co., 2020.

3.2. Challenges related to climate resilience and digitalisation

This subchapter deals with the budget-related challenges related to the ever-more horizontal⁸² expectations of transforming the EU into a green/sustainable (and digital) economy and society. Building a sufficiently climate-resilient EU requires serious resources to be allocated to this purpose. This goal is reflected in the 2021-27 MFF, especially with the added extra resources of the Recovery and Resilience Facility; in the reform of the Common Agricultural Policy up to the 2023-27 period; and – indirectly – in almost every policy-making effort today, from the reform of the Erasmus+ programme to the new Industrial Strategy.⁸³ Furthermore, a risk-oriented approach should be adopted to handle the physical and transitional climate risks.

It is praiseworthy that in 2022, all the relevant budgetary documents of the EU include some kind of response to the issue of climate change. These responses are elaborated programmes, for example, the LIFE programme and the Just Transition Mechanism. Such programmes are explicitly aimed at combating climate risks, including transition risks, which are the most prevalent and perhaps the most hidden in the portfolios of the banks and companies. It is noteworthy, however, that the NextGenerationEU, which added enormous additional resources for environment and climate action, does not include the LIFE programme but doubles the budget of the Just Transition Mechanism. It also cannot be overlooked how the ‘green and digital transition’ is almost horizontal in the whole spectrum of the sectoral policies of the EU.

It should be noted that in today’s EU policy-making, two tendencies are always taken into consideration. The selected policy solutions always aim to enhance these two tendencies in order to make everything as ‘green’ and ‘digital’ as possible. Examining policy-shaping in three very different fields in the last few years provides support for this claim – and considering these fields, there are likely also other examples.

The new Industrial Strategy introduced in 2020 has three key priorities. Two of these priorities are ‘making Europe climate-neutral by 2050 and shaping Europe’s digital future’.⁸⁴ Meanwhile, among the five key priorities of the Erasmus+ Implementation Programme, the first and third are ‘making Erasmus+ a more environmentally sustainable program and fostering sustainable behaviors’ and ‘promoting the use of digital tools and the development of digital skills’, respectively.⁸⁵ Even the Data Act, which is *per definitionem* a digital development, states that ‘[b]y having more information, consumers and users such as farmers, airlines or construction companies will be in a position to take better decisions such as buying higher quality or more sustainable products and services, contributing to the Green Deal

82 Szegedi and Szirbik, 2023; Szegedi, 2023.

83 Tagliapietra and Veugelers, 2020; Teleki, 2023.

84 European Commission, 2020c.

85 Arroyo, 2020; Nogueiro et al., 2022.

objectives'.⁸⁶ Further, the new MiCA regulation, which regulates cryptocurrencies and crypto-asset service providers in the EU, was designed in such a way that the ecological footprint of crypto-related transactions is placed among the top three priorities, in addition to consumer protection and anti-money laundering rules.⁸⁷

The first conclusion that should be drawn here is that with the current post-European attitude to Green Deal policy-making, virtually any policies made and funded by the EU contribute to the green and sustainable (and digital) development of Europe. Consequently, from a financial perspective, the funding of almost all policies should be considered as indirect funding for a greener and more sustainable (and more digital) Europe.

In the European Commission's view, digitalisation is one of the main tools for '*transforming the resilience of Europe*'.⁸⁸ Since 2014, the Commission annually issues the Digital Economy and Society Index (DESI) reports, which contain a general analysis of the EU and country profiles of each Member State. As per the last DESI report,⁸⁹ measures aimed at digitalising public services and introducing or improving e-government solutions figure prominently across the Recovery and Resilience Plans. The estimated cost of planned investments and reforms under the Recovery and Resilience Facility amounts to EUR 46 billion in the field of digitalising public services and government processes, including e-health, e-justice, and the digitalisation of transport and energy systems. The most significant expenditure will benefit e-government, eID, e-justice (EUR 24 billion), and e-health (EUR 13 billion).⁹⁰

From the perspective of hardcore fiscal policy, ensuring an appropriate way to establish the opportunity for digital taxation is among the EU's priorities. As the Council puts it in its proposal, the current rules governing international taxation were designed to apply to businesses with a physical presence in a country. The increasing digitalisation of economies presents tax challenges, such as the reduction of tax revenues due to tax avoidance and tax evasion. Tax rules, therefore, need to be adequately updated.⁹¹

Another issue that cannot be overlooked in the context of the EU's digital finances is the *possibility of the digital euro*. Annunziata identifies five types of tensions linked to digital currencies, among which the connection of the potential digital euro to the general body of public law and the whole economic ecosystem (public and private sector), as well as the questions of centralisation and decentralisation,

⁸⁶ European Commission, 2020d.

⁸⁷ See: Council of Europe, 2022.

⁸⁸ See: *2030 Digital Compass: Your digital decade* [Online]. Available at: <https://futurium.ec.europa.eu/en/digital-compass> (Accessed: 30 September 2023).

⁸⁹ European Commission, 2023a.

⁹⁰ European Commission, 2023a.

⁹¹ See: *Digital taxation – Tax rules for the digital economy which are based on the principles of tax good governance can help promote growth and, among other benefits, deliver on the green and digital transitions* [Online]. Available at: <https://www.consilium.europa.eu/en/policies/digital-taxation/> (Accessed: 30 September 2023).

can be found. These problems are not solely of a monetary nature but also have an intense connection to the fiscal and regulatory fields.⁹² Omig adds that introducing a digital euro would mean a ‘procedural efficiency’ as a bonus, which represents, in economic terms, a positive externality for the EU.⁹³

4. Conclusion

Up to the 2008 financial crisis and the Eurocrisis, the two main cornerstones of the EMU were the Maastricht Treaty and the SGP. Pursuant to the subsequent crisis management, many addenda have complemented this regulatory framework with relation to EU public finances, including the European Semester, the Fiscal Pact, the Two Pack, and the Six Pack. Nevertheless, the most pressing question of the current decade is whether the convergence criteria of the Maastricht Treaty and the whole EMU could be reformed to provide a more flexible and viable path for the Member States. These intentions are summarised as the EMU 2.0, and many directions have been considered by policy-makers and the existing literature. The European Commission is devoted to the idea of some kind of reform, as is indicated by the Five Presidents’ Report in 2015, the Commission’s 10 Points in 2022, and the latest press releases. However, the most neuralgic part of the criteria, the thresholds, seem to remain the same.

There are also some inherently contemporary challenges, such as the green and digital transition, especially since the Recovery and Resilience Fund added considerable extra resources to the central budget of the EU. Notably, this requirement in the last few years has gradually become such a general expectation of all sectoral policies that these two fields are now to be considered relatively horizontal rather than sectoral.

To sum up, the coming years will be crucial for the reform of the EMU. Some sort of realisation of the EMU 2.0 seems inevitable, and the most recent tendencies pose challenges for policy-makers. What exact regulatory answers will be given to all these questions will be intriguing to observe.

⁹² Annunziata, 2023.

⁹³ Omig, 2023; For a deeper understanding of the issues related to digital taxation, see the ‘EU law chapter on EU state aid rules’ of this book, written by Szegedi and Teleki.

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CHAPTER 2

CROATIA: EU-DRIVEN REFORMS AS A WIND OF CHANGE IN THE PUBLIC FINANCE LEGAL FRAMEWORK



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Abstract

The legal framework of public finance in Croatia has been under the significant influence of fiscal integration within the European Union (EU). A prerequisite for analysing the impact of EU law on national fiscal governance is a prior understanding of the national fiscal framework; thus, the introductory section of this chapter presents an overview of the legal sources relevant to public finance. Special emphasis is placed on the constitutional and statutory provisions related to the budgetary process, highlighting the Croatian Parliament's authority in adopting the central budget. In the following section, the chapter offers an overview of the constitutional foundations of fiscal federalism in Croatia. As the fiscal architecture at the subnational level is based on the two-tiered system of local self-government and regional units, this section presents the most important aspects of subnational fiscal sovereignty, remarking on the influence of EU law on fiscal decentralisation in Croatia. Thereafter, the next section explores the regulation of public debt and the tools for effective fiscal policy. Finally, this chapter investigates the interplay between EU crisis management and its implications for Croatian fiscal governance.

Keywords: *public finance law, budget law, fiscal policy, EU law*

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1. Overview of legal sources

1.1. The Constitutional provisions

The starting point for an analysis of the legal sources underpinning the public finance system in Croatia is the Constitution of the Republic of Croatia (hereinafter: ‘the Constitution’).¹ It should first be pointed out that the Constitution does not contain a specific chapter regarding public finance; instead, the provisions related to fiscal politics are scattered among its various chapters.

Regarding the budgetary system, the Constitution stipulates the division of competences in the budgetary process. Pursuant to Art. 81, the Croatian Parliament (*Hrvatski sabor*) adopts the central budget. The authority of the Croatian Parliament is reiterated in Art. 91, affirming the Constitution’s endorsement of the ‘supremacy of the parliament in budgetary matters as a widely accepted principle in all democratic countries’.² The Constitution also requires that the budget be enacted by a qualified majority vote. Statutes (*zakoni*), in contrast, are adopted with a simple majority, which highlights the paramount importance of the central budget to the state. When it comes to the government, the Constitution states that ‘governmental revenues and expenses shall be established in the central budget. Any law whose implementation requires financial resources shall provide for the sources thereof’.³

According to Art. 104 of the Constitution, if the budget is not approved in time the President may, at the government’s proposal and with the Prime Minister’s countersignature, dissolve the Croatian Parliament.⁴ If the budget for the following year is not adopted by 31 December, the Parliament shall adopt a decision on temporary financing (*Odluka o privremenom financiranju*). Further regulation of this exceptional budgetary regime⁵ is stipulated in the Budget Act;⁶ namely, that the temporary financing can last no more than 3 months. This temporary financing is allocated in proportion to the income generated in the previous year and is limited to a maximum of 25% of the total income from the previous year. During this period, the budgetary beneficiaries may not increase the number of employees beyond the number on 31 December of the previous year. All revenues and expenses realised during temporary financing are included in the subsequently adopted budget.

1 The Constitution of the Republic of Croatia, Official Gazette (‘Narodne novine’) No. 56/1990, 135/1997, 113/2000, 28/2001, 76/2010, 5/2014.

2 OECD, Journal on Budgeting, 2004, p. 19.

3 Art. 91 of the Constitution.

4 Art. 104 of the Constitution.

5 Art. 104 of the Constitution was activated only once, in 2015, as the State Budget was not adopted before 31 December, the Croatian Parliament was dissolved. The Decision on Temporary Financing was published in the Official Gazette No. 109/2015.

6 The Budget Act, Official Gazette No. 144/2021.

It might be surprising that only one constitutional provision explicitly refers to tax policy. In this respect, Art. 51 enshrines the fundamental principles underpinning the Croatian tax policy and stipulates that ‘everyone shall participate in the defrayment of public expenses, in accordance with their economic capability’.⁷ It is apparent that this provision lays down the ‘ability to pay’ principle,⁸ but it should be emphasised that it also defines the tax obligation as universal. The latter stems from the wording of the article, which begins with the term ‘everyone’ (*svatko*). Put differently, there are no specific groups who are exempted from tax liability in advance based on, for example, race, religion, gender, or political belief.⁹ Furthermore, Art. 51 explicitly stipulates that the tax system ‘shall be based upon the principles of equality and equity’.¹⁰

1.2. Constitutional foundations of fiscal federalism in Croatia

Though there are few constitutional provisions governing taxation or the budget system, the opposite situation is observed in the regulation of local and regional self-government: an entire chapter of the Constitution is dedicated to the regulation of subnational levels of government. Pursuant to Art. 4 of the Constitution, the government is limited by the right to local and regional self-government. Croatia has a two-tiered system of subnational government: the units of local self-government are towns and municipalities, whereas counties are the regional units. The capital, Zagreb, has a two-fold legal status as it is considered both a county and a city at the same time. The local government system is a result of the decentralisation process in Croatia, which was influenced by the European Charter on Local Self-Government.¹¹

Several constitutional provisions regarding the units of local and regional self-government have direct effects on their financial management. By delineating the general scope of public services under the authority of local units, Art. 129a determines their basic spending powers.¹² The competences of local units include urban planning, primary healthcare, elementary education, fire prevention, and civil protection. Meanwhile, the competences of counties, as regional units, include education, health, urban planning, economic development, traffic infrastructure, and the planning and development of networks of educational, health, social, and cultural institutions. From the perspective of fiscal federalism,¹³ the most important

7 Art. 51 of the Constitution.

8 See: Gadžo, 2015, p. 135. For an in-depth analysis of the ‘ability to pay’ principle in the EU, see: Vanistendael, 2014.

9 Jelčić et al., 2008, pp. 190–191.

10 Art. 51 of the Constitution.

11 See: Blažević, Dobrić Jambrović and Menger, 2020, pp. 108–114.

12 Dobrić, Gadžo and Bodul, 2016, p. 312.

13 Fiscal federalism has a two-fold meaning: it addresses both the division of fiscal competencies between the different levels of government and the degree of freedom of decision-making enjoyed by regional and local authorities in the assessment of local taxes.

constitutional provision is Art. 138, which stipulates that the units of local and regional self-government shall be entitled to their own revenues and to dispose of them freely in the performance of the tasks under their purview. In addition, the article defines that their revenues should be proportionate to their powers as envisaged by the Constitution. As such, this article prescribes the basic principles with regard to the distribution of the revenue-raising powers of local units, namely: (i) the right of local units to their own resources, (ii) the principle of proportionality of income and expenditure, and (iii) the principle of solidarity, that is, the duty of the state to help financially vulnerable units. The Constitution, thus, lays the foundations of fiscal federalism in Croatia, following the principles of the Charter on Local Self-Government.¹⁴

The question of fiscal sovereignty is further addressed in the Act on the Financing of Local and Regional Self-Government Units, which prescribes that subnational units can raise revenue from local taxes, grants from the government, and, in the case of towns and municipalities, locally raised administrative charges.¹⁵ According to the Act on Local Taxes,¹⁶ local units of self-government can decide whether they will introduce one of the following taxes: surtax on income tax, consumption tax, tax on holiday homes, and tax on the use of public land. On the other hand, regional units can introduce inheritance and gifts tax, motor vehicles tax, vessels tax, and a tax on coin-operated machines for games for amusement. The crucial issue regarding fiscal sovereignty at the subnational level of government is that 'local taxes are introduced and regulated on the state level, while some elements (e.g., tax rates) are left to the local units to prescribe, within the boundaries set out by the state-level act'.¹⁷ Although the process of decentralisation began in 2001, the discrepancy between the functions conveyed to the local units and sources for their financing is still significant. To be more precise, Croatia has 428 towns and 127 counties, which equals 555 units of local self-government. There is a significant difference in the sizes of the populations among these local units, which affects their ability to collect revenue and, subsequently, their financial capacity. Data on decentralisation in Croatia show that the majority of local units did not take over the decentralised functions: more than half of the units that responded to a survey conducted in 2018 had not taken over decentralised functions at all. Furthermore, only 1% of the surveyed units had taken over decentralised functions in healthcare, 5% in social care, and 8% in education.¹⁸ All of the above supports the conclusion that without funding from the state budget, subnational units are incapable of fulfilling the public functions for which they were established, implying that Croatia remains a centralised state.¹⁹

¹⁴ Dobrić, Gadžo and Bodul, 2016, p. 312.

¹⁵ Act on the Financing of Local and Regional Self-Government Units, Official Gazette No. 127/17, 138/20, 151/22, 114/23.

¹⁶ Act on Local Taxes, Official Gazette No. 115/16, 101/17, 114/22.

¹⁷ Rogić, Lugarić and Klemenčić, 2022, p. 49.

¹⁸ See: Đulabić, 2018.

¹⁹ Dobrić, Gadžo and Bodul, 2016, pp. 290–340.

Finally, the influence of European Union (EU) law, namely, the integral parts of the Treaty of Lisbon, including the Protocol on the Application of the Principles of Subsidiarity and Proportionality and the Charter of Fundamental Rights, on domestic legislation and the process of fiscal decentralisation should be addressed. The institutionalisation of the principle of subsidiarity at the EU level subsequently narrowed the scope of state supervision over the local and regional units in Croatia, although it is still noticeable.²⁰

1.3. Domestic legislation

In general, ‘the legal framework that underlies the public finance system includes tax laws, budget system laws and local government finance laws’.²¹ This structure also applies to domestic legislation in Croatia. On the one hand, the substantive tax law is governed by a manifold of statutes that are enacted by the Parliament.²² On the other hand, the procedural tax law is, for the most part, regulated in the General Tax Act.²³ As Chapter 3 offers an in-depth analysis of the Croatian tax system and its evolution under the influence of EU law, this chapter focuses on the statutes governing the budgetary process. The statute of paramount importance is the Budget Act, which stipulates the steps in every phase of the budgetary process. However, several other statutes complement the legal basis of the budgetary process, such as the Act on Executing the Budget, the Fiscal Responsibility Act, the State Audit Act, and the Act on the Financing of Local and Regional Self-Government. The role and content of these statutes are examined throughout this chapter.

The adoption of the state budget is considered one of the most important financial and political events of the year.²⁴ The legal nature of the state budget in Croatia is rather peculiar. From the perspective of its enactment, the budget is similar to a statute (*zakon*). As mentioned above, the state budget is adopted by a qualified majority vote in the Parliament. However, the budget itself is not a statute; rather, it is defined as an Act that estimates revenues and determines expenditures and does not consist of legally binding provisions. Consequently, to ensure the fiscal discipline of the public authorities included in the budgetary process, the management of the budget is intertwined with the Budget Act as a systematic statute governing the budgetary system in Croatia. The structure of the Budget Act clearly follows the stages of the budget cycle: preparation, approval, execution, reporting, and finally, the audit. However, the Budget Act also regulates the management of assets and liabilities, the management of the public debt, and borrowing by the state and the units

²⁰ Ibid.

²¹ Lienert, 2013, p. 63.

²² Rogić, Lugarić and Klemenčić, 2022, p. 44.

²³ General Tax Act, Official Gazette No. 115/16, 106/18, 121/19, 32/20, 42/20, 114/22.

²⁴ As stated by the Ministry of Finance of the Republic of Croatia. See: *Proračun* [Online]. Available at: <https://mfin.gov.hr/proracun-86/86> (Accessed: 1 June 2023).

of local and regional self-government.²⁵ Put differently, this Act lays down the public sector's obligations regarding the management of state finances.

The Budget Act prescribes the guiding principles that public authorities included in the budget cycle are obliged to respect. Accordingly, the budgetary process follows the principles of unity and accuracy, annuality, multi-year planning, balance, universality, specificity, sound financial management, and transparency. The Budget Act also defines which entities are included in the budgetary process. Against this backdrop, it should be noted that the Croatian Budget Act differentiates budgetary beneficiaries and extra-budgetary beneficiaries as two similar yet different categories of entities connected to the budget. Budgetary beneficiaries are institutions whose sole founder is the Republic of Croatia or units of local and regional self-government, whose expenses are insured in the budget, and which generate more than 50% of their total revenues from the state budget.²⁶ For example, some of the budgetary beneficiaries of the state budget include public universities, museums, and national theatres. Meanwhile, extra-budgetary beneficiaries are defined as institutions, companies, and other legal entities that are not budget beneficiaries and that individually or cumulatively meet the following conditions: i) their sole founder or owner is the Republic of Croatia or a unit of local and regional self-government, provided that they also have a decisive influence on management and that they are included in the general budget; and ii) they are classified into the general government sector, according to the rules of the statistical methodology of the EU (European System of National Accounts (ESA) 2010, prescribed by Regulation (EU) 549/2013 of the European Parliament and of the Council). The extra-budgetary beneficiaries may be included in the state budget, but they usually 'function as a special fund budget funded by specific mostly earmarked revenues'.²⁷ In addition, they might be subject to different accounting rules than budget beneficiaries.

The budget cycle in Croatia lasts for 3 years. The initial stage is the preparation of the budget, in which the Ministry of Finance has a dominant role. To be more precise, after an independent body agrees upon the macroeconomic and budgetary projections, the Ministry of Finance proceeds to deliver the Convergence Programme. The Convergence Programme determines the macroeconomic and fiscal framework in the current budget year and the next 3 years.²⁸ Following the government's approval, the Convergence Programme is sent to the European Commission, in accordance with the European Semester framework. Ultimately, this programme serves as a legal basis for decisions on the budget framework for the next 3-year period. The Ministry of Finance governs the subsequent steps of the budgetary cycle and, finally, drafts the budget for the following year. If the government approves the draft budget, it will be submitted to the Croatian Parliament for possible amendments and approval.

25 Art. 1 Budget Act.

26 Art. 4 para. (45) Budget Act.

27 Rogić Lugarić and Klemenčić, 2022, p. 39.

28 Art. 22 Budget Act.

Another piece of the puzzle of budgetary law in Croatia is the Act on Executing the Budget,²⁹ which is adopted annually together with the budget.³⁰ While the Budget Act consists of provisions that address the budget cycle in general, the Act on Executing the Budget stipulates specific provisions regarding the budget each year, for example, the scope of general budget borrowing and central budget guarantees, the management of financial and non-financial assets and debt in the general budget, the use of earmarked revenues, and fines for the non-fulfilment of obligations and other issues in the execution of the state budget for the given year.

In the concluding phase of the budgetary cycle, the State Audit Office plays a crucial role. Pursuant to Art. 54 of the Constitution, the State Audit Office is an independent and autonomous supreme audit institution in the Republic of Croatia. It was founded in 1993, and its jurisdiction is regulated by the State Audit Office Act. 'The office performs audits of government income and expenditures, financial statements and financial transactions of government sector units and local units, legal entities financed from the budget, legal entities founded by the Republic of Croatia or local units, companies and other legal entities, in which the Republic of Croatia i.e., local units have majority share ownership'.³¹ It is also authorised to audit the management of funds received from the EU.

1.4. Impact of EU legislation

The influence of the EU's policies on national legislation commenced years before Croatia became a Member State: the Stabilisation and Association Agreement came into force in 2001 and can be seen as the first stepping stone on the road toward harmonisation with EU law. The next step toward closer economic coordination with the EU was made in 2005 when Croatia started creating Pre-Accession Economic Programmes. This process significantly improved the institutional and analytical capacities of the Croatian state administration to manage sound economic policy.³² The following year, the Act on the System of Interior Financial Control in the Public Sector came into force,³³ aiming to accomplish uniform conduct in the public sector in terms of the management of public finances. Another important step for sustainable public finance management was the adoption of the Fiscal Responsibility Act in 2010. This legislative Act aimed to increase the transparency and sustainability of public finance in Croatia. In addition, the Fiscal Responsibility Act was soon amended to reflect the criteria stipulated in the 'Six Pack' and 'Two Pack', that is, the set of EU regulations and directives that enhanced the Stability and Growth Pact (SGP). In this

29 The Act on Executing the Budget in 2023, Official Gazette No. 145/22, 63/23.

30 See: Rogić, Lugarić and Klemenčić, 2022.

31 *State Audit Office – Organisation* [Online]. Available at: <https://www.revizija.hr/root/en/pages/about-us/organisation/684> (Accessed: 1 June 2023).

32 Tišma, Samardžija and Jurlin, 2012, p. 111.

33 The Act on the System of Interior Financial Control in the Public Sector, Official Gazette No. 141/2006.

regard, one of the most important reforms was the new fiscal rule, which allowed the conduct of countercyclical fiscal policy. This fiscal rule, which came to the fore in 2013, was also, expectedly, in alignment with EU law on economic governance. Thus, as negotiations with the EU gained momentum, the impact of EU law on national legislation was amplified.

1.4.1. The excessive budget deficit procedure

During the years that preceded the accession to the EU, the Croatian budget was severely affected by the financial crisis. Due to the decline in economic activity, state budget revenues decreased, while public expenditures remained at the same level or even increased. The growth of the budget deficit subsequently led to the rapid growth of the public debt, which rose to 85% of GDP by the end of 2014.³⁴ In this respect, several months after Croatia acceded to the EU in June 2013, the excessive budget deficit procedure was launched against the country. The European Council adopted the decision on the existence of an excessive deficit in Croatia on 28 January 2014.³⁵ The Council also issued recommendations to end the situation of an excessive government deficit, stating that Croatia should put an end to this issue by 2016. To do so, the Council recommended that Croatia lower the rate of its government deficit each year; specifically, the Council envisaged that Croatia should reach a headline general government deficit target of 4.6% of GDP for 2014, 3.5% of GDP in 2015 and 2.7% of GDP in 2016. Furthermore, the Council recommended the implementation and specification of the measures necessary to achieve these goals, as well as the use of windfall gains to reduce the deficit.³⁶ Croatian authorities were encouraged to review their expenditures, with a special focus on growth-enhancing expenditures, and to work on improving tax administration efficiency. All of the above matters affected the fiscal management in Croatia.

The trajectory of the steps taken by Croatian authorities to meet the Council's recommendations can be traced through the positions issued by the Fiscal Policy Commission. This Commission was established in 2013 by the Croatian Parliament 'as a professional and independent body aimed to improve the public finance system and to monitor the application of the fiscal rules established by the Fiscal Responsibility Act'.³⁷ The founding year of this Commission is indicative as it aligns with Croatia's entry into the EU, and its establishment is one of many novelties in Croatia's national fiscal policy that were caused by the accession to the EU. To be more precise, the Commission was established following the provisions of Council Directive 2011/85/

³⁴ Šimović and Matanović, 2015, p. 31.

³⁵ Council decision of 28 January 2014 on the existence of an excessive deficit in Croatia (2014/56/EU), OJ L 36, 6.2.2014, 13–14.

³⁶ Council Recommendation with a view to bringing an end to the situation of an excessive deficit in Croatia 17904/13, 21 January 2014.

³⁷ The Croatian Parliament, Decision on the establishment of the fiscal policy commission, 18 December 2013.

EU³⁸ to strengthen the role of the body authorised to supervise the implementation of the Fiscal Responsibility Act. It was necessary to establish an independent body, separate from the Ministry of Finance; thus, the Fiscal Commission replaced its predecessor, the Committee for Fiscal Policy, and took over its duties.³⁹ In this regard, the Position of the Fiscal Policy Commission from 2015 represents a valuable source of information on Croatia's national fiscal policy, especially in terms of how the European Council's recommendations to address the excessive budget deficit procedure were followed.

In the first year of the excessive deficit procedure, Croatia increased its government budget deficit; by the end of 2014, it was 5.7% of GDP. The Croatian government implemented structural measures to the extent that was agreed with the Commission; thus, it was concluded that Croatia had taken effective actions to reduce the excessive deficit. However, the implementation of these structural measures was largely focused on the revenue side of the budget, primarily: (i) an increase in the rate of contributions for health insurance, (ii) changes in the system of contributions for pension insurance based on seniority, (iii) an increase in the tax on winnings from games of chance, (iv) the introduction of fees for telecommunications services, and (v) an increase in excise duty on energy products. Conversely, no strong structural measures were implemented on the expenditure side, except for certain reductions in subsidies, intermediate consumption, social benefits, and investment expenditure. Measures aimed at increasing the efficiency of public administration and reducing structural expenditures were also absent. In addition, the Fiscal Policy Commission emphasised that the methodology of adopting structural measures did not come from a designed strategy in the medium-term budget period; instead, all of the measures were discretionary and *ad hoc*.⁴⁰ In this respect, the importance of the EU economic governance for the conduct of fiscal policy in Croatia is best illustrated by the fact that the first Convergence Programme for the period 2014–2017 points out that 'the excessive budget deficit procedure completely determines the framework of the fiscal policy in the medium term'.⁴¹ According to the Position of the Fiscal Policy Commission issued in 2015, the level of general government debt decreased from 5.4% of GDP in 2014 to 3.3% of GDP in 2015. This was made possible by an increase in revenues from indirect taxes on the one hand, and a significant reduction in expenditures for public investments on the other. In this way, Croatia reached the goal set by the Council's recommendations for 2015.⁴² The following

38 Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L 306, 23.11.2011, 41–47.

39 *Povjerenstvo za fiskalnu politiku* [Online]. Available at: <https://mfin.gov.hr/proracun-86/povjerenstvo-za-fiskalnu-politiku/613> (Accessed: 10 May 2023).

40 5th Position paper of the Fiscal Policy Commission on the application of the fiscal rule for the year 2014, 9 July 2015.

41 Deskar-Škrbić, 2018, p. 12.

42 9th Position paper of the Fiscal Policy Commission on the application of the fiscal rule for the year 2015, 11 November 2016.

year, the target for the 2016 government deficit was also fully met, with the deficit amounting to 0.8% of GDP. Finally, at the Council for Economic and Financial Affairs meeting held on 16 June 2017, Croatia's exit from the excessive budget deficit procedure was confirmed.⁴³

1.4.2. *The European Semester*

After its accession to the EU, Croatia also became part of the European Semester, another essential part of the EU economic governance framework. The two integral elements underpinning the European Semester are the SGP and the Macroeconomic Imbalance Procedure (MIP).⁴⁴ Regarding the latter, Croatia faced macroeconomic imbalances following the financial crisis. These were potentially harmful as such macroeconomic imbalances – ‘if uncorrected over time – make the national savings-investment balance so untenable that it self-corrects abruptly, thereby causing significant adjustment shocks’.⁴⁵ If macroeconomic imbalances are prolonged, they can lead to the accumulation of public debt. To avoid these negative repercussions, Croatia was subject to the MIP⁴⁶ from 2014 until 2018. Specific monitoring reports after the initial year of the MIP indicated slight progress in the implementation of the Commission's recommendations. However, in terms of the measures for long-term fiscal sustainability, ‘very limited steps towards increasing the alignment of budgetary projections to ESA standards [had] been taken to tackle the issue of reconciling the differences between ESA definitions and national budgetary definitions’.⁴⁷ In 2014, the government also undertook the preparation of the expenditure review but did not decide on a deadline for its implementation. The next year, the government introduced the following measures related to public finance management: (i) the adoption of a new standard form for the fiscal impact assessment of the legislation, (ii) an increased budget for the State Audit Office, and (iii) the drafting of the new Fiscal Responsibility Act. In addition to the fiscal measures, the government also implemented various new measures in areas such as labour law, public administration, and the business environment.⁴⁸ However, excessive imbalances were still

43 *Potvrđena odluka o izlasku Republike Hrvatske iz Procedure prekomjernog proračunskog manjka*, 2017.

44 At the EU level, a macroeconomic imbalance is defined in Art. 2 of Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the Prevention and Correction of Macroeconomic Imbalances, OJ L 306, 23.11.2011, 25–32, as follows: ‘[A]ny trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole’. Macroeconomic imbalances are also defined as ‘severe imbalances, including imbalances that jeopardise or risk jeopardising the proper functioning of the Economic and Monetary Union’.

45 Pierluigi and Sondermann, 2018, p. 6.

46 The MIP was introduced in 2011 as an integral part of the European Semester.

47 European Commission, 2014.

48 European Commission, 2015.

present in Croatian public finance during 2015.⁴⁹ There was some small progress regarding economic activity in 2016, although the country still needed to tackle the high public, corporate, and external debt, as well as high unemployment rates.⁵⁰ Nevertheless, the ratio of general government debt to GDP and the unemployment rate both declined, indicating progress that was heavily influenced by the Commission's recommendations. As a result, in 2017, Croatia 'came out of its six-year long recession and economic activity has been accelerating steadily since then'.⁵¹ Finally, in 2018 Croatia was no longer subject to the MIP.

The impact of the European Semester on Croatia's national legislation is undoubtedly noticeable in the Budget Act. For example, an explicit reference to the requirements of the SGP can be found in Art. 4 of this Act, with the draft budget plan being defined as follows:

An act of the Government which is drawn up based on the SGP and which defines the macroeconomic and fiscal framework of an individual Member State of the euro area in the next budget year and which the Member States of the euro area submit to the European Commission to ensure a coordinated economic policy.⁵²

Furthermore, the Directive 2011/85/EU on the requirements for the budgets of euro area countries, which was an upgrade of the SGP, was implemented in the Budget Act. However, the European Semester addresses aspects beyond fiscal oversight, with a specific focus on structural policies, public administration, and the business environment. Namely, at the end of the European Semester cycle, the Council formally approves recommendations tailored to each participating Member State. These country-specific recommendations encompass five main policy domains: fiscal matters and taxation; the financial sector; labour market dynamics, social inclusion, and education; structural policies and public administration; and the business environment.⁵³ As such, in the latest country-specific recommendations for Croatia, the Council emphasised that the nation should 'continue to pursue a medium-term fiscal strategy of gradual and sustainable consolidation, combined with investments and reforms conducive to higher sustainable growth, to achieve a prudent medium-term fiscal position'.⁵⁴ The Council also suggested a reduction of dependence on fossil fuels by promoting sustainable solutions, such as the electrification of road transport. This suggests that EU policies have an impact not only on economic governance but on every aspect of national politics. In addition, the immediate fiscal implication of

49 European Commission, 2016b.

50 European Commission, 2016a.

51 European Commission, 2017.

52 Art. 4 para. (25) Budget Act.

53 Keppenne, 2020, p. 853.

54 European Commission, Recommendation for a Council Recommendation on the 2023 National Reform Programme of Croatia and delivering a Council on the 2023 Stability Programme of Croatia, COM(2023) 611 final, 24.5.2023, p. 10.

accession to the EU was that customs duties were no longer a source of revenue for the state budget. ‘The EU has exclusive competence regarding the determination of the scope and structure of customs duties, and the revenues that are collected accrue directly to the EU budget after a 25% (since 2021) deduction, which is supposed to remunerate for collection costs’.⁵⁵ As a result, in 2013, the revenue from customs duties decreased; however, conversely, there was an increase in income from international aid due to the inflow of funds from the EU.⁵⁶

2. Regulation of public debt

The legal architecture of public debt regulation in Croatia is based upon three statutes: the Act on the Conclusion and Execution of International Agreements, the Act on Credit Transactions with Foreign Countries, and the Budget Act. Among these statutes, the Budget Act features provisions that are specifically related to public debt, whereas the other two are more general.⁵⁷

The Budget Act defines public debt as the debt of the general government, which is calculated according to the methodology of the ESA (ESA, 2010).⁵⁸ Put differently, the umbrella term of public debt encompasses the financial obligations of the general government as an institutional sector, which, in the Republic of Croatia, consists of sub-sectors of the central state, local state, and social security funds.⁵⁹ An agreement on public debt can be concluded only for one of the purposes specifically prescribed in the Budget Act. Namely, the state can enter into public debt to finance: (i) the deficit of the central budget; (ii) investment projects and special programmes, as approved by the Parliament; (iii) current debt repayments of the central budget; (iv) the settlement of overdue payments in connection with state guarantees; (v) for budget liquidity management; and (vi) for the needs of the Croatian National Bank for the international reserves. Debt financing can also be achieved by taking credit, a loan, or issuing securities.⁶⁰

However, there are additional conditions for debt financing by local and regional units of self-government. These units can borrow in the short term exclusively to bridge gaps created by the different dynamics of the inflow of funds and the maturity of obligations, for a maximum of 12 months, without the possibility of further reprogramming. On the other hand, in the case of long-term borrowing by local and regional units, several additional conditions must be met. Namely, local units

⁵⁵ Traversa, 2021, p. 63.

⁵⁶ Deskar-Škrbić, 2018, pp. 3–13.

⁵⁷ Arbutina et al., 2022, p. 366.

⁵⁸ Art. 4 para. (21) Budget Act.

⁵⁹ Rogić Lugarić and Klemenčić, 2022.

⁶⁰ Art. 4 para. (71) Budget Act.

can borrow on financial markets only for investments previously incorporated into their budgets, for capital assistance to companies and other legal entities in their ownership, and for the realisation of investments that are co-financed by EU funds. In addition, units of local and regional self-government need approval from the government to enter into an agreement resulting in public debt. Finally, the Budget Act provides the threshold for the maximum amount of annual public debt for each local and regional self-government unit, which is set to 20% of the unit's total income from the previous year. An additional limitation is established regarding the total indebtedness of all units of local and regional self-government. The government decides upon this threshold every year.

The issue of indebtedness came to the fore in light of Croatia's accession to the Economic and Monetary Union. The biggest obstacle for Croatia was the criterion of the sustainability of public finances as its public debt exceeded the reference value of 60% of GDP prescribed in the Maastricht criteria. However, the ratio of public debt to GDP in Croatia continuously decreased from 2014 until 2019. Ultimately, the criterion of sustainable public finances was met based on a decrease of public debt at a satisfactory pace.

3. Fiscal rules and other instruments of sound fiscal policy

The centrepiece of sound fiscal policy management in Croatia is the Fiscal Responsibility Act.⁶¹ The purpose of this Act is to determine the rules that limit the level of expenditure and the deficit of the general budget, to regulate public debt, and to strengthen the responsibility for the use of budget funds.⁶² The Fiscal Responsibility Act encompasses three numerical fiscal rules, which are harmonised with the provisions of the revised SGP: (i) the structural budget balance rule, (ii) the expenditure rule, and (iii) the public debt rule.⁶³ In this regard, Art. 6 of this Act provides that the structural balance, expressed as a share in the GDP, is realised according to the adjustment plan to reach the medium-term budget goal defined by EU law. This fiscal rule is considered fulfilled when the structural balance shown in the annual report on the application of fiscal rules for the previous year (i) is equal to or greater than the medium-term budget goal or deviates from that goal by an amount that is not significant, or (ii) ensures convergence to the medium-term budget goal according to the established adjustment plan or deviates from the planned adjustment plan by an amount that is less than the amount from Art.

61 The Fiscal Responsibility Act, Official Gazette No. 111/18, 41/20, 83/23.

62 Art. 2 Fiscal Responsibility Act.

63 See: Grubišić, 2020, p. 242.

10 para. 1 of this Act.⁶⁴ Furthermore, the expenditure rule is stipulated in Art. 7 of the Fiscal Responsibility Act. This article prescribes that the annual growth of general government expenditure must not exceed the reference potential growth rate of GDP, which is determined following the legal provisions of the EU. In terms of the public debt fiscal rule, this Act implements the general rules of the EU fiscal policy. For example, it provides that the share of public debt in the GDP may not exceed the reference value of 60%, following EU legal provisions. This limit is an obvious reflection of the Maastricht criteria in Croatia's national legislation. In addition, the Act stipulates that whenever it refers to 'the law of the Union' in the context of fiscal responsibility, this formulation covers the SGP and all of its subsequent amendments. However, in March 2020, following a recommendation from the European Commission, the Council invoked the general escape clause within the SGP for the first time. This was done to allow Member States the flexibility to implement emergency measures for tackling the economic downturn caused by the COVID-19 pandemic.⁶⁵ As a consequence, Croatia's national public debt fiscal rule was also temporarily suspended,⁶⁶ with a similar justification as it was at the EU level; specifically, the government decided on the suspension 'due to extraordinary circumstances because of the epidemic of the disease COVID-19 (SARS-CoV-2) in the territory of the Republic of Croatia'.⁶⁷ Although the fiscal rule is prescribed in the Fiscal Responsibility Act, the legal basis for its suspension was not an amendment to the Act but a decision by the government, which is in accordance with the Act itself. Furthermore, it is interesting to note that though the Croatian government declared the end of the COVID-19 pandemic on 11 May 2023,⁶⁸ the suspension of the public debt fiscal rule is ongoing.

The provisions of the Fiscal Responsibility Act refer both to the state budget and the budgets of local and regional self-government units, as well as the financial plans of budgetary and extra-budgetary beneficiaries.⁶⁹ It is also applied to the financial management of legal entities that are, according to the statistical methodology of the ESA 2010, classified in the general government sector.⁷⁰ The Act provides that the individual who is either the head of the budget and extra-budgetary beneficiaries or the head of the local and regional self-government units is accountable for the lawful use of budgetary funds. These individuals also have the responsibility to

64 Art. 10 para. (1) of the Fiscal Responsibility Act states: 'A deviation from the fiscal rule from Article 6, paragraphs 1 and 2 of this Act is, in accordance with the legal provisions of the European Union, significant if the deviation from the medium-term budget goal or the adjustment plan for reaching the medium-term budget goal is at least 0.5% of GDP in a single year or at least an average of 0.25% of GDP per year in two consecutive years'.

65 Fabbrini, 2022.

66 Odluka o privremenom odgađanju primjene fiskalnih pravila, Official Gazette No. 41/20.

67 Odluka o privremenom odgađanju primjene fiskalnih pravila.

68 See: Odluka o proglašenju prestanka epidemije bolesti Covid-19 uzrokovane virusom SARS-COV-2, Official Gazette No. 51/2023.

69 For the definition of budgetary and extra-budgetary beneficiaries, see *supra*, 1.2.

70 Art. 3 Fiscal Responsibility Act.

ensure the efficient and effective functioning of the internal control system within the framework of the funds determined by the budget or financial plan. Each year, the head of the institution is obliged to draw up a Statement of Fiscal Responsibility for the previous budget year for the period during which she held office (i.e. performed leadership duties). If the Statement on Fiscal Responsibility is not drawn up or delivered in time, the Act prescribes a monetary fine.

Another important segment of sound fiscal policy in Croatia is the Commission on Fiscal Policy. Before this commission was established, a similar function was vested with the former Committee for Fiscal Policy. However, the Committee for Fiscal Policy was not considered an independent body as it was overseen by the Ministry of Finance. Hence, the Commission on Fiscal Policy was founded in 2011 and works on assessments of national fiscal policy. The President and members of this commission are appointed by the Croatian Parliament. It should be emphasised that candidates for the Commission on Fiscal Policy must not be members of a political party either currently or for the last five years up to the date of their candidacy. Moreover, a member of this commission cannot have held office in representative or executive bodies at the state level as an independent candidate, or in local or regional self-government.⁷¹ According to the Fiscal Responsibility Act, if the Commission on Fiscal Policy decides that there is a risk of significant deviations from the fiscal rules, it will prepare a report and submit it to the government. Within 45 days of receiving this report, the government is obliged to declare the existence of risks related to the fulfilment of fiscal rules. If the government assesses that a risk exists, it is obliged to propose a plan of necessary measures with implementation deadlines, which will lead to the fulfilment of the fiscal rules. This plan will be applied immediately after its adoption, and the Commission of Fiscal Policy is authorised to monitor its implementation.⁷²

4. Impact of EU crisis management instruments on Croatian public finances

The global financial crisis had a significant influence on fiscal integration in the EU, which subsequently affected the public finance systems of all Member States. Though Croatia was not a Member State when the global financial crisis hit the EU, the legislation adopted as a result of EU crisis management nevertheless had an impact on Croatian economic governance.

During the global financial crisis, the spillover effect within the Eurozone highlighted the need for budgetary coordination at the EU level, which led to reforms of

71 Art. 16 Fiscal Responsibility Act.

72 Art. 24 Fiscal Responsibility Act.

the legal framework and the strengthening of the SGP.⁷³ The SGP was strengthened through the so-called ‘Six Pack’ and ‘Two Pack’.⁷⁴ The ‘Six Pack’ and ‘Two Pack’ introduced a new procedure in the field of macroeconomic imbalances, established a framework for dealing with states experiencing difficulties with financial stability, and codified budgetary surveillance in the form of the European Semester. The latter influenced the budgetary process in all Member States, including Croatia. As a result of compliance with the requirements of the European Semester, Croatia’s budgetary process now includes the adoption of the Convergence Programme, which is subsequently sent to the European Commission. Based on the Convergence Programme, the Ministry of Finance prepares a draft of the budget plan for the next budget year, which the government adopts by conclusion and submits to the European Commission no later than 15 October of the current year. The draft budget plan is drawn up according to the rules of the European statistical methodology (ESA 2010) and is based on the fiscal goals defined in the Convergence Programme in accordance with the special recommendations of the Council for the Republic of Croatia. The Commission’s opinion on the draft budget plan is taken into account when preparing and adopting the state budget. Hence, the EU economic surveillance tools implemented before Croatia became a Member State unquestionably served – and continue to serve – as a vital resource for shaping Croatia’s national fiscal policy.

Furthermore, the outbreak of the COVID-19 pandemic in 2020 caused another economic downturn that urged EU institutions to adopt new legal instruments. Among the instruments adopted to tackle the economic implications of the pandemic, the NextGenerationEU (NGEU) recovery plan stands out as the most important. This recovery plan combined several instruments worth more than EUR 800 billion, which were disbursed to Member States. The central element of the NGEU legal architecture is the Recovery and Resilience Facility (RRF). The criteria for the allocation of the RRF funds differ, depending on whether they will be allocated as a grant or a loan. Moreover, the allocation of funds through the RRF can be suspended if a Member State does not comply with its obligations under the SGP or the Macroeconomic Balance Procedure.⁷⁵ To obtain financing from the RRF, Member States must submit National Recovery and Resilience Plans (NRRPs) to the Commission. However, all investments that will be financed with RRF funds must be aligned with EU goals for faster recovery, including (i) green transition; (ii) digital transformation; (iii) smart, sustainable, and inclusive growth; (iv) social and territorial cohesion; (v) health and economic, social, and institutional resilience;

73 See: Lionello, 2020, p. 24; Fromage, 2021, p. 386.

74 The ‘Six Pack’ consists of five regulations and one directive that define the concept of significant deviation from the medium-term budgetary objective and sanctions if the deviation is not reduced. The ‘Two Pack’ comprises two regulations that introduce additional elements to strengthen the fiscal surveillance of Member States, particularly those facing difficulties with financial stability.

75 Art. 10 of Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, OJ L 057, 18.2.2021, 17–75.

and (vi) policies for the next generation, such as education.⁷⁶ These policy pillars affect the macroeconomic plans of all Member States, including Croatia, and are considered ‘the progressive emergence of a fully-fledged EU economic policy’.⁷⁷ As a consequence, the Croatian NRRP mirrors the above-mentioned goals set at the EU level. In this regard, ‘40.3% of the plan will support climate objectives, while 20.4% of the plan will foster the digital transition’.⁷⁸ It is important to underline that the value of the Croatian NRRP amounts to EUR 6.5 billion, and approximately 86% of this value will be financed through the RRF grants. The impact of the RRF financing in Croatia will be far-reaching, affecting not only economic governance but also a plethora of different areas, such as education, healthcare, transport, the energy sector, and the labour market.⁷⁹ The possible advantages of the NGEU financing are significant: the ‘NGEU’s fiscal stimulus can help to preserve the economy’s supply-side capacity in the aftermath of the COVID-19 shock, facilitate the adaptation of the economy to the post-pandemic environment and mitigate possible transition costs of reforms’.⁸⁰ On the other hand, keeping in mind the intensity of the NGEU’s imprint on Member States’ fiscal policy management, it is unsurprising that it raised the question of possible limitations to national parliaments’ budgetary powers.⁸¹ As Allemand et al. point out regarding the NGEU, ‘any coordination of fiscal policies reduces parliamentary budgetary power at the national level, both quantitatively and qualitatively’.⁸² However, criticism in this regard was not observed at the national level in Croatia.

5. Summary

A comprehensive overview of the legal framework governing public finances in Croatia must begin with an analysis of its constitutional provisions. The Constitution does not include a dedicated section on public finance; instead, relevant provisions are scattered across various chapters. However, the Constitution does highlight the pivotal role of the Croatian Parliament in the budgetary process. In addition,

76 Art. 2 of Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, OJ L 057, 18.2.2021, 17–75.

77 Dermine, 2020, p. 352.

78 *Croatia’s recovery and resilience plan* [Online]. Available at: <https://shorturl.at/oGHRH> (Accessed: 6 May 2023).

79 European Commission, Commission staff working document: Analysis of the recovery and resilience plan of Croatia – Accompanying the document Proposal for a Council Implementing Decision on the approval of the assessment of the recovery and resilience plan for Croatia, Brussels, 8.7.2021, COM(2021) 401 final, p. 82.

80 Bańkowski et al., 2022, p. 10.

81 See, for example: Allemand et al., 2023.

82 Allemand et al., 2023, p. 8.

the Budget Act stands out as a key statute, dictating every phase of the budgetary process, which has been under the influence of various EU legal instruments. For example, the excessive budget deficit procedure, which Croatia underwent due to the financial crisis, and the subsequent measures taken to rectify the situation significantly influenced sound fiscal management. The establishment of the Fiscal Policy Commission in 2013 was a crucial development in Croatia's fiscal policy, aligning it with EU directives. In addition, Croatia's involvement in the European Semester, an integral part of EU economic governance, impacts various aspects of its national politics, even beyond economic governance itself.

The legal framework for public debt regulation in Croatia is based on three key statutes: the Act on the Conclusion and Execution of International Agreements, the Act on Credit Transactions with Foreign Countries, and the Budget Act. Following the ESA 2010 methodology, the Budget Act defines public debt as a financial obligation of the general government, encompassing the central state, local state, and social security funds. Public debt agreements can only be made for specific purposes outlined in the Budget Act, which also prescribes additional conditions for local and regional self-government units regarding short-term and long-term borrowing. During Croatia's accession to the Economic and Monetary Union, addressing the sustainability of public finances has been crucial, especially in light of the Maastricht convergence criteria. The public debt level continuously declined from 2014 to 2019, ultimately meeting the criteria for sustainability.

The cornerstone of sound fiscal policy in Croatia is the Fiscal Responsibility Act, which encompasses three numerical fiscal rules: the structural budget balance rule, the expenditure rule, and the public debt rule. These rules are harmonised with the provisions of the revised SGP, thus aligning Croatian fiscal policy with EU standards. This Act applies not only to the state budget but also to local and regional self-government units, as well as the financial plans of budgetary and extra-budgetary beneficiaries. It holds heads of budgetary beneficiaries accountable for the lawful use of funds and requires the creation of an annual Statement of Fiscal Responsibility.

While Croatia was not an EU member during the global financial crisis, it was affected by legislation resulting from EU crisis management. Various reforms, including the 'Six Pack' and 'Two Pack', strengthened the SGP, introduced procedures for macroeconomic imbalances, and established the European Semester, subsequently influencing Croatia's budgetary process. In addition, the COVID-19 pandemic prompted the adoption of new legal instruments. The RRF, a key element of the NGEU recovery plan, allocates funds based on specific criteria and the submission of NRRPs. The impact of NGEU financing in Croatia is expected to be far-reaching, affecting various sectors such as education, healthcare, and energy. This brief overview of the public finance legal framework and its development in Croatia presents a paramount example of the accelerating process of fiscal integration in the EU.

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CHAPTER 3

CZECH REPUBLIC: LIMITED CONSTITUTIONAL FISCAL POLICY AND PUBLIC FINANCE REGULATION



MICHAL RADVAN – EVA TOMÁŠKOVÁ

Abstract

This chapter focuses on the fiscal policy in the Czech Republic. It introduces the theoretical approach to public finance according to leading authors and experts in the field. From the legal perspective, it is necessary to highlight the constitutional foundations of public finance and budgetary institutions. However, public finance does not have a crucial role in the Czech Constitution and is not regulated in the Constitution in detail. The following section deals with the budget law, which is strongly connected to state fiscal policy. While fiscal policy as such is the responsibility of the entire government, the central state body upon which attention is focused in the area of public budgets is the Ministry of Finance. The most important laws in the area of fiscal policy include laws on the state budget and budgetary rules for the state budget and local self-government budgets. These are complemented by laws on the issuance of state bonds and the state bond programme. Most recently, the Act on the Rules of Budgetary Responsibility was introduced to regulate fiscal policy. The chapter presents several insights into state debt issues and fiscal deficits. It also analyses the Czech Republic's crisis management in the context of crisis management at the European Union level. Finally, the main findings are summarised, and several *de lege ferenda* recommendations are offered.

Keywords: *Czech fiscal policy, Czech public finance, Czech budget law, budgetary responsibility, state debt, fiscal deficit, crisis management in the Czech Republic*

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1. Czech public finance – selected theoretical approaches

Public finance combines knowledge from several scientific disciplines, including sociology, politology, economics, and last (but not least) law. It is a very dynamic discipline with many topical circumstances, relations, and functions. This diversity dictates how individuals perceive public finance. There are two main groups of opinions on public finance in society: whereas the first group prefers an intensive role in public finance (a robust state, a redistribution mechanism, high levels of taxation, powerful supervising bodies, etc.), the second tries to eliminate public finance and its role. This group believes that a laissez-faire system is the best option for every state and society and that transactions between private groups of people should be free from any form of economic interventionism, such as regulations or subsidies. Though the opinions of society and scientists on the role of public finance differ, one conclusion is clear to all experts: public finance played, plays, and will continue to play a crucial role in the economy, both at the national and international levels. Even if it is not always immediately clear, public finance greatly influences individuals' behaviour.¹

Public finance in the Czech Republic, as in the rest of the world, is defined as specific financial relations in the economic system between public law authorities (public bodies and institutions) and other subjects (natural persons, legal entities, etc.).² There are several areas of interest related to public finance: public financing (basic principles and main fiscal functions), the effectiveness of using public interventions, the influence of financial tools and public expenditures on individual behaviour and decision-making, the characteristics and typology of public revenues and expenditures, public budget deficits, and public debt.³ The main aim of public finance is to identify the most effective way to allocate sources, that is, how to achieve maximal benefits with limited sources.⁴ The content of public finance is to secure certain estates, assure the financing of transfers, and stimulate economic subjects to undertake specific forms of behaviour.⁵

Naturally, public finance is connected with the activities of the state; in other words, one part of the public finance relationship is always the state or any other public law authority. This fact is also evident in the principles of public finance: (i) Irreversibility (non-refundability) – the entity who paid the money (usually the taxpayer or the paying agent) does not have any legal right to its return or the realisation of a counterclaim; there is no individual right to draw money raised by tax collection; (ii) Non-equivalence – the share of money drawn from the public budget is not equivalent to the amount of taxes paid by the taxpayer; (iii) Involuntariness

1 Tomášková and Pařízková, 2015, p. 9.

2 Tomášková and Pařízková, 2015, p. 11.

3 Peková, 2005; Tomášková and Pařízková, 2015, p. 12.

4 Tomášková and Pařízková, 2015, p. 12.

5 Hamerníková and Kubátová, 2004; Tomášková and Pařízková, 2015, p. 12.

– the state has the power to collect taxes (established in the relevant Act) because, otherwise, in the case of voluntariness, nobody would be willing to pay taxes.⁶

With increasing globalisation, public finance now extends beyond national territories. This results in the creation of many international economic groups aiming for stabilisation, support, and cooperation. For these activities, financial sources at the national level are necessary. The most typical example of such an international budget is that of the European Union (EU). This budget is derived from national public finance and, at the same time, has an autonomous scope. The efforts of more centralised EU public finance have been evident in recent years, and it can be assumed that the EU will have further ambitions to influence public finance in its Member States.⁷

The main functions of both national and international public finance are allocation, redistribution, and stabilisation. The basis of the allocation function is to assign financial sources and correct market failures using budget revenues and spending. The redistributive function aims to secure a fairer distribution of incomes and wealth in society. The issue is to define the precise limits of redistribution. Several tools can be used to achieve redistribution, including progressive taxation in both income and property taxes, higher taxation of specific goods, and targeted cash transfers (subsidies) to low-income individuals and families. The stabilisation function seeks to secure minimal economic fluctuations within the economic cycle. Such a state economic policy influences the economy to ensure economic stability.

Public finance also has other, secondary functions. The control function concerns the control of all public revenues and spending. In addition, the regulative function buffers adverse effects in the economy that affect production, unemployment, or prices. The opposite of the regulatory function is the stimulatory function, which motivates subjects toward investments or savings.⁸

From a legal perspective, the legislative function and corresponding regulatory function must also be taken into account. The legislative function aims to create a legal environment for the whole society, from constitutional regulation through legal regulation up to sub-statutory rules. The regulative legal norms are focused on individuals (natural persons, legal entities, and other subjects) to regulate their behaviour, rights, and obligations.⁹

1.1. (Limited) constitutional foundations of public finance and budgetary institutions

The Constitution *sensu lato* in the Czech Republic is also called the ‘constitutional order’. This is because, unlike in other countries, there are two main constitutional

6 Tomášková and Pařízková, 2015, p. 13.

7 Týč, 2000; Tomášková and Pařízková, 2015, pp. 24–25.

8 Tomášková, 2006; Tomášková and Pařízková, 2015, pp. 13–16.

9 Tomášková, 2006; Tomášková and Pařízková, 2015, p. 17.

Acts. The first is the Constitution of the Czech Republic.¹⁰ However, this Constitution *sensu stricto* does not include the list of fundamental rights and basic freedoms that is typical of most constitutions around the world. The legislator has chosen to create a separate Constitutional Act called the Charter of Fundamental Rights and Freedoms,¹¹ which is part of the Czech Constitution *sensu lato* (in the broad sense).¹²

In an honest assessment, and again in comparison with other EU Member States, public finance does not have a crucial role in the Czech Constitution and is not regulated in the Constitution in detail (*sensu lato*): neither the Constitution *sensu stricto* nor the Charter of Fundamental Rights and Freedoms includes a specific part concerning public finance. The Constitution *sensu stricto* in its structure more or less echoes the division of powers (legislative, executive, and judiciary powers) and adds two, or even three, more powers in the state. A specific part of the Constitution on the Supreme Audit Office could be called ‘control power’, whereas a specific part on the Czech National Bank might be referred to as ‘bank power’. The bank power could also be easily transferred to the financial power, with the other (however rare) financial institutes named in the Constitution.¹³ The sixth power in the state could, then, be considered to be local self-government power as it deals with the fundamental aspect of local self-government units.

Analysing specific areas of public finance, the current Czech constitutional regulation is limited only to several branches of financial law and several financial institutes.¹⁴ The constitutional regulation of the tax law is very limited: only one sentence in the Charter of Fundamental Rights and Freedoms states that taxes and fees can be imposed only by Acts. The term ‘taxes and fees’ is broader as it covers all taxes, *sensu lato* (taxes, fees, charges, duties, levies, tolls, and other terms used for public payments to public budgets). All taxes *sensu lato* must be imposed by legal Acts; alone, municipal generally binding ordinances, governmental decrees, or ordinances issued by ministries would not be enough to assure the constitutionality of the tax. Interestingly, this principle, called ‘*nullum tributum sine lege*’, is set in Art. 11 of the Charter of Fundamental Rights and Freedoms, which deals with ownership rights protection. According to the principle *nullum tributum sine lege* set in Art. 11 para. (5), taxes then limit ownership rights. The missing constitutional principles must be supplemented by the decision-making activity of the Constitutional Court. The court mainly considers extreme disproportionality (the so-called ‘choking effect’) and non-accessory and accessory equality.¹⁵ More about taxation in the Czech Republic is presented in the chapter on tax policy as a part of Czech fiscal policy.

In the area of public subsidies law, the Charter of Fundamental Rights and Freedoms guarantees the free provision of public goods in the field of education.

10 Act no. 1/1993 Sb., the Constitution of the Czech Republic, as amended.

11 Act no. 2/1993 Sb., the Charter of Fundamental Rights and Freedoms, as amended.

12 Radvan, 2016, p. 517.

13 Hulkó and Radvan, 2022, p. 62.

14 Ibid.

15 Constitutional Court, Pl. US 29/08; Hulkó and Radvan, 2022, p. 62.

It also establishes the existence of public health insurance, that is, the creation of specific public monetary funds and the right to the free provision of healthcare as a public good.¹⁶ In addition, the banking law is regulated at the constitutional level – in the Constitution *sensu stricto*. The Constitution states that the Czech National Bank is the central bank of the state and defines that the main objective of the bank's activities is to ensure price stability. The activities of the Czech National Bank may be interfered with only based on law.¹⁷ More about the national bank in the Czech Republic is available in the chapter on monetary policy.

The budget law is likely the most comprehensively regulated at the constitutional level. The Constitution *sensu stricto* includes the basic principles for public budgets, setting out that the state budget is a legal Act. The government has a monopoly on drafting the state budget and the final state account, while the Chamber of Deputies of the Parliament of the Czech Republic has sole responsibility for discussing these proposals. This means that the Senate has no rights in this field. The management of state property and the implementation of the state budget is controlled by the Supreme Audit Office. Meanwhile, the Constitution guarantees the budget autonomy of local self-government units. However, there are no constitutional guarantees for fiscal federalism at the constitutional level.¹⁸ The following section examines budget law in the Czech Republic in more detail.

1.1.1. Budget law regulation in the Czech Republic

The budget law is strongly connected to the fiscal policy of the state. While fiscal policy as such is the responsibility of the entire government, the central state body upon which attention is focused is the Ministry of Finance. The most important laws in the area of fiscal policy are those on the state budget and budgetary rules for the state budget¹⁹ and local self-government budgets.²⁰ These are complemented by laws on the issuance of state bonds and the state bond programme. Most recently, the Act on the Rules of Budgetary Responsibility was introduced to regulate fiscal policy.

Budget law is a set of legal norms regulating the relationships arising in the creation, distribution, and use of financial assets in public budgets, as well as the system and content of public budgets, fund management, and the budgetary process. Budget law must regulate these relationships because the redistribution of resources from resource-creating entities to those that do not create resources but are an integral part of society is undertaken through public budgets. Budget law is commonly classified into three main parts. The general part defines the general terms of budgeting, the various types of public budgets, budgetary principles, and budget functions. The

¹⁶ Hulkó and Radvan, 2022, p. 62.

¹⁷ Ibid.

¹⁸ Radvan, Mrkývka and Schweigl, 2018; Radvan, Mrkývka and Schweigl, 2021; Hulkó and Radvan, 2022, p. 62.

¹⁹ Act no. 218/2000 Sb., Budgetary Rules Act, as amended.

²⁰ Act no. 250/2000 Sb., Act on Budgetary Rules for Territorial Budgets, as amended.

special part focuses on the special rules regarding individual public budget types, such as the state budget, budgets of state funds, and budgets of local self-government units. Finally, the procedural part contains the procedural rules of budget creation, time limits, and sanctions.²¹

The Czech Republic is a unitary state. According to its Constitution, the country is divided into municipalities, which are basic territorial self-government units, and regions, which are higher territorial self-government units. These central and local levels are also replicated in the levels of public finance and public budgets. At the central level, there are the state budget and state funds budgets. The state budget is the most important public budget; its purpose is to create a financial plan to reallocate the state's funds to certain state tasks in the following year. From an economic perspective, the state budget is a monetary fund that collects the state's revenues so that these can be further used to cover its expenditures and functions. This type of budget is characterised by its irreversibility, non-voluntariness, and non-equivalence, whereby revenues and expenditures are used for the needs of the state.²² From a legal perspective, in accordance with the Constitution, the state budget is a legal Act. The State Budget Act must be approved each year through the legislative process specified in the Budgetary Rules Act. The Budgetary Rules Act also regulates, *inter alia*, the functions and content of the state budget and the state final account, the revenues and expenditures of the state budget, the financial management of the organisational units of the state, financial control, conditions for the establishment of state funds, and the methods of managing the State Treasury and state debt. The state funds are established by special Acts as legal entities for the financial security of specially defined tasks.

The draft Act on the state budget is prepared by the Ministry of Finance in cooperation with chapter administrators (central state administration bodies and other organisational units of the state), local self-government units, voluntary associations of municipalities, and state funds. The state budget is based on the medium-term outlook, which contains the expected revenues and expenditures of the state budget and state funds for the two years ahead. The medium-term outlook is prepared simultaneously with the draft Act on the state budget. The Ministry of Finance then submits the draft to the government for approval. Thereafter, the government submits the draft to the Chamber of Deputies at the latest three months before the start of the financial year. Amendments or abolitions of other laws cannot be part of the draft. The proposal is discussed in a public meeting and decided only by the Chamber of Deputies, not the Senate.

In the Chamber of Deputies, the draft Act on the state budget is referred to the Budget Committee for consideration. In the first reading during the general debate, the Chamber of Deputies discusses the basic parameters of the draft state budget, including the amount of revenues and expenditures, the balance, the method of

21 Bakeš, 2012, p. 83; Marková and Boháč, 2007, pp. 41–42; Hulkó and Radvan, 2022, p. 73.

22 Marková and Boháč, 2007, p. 3; Hulkó and Radvan, 2022, p. 74.

settling the balance, the overall relationship to the budgets of higher territorial self-government units and municipalities, and the scope of the executive authorities' powers. The Chamber of Deputies approves the basic parameters or recommends changes to the government and sets a deadline for submitting a new draft. If the Chamber of Deputies approves the basic parameters of the draft state budget, they may not be changed during its further consideration. At the same time, the Chamber of Deputies resolves to assign the individual chapters of this draft budget to committees. The Budget Committee considers the resolutions of the other committees and adopts a resolution thereon.

At the second reading, a detailed debate on the draft state budget and the Budget Committee's resolution on it is held, during which amendments or other proposals are presented. The third reading is a debate in which only corrections of legislative-technical errors, grammatical errors, or clerical errors may be proposed. At the conclusion of the third reading, the Chamber of Deputies votes on amendments. The Chamber of Deputies then decides whether it approves the draft Act on the state budget. Unless the draft Act for the relevant budget year is approved by the Chamber of Deputies before the first day of the budget year, the organisational unit of the state shall manage its budget according to the indicators of the budget provision. As stated above, the Senate has no powers concerning the draft Act on the state budget. An approved Act on the state budget is signed by the president.

The chapter administrator is responsible for managing the state budget resources and other state financial resources in its chapter. The government is accountable to the Chamber of Deputies for the implementation of the state budget, and after the half-year end, submits a report to the Chamber of Deputies in which it assesses the development of the economy and the implementation of the state budget. Furthermore, the Ministry of Finance continuously assesses the performance of the state budget and reports on it to the government after the end of the first and third calendar quarters, with the government submitting it to the Budget Committee of the Chamber of Deputies. State property management and the state budget implementation are also controlled externally by the Supreme Audit Office.

No later than 30 April of the year following the financial year under review, the government submits the draft of the state's final accounts to the Chamber of Deputies. The state's final accounts contain data on the results of the budgetary management of the previous year and a proposal for the use of the budget surplus or the payment of its deficit. It is drawn up by the Ministry of Finance in cooperation with chapter administrators, local self-government units, voluntary associations of municipalities, and state funds. After discussion in the Chamber of Deputies, the Ministry of Finance must publish the state's final accounts, together with the opinion of the Chamber of Deputies, on the Internet.

Regarding the relation between the Czech state budget and the EU budget, the own resources system and the financing of the EU budget are governed by Council Decision 2014/335/EU, Euratom of 26 May 2014 on the System of Own Resources of the European Union. Expenditure indicators for programmes or projects that are

co-financed from the EU budget are referenced to draft the Act on the state budget. For European financial resources, the National Fund was established. The National Fund is the sum of the financial resources entrusted by the EU to the Czech Republic for the implementation of programmes or projects co-financed from the EU budget through the Structural Funds, Cohesion Fund, European Maritime and Fisheries Fund, and European Union Solidarity Fund. The financial resources concentrated through the National Fund must be used in accordance with the principles of the budgetary outlook and the obligations arising for the Czech Republic from EU law or international treaties.

There is a close relationship between the central state budget and the budgets of local self-government units (regions and municipalities). As stated above, the draft Act on the state budget, the medium-term outlook, and the draft of the state's final accounts are prepared in cooperation with local self-government units. The state budget pays for grants and repayable financial assistance to local authorities for activities other than those related to business. The state budget also includes subsidies provided for the budgets of local self-government units. The criteria for calculating the amount of subsidy assigned to regional budgets are generally determined annually by the State Budget Act. Subsidies from the state budget to the budgets of municipalities, with the exception of subsidy investment actions, are typically provided through the region in which the municipality is located.

Local self-government in the Czech Republic and the existence of autonomous local units are guaranteed by Art. 8 the Constitution. The other provisions dealing with local self-government in the Constitution are rather strict. Art. 99 states, 'The Czech Republic is subdivided into municipalities, which are the basic territorial self-governing units, and into regions, which are the higher territorial self-governing units'. Regions were created in 2000 by the Constitutional Act.²³ There are 14 regions; however, their borders do not correspond to the historical borders of lands or any previous territorial units. The regions are regulated by the Regions Act,²⁴ while the Municipalities Act governs the rights and duties of municipalities.²⁵ The regulation thereof is complex and detail-oriented, especially considering the extremely high number of municipalities in the Czech Republic (almost 6,300). The capital city of Prague has a specific status regulated by the Act on the Capital City of Prague:²⁶ as a region *sui generis*, Prague is not divided into separate municipalities but city districts.²⁷

Art. 101 para. (3) of the Constitution states that local self-government units are public corporations that may have their own property and manage their own budgets. Unfortunately, this is the only constitutional rule concerning the financial aspects

23 Constitutional Act no. 347/1997 Sb., on Creation of Higher Local Self-Governing Units, as amended.

24 Act no. 129/2000 Sb., Regions Act, as amended.

25 Act no. 128/2000 Sb., Municipalities Act, as amended.

26 Act no. 131/2000 Sb., on the Capital City of Prague, as amended.

27 Radvan, Mrkývka and Schweigl, 2018, p. 897.

of local self-government. Moreover, while the Czech Republic ratified the European Charter of Local Self-Government in 1999, it also declared that it does not consider itself bound by certain provisions of this charter, specifically, the third, fifth, and sixth paragraphs of Art. 9. The provisions in these paragraphs grant local authorities the possibility of introducing local taxes, protect financially weaker local authorities, and grant local authorities the right to be consulted in matters that concern them, respectively. The reason behind the country's decision not to commit itself to at least the latter two paragraphs can be found in a typical Czech feature: the extreme fragmentation of municipalities, which could potentially cause serious complications while implementing the given provisions.²⁸

Concerning local self-government budgets, the primary legal source is the Act on Budgetary Rules for Territorial Budgets. This Act regulates the formation, status, content, and functions of the budgets of local self-government units (both municipalities and regions²⁹) and establishes rules for the management of these units' financial resources. The financial management of a local self-government unit is governed by its annual budget and medium-term budget outlook. The medium-term budget outlook is a local self-government unit instrument for the medium-term (as a rule, 2 to 5 years following the year for which the annual budget is drawn up) planning of its financial management. This outlook is drawn up on the basis of the contractual relations concluded and commitments entered into.

The annual budget of a local self-government unit is prepared based on the medium-term budget outlook. No legal form is established for local budgets in Czech law; the budget is defined as the financial plan that governs the financing of the activities of the local self-government unit during the budget year (which is the same as the calendar year). As a rule, the budget should be drawn up as a balanced budget. It may also be adopted as a surplus if some of the revenue of a given year is intended to be used in subsequent years or if it is intended to repay the principal of loans from previous years. In addition, it may be adopted as a deficit budget, but only if the deficit can be covered with funds from previous years or a contractually secured loan, credit, repayable financial assistance, or the proceeds from the sale of the local self-government unit's municipal bonds.

The revenues of municipal budgets mainly consist of incomes from own property and own activities, revenue from local charges,³⁰ shared taxes (e.g. personal income tax, corporate income tax, value-added tax, gambling tax) and own taxes (immovable property tax), incomes from the municipality's own administrative activities (in particular, administrative charges), and subsidies from the state budget and regional budget, etc. The revenues of regional budgets are more or less the same, with the

28 Radvan, 2017, p. 19; Pál and Radvan, 2022, pp. 1160–1161.

29 As well as associations of municipalities.

30 Municipalities have the right to adopt the local bylaw and collect dog charge, charge for stay, charge for using public places, charge on entrance, charge for permission to enter selected places by motor vehicles, charges on communal waste, and charge on evaluation of building land.

exception of subsidies from the regional budget. Czech regions also do not have any own taxes.

In addition to referencing the medium-term budget outlook, local self-government units draw up their budgets based on data from the state budget schedule, through which the state budget determines its relations to the budgets of regions or individual municipalities. Municipalities must also consider data from the regional budget, whereby the regional budget determines its relations to the budgets of the municipalities. The budget of the local self-government unit is adopted by the municipal assembly. The public is involved in the process: the local self-government unit must publish the draft budget on its website and its official notice board at least 15 days before the day on which it is to be discussed at the assembly meeting so that citizens can submit comments on it, either in writing or orally during the discussion at the assembly meeting. The approved budget is published on the local self-government unit's website. If the budget is not approved before 1 January of the financial year, the budgetary management of the local self-government unit is governed by the rules of budgetary provisionality until the budget is approved.

Budgetary management (i.e. the management review) is controlled both internally and externally. Internally, budgetary management is carried out by the financial and control committees. Externally, the municipality has the right to choose to be reviewed by the regional office or auditor. Regions and the capital of Prague are reviewed by the Ministry of Finance. A report on the result of the management review forms part of the final accounts. The discussion of the final accounts at the municipal assembly concludes with a statement of approval of the annual accounts without reservations or approval with reservations. In cases where reservations are raised, the local self-government unit must adopt the measures necessary to correct the identified errors and deficiencies. The same rules apply for publicising the final accounts as for the draft budget.

To summarise this discussion on the Czech budget law, both the central (state) budget and local self-government unit budgets display several common basic features, which can be considered as the budgetary principles underlying the preparation, adoption, management, and control of public budgets. The principle of annuality sets out that public budgets are prepared and approved annually, and that they are valid for one year (with the exception that the carryover of funds to the following year is possible only to a limited extent). The principle of the timeliness of public budgets states that public budgets must be approved and published before the beginning of the financial year, except for budgetary provision. In addition, the principle of the time-limited use of funds expresses that only revenues gained and expenditures allocated during the actual calendar year are included in the budget, and that budgetary units need to spend their allocated funds by the end of the financial year. The rule that public budgeting should be based on an analysis of economic processes and real numbers is called the principle of reality and veracity of public budgets. Meanwhile, the principle of the completeness of public budgets means that the public budget should offer complex coverage of all revenues and expenditures over a given territory.

The principle of the unity of public budgets states that a uniform qualification and classification of revenues and expenditures in public budgets is required. Further, the budgetary structure should be clear, simple, and comprehensible as expressed in the principle of the clarity of public budgets. In addition, the principle of the non-earmarking of revenue and earmarking of expenditure establishes that budget revenues should not be earmarked for predetermined purposes, and conversely, that expenditures should only be used for a predetermined purpose (with the exception of local charges as these compulsory payments are usually paid in return for a public service). The principle of the long-term balance of public budgets expresses that from the long-term perspective, public budgets should be drawn up as balanced. The rule that public budgets are made publicly available in an appropriate manner that allows citizens to comment on the published draft budget is represented in the principle of the publicity of public budgets. Moreover, the principle of gross budgets establishes the need to draw up public budgets containing total revenue and total expenditure. The principle of the efficiency and economy of public budgets defines that public funds should not be wasted. The principle of expenditure over revenue states that expenditures should serve economic growth, for which adequate resources should be provided; to achieve this goal, it is necessary to have objectives for which expenditure is needed and to provide the required revenue to achieve them. Finally, the principle of the identification of the budgetary implications of legislation means that the expected impact of new legislation on public budgets should be quantified.³¹

Many of these principles are set out in the Act on the Rules of Budgetary Responsibility,³² which contains the core of the regulation, and in the Act Amending Certain Acts in Connection With the Adoption of the Legal Regulation of Budgetary Responsibility, which is an amendment Act.³³ The Act on the Rules of Budgetary Responsibility incorporates EU law,³⁴ in particular the requirements for timely and regular public access to fiscal data for all subsectors of general government. Specifically, the Act stipulates that state, territorial self-governing units, and other public institutions must comply with the rules of transparency, effectiveness, economy, and efficiency in the management of public finances during the performance of their activities.

The Czech Fiscal Council is the key body for evaluating whether the state and other public institutions comply with the rules of budgetary responsibility. This independent expert body also contributes to the sustainability of the Czech Republic's public finances and reduces the risk of the over-indebtedness of the state. Its opinions and reports serve as inputs for the Czech government, Parliament, and local

31 Hulkó and Radvan, 2022, pp. 73–74.

32 Act no. 23/2017 Sb., on the Rules of Budgetary Responsibility, as amended.

33 Act no. 24/2017 Sb., Amending Certain Acts in Connection with the Adoption of the Legal Regulation of Budgetary Responsibility.

34 Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L 306, 23.11.2011., 41–47.

and regional authorities so that they can plan and implement fiscal and budgetary policies.³⁵

The Czech Fiscal Council has several tasks, as follows. The Fiscal Council should

evaluate the implementation of numerical fiscal rules and ... draw up and submit reports on their implementation to the Chamber of Deputies. Examples of such rules include the debt limit, the determination of the total expenditure of the public institutions' sector, or the derivation of the state budget and state funds' expenditure framework.

The Fiscal Council must also 'determine the amount of the debt and announce it the way laws are announced, i.e. within one month of the first publication of the public institutions' sector's debt for the previous calendar year by the Czech Statistical Office'. With regard to the Chamber of Deputies, the Fiscal Council prepares

a report on the long-term sustainability of public finances, including an assessment of how the direct long-term effects of planned government policies will likely affect the sustainability of public finances. In drawing up this report, the Council shall consider economic and social development, employment, and intergenerational cohesion.

The Fiscal Council must also 'monitor the development of economic management of the public institutions' sector' and 'formulate an opinion on the calculation of the corrective component, which serves to adjust the deviation of the actual economic result of the public institutions' sector from the expected result'.³⁶

2. State debt issues: How far is the debt brake threshold?

EU Member States are most often inclined toward rules at the level of the government sector, especially those limiting the size of the general government balance. In addition, rules setting a limit on the size of government debt or government expenditure are also used. Rules limiting government revenues are rather the exception. The rules imposed on local governments (i.e. municipalities) are significantly represented. Again, these rules most often comprise a limit set for the municipal budget balance and, less often, a limit set for municipal debt. Very sporadically, they

35 *The Czech Fiscal Council* [Online]. Available at: <https://www.rozpocetovarada.cz/en/cfc/the-czech-fiscal-council/> (Accessed: 21 November 2023).

36 *The Czech Fiscal Council* [Online]. Available at: <https://www.rozpocetovarada.cz/en/cfc/the-czech-fiscal-council/> (Accessed: 21 November 2023).

stipulate a limit on municipal spending. There is no limit on municipal revenues. Central governments and social security funds also use revenue limits more often than other types of public budgets. Regional governments use the fewest types of rules, with only a limit placed on budget balance and expenditure.³⁷

As mentioned above, the state debt is regulated by the Act on the Rules of Budgetary Responsibility, which was originally established in accordance with EU criteria. The requirements imposed by this law can be summarised as follows. The demands are linked to greater transparency in the management of public funds. Public institutions are obliged to publish not only the draft budget and the draft final account, as in the past, but also the newly approved draft and approved wording of the medium-term budget outlook, the budget, the final account, the rules of the provisional budget, and the budgetary measures implemented. The Ministry of Finance of the Czech Republic has also been given a new agenda, which, according to the given schedule, is to publish data on public institutions' compliance with the rules of budgetary responsibility. At the same time, this ministry is obliged to quantify contingent liabilities, the ownership interests of public institutions, estimates of tax relief, overdue liabilities, and other aspects. The Czech Ministry of Finance also prepares a budgetary strategy for the public institutions sector, which includes the Convergence Programme and expenditure frameworks for the public institutions sector, respectively, for the state budget and state funds.

One of the main rules is the debt brake. If the level of public sector debt rises above 55% of GDP, various measures will be applied in the next calendar month. For the government, this involves preparing a draft and medium-term outlook for the state budget and the budget of state funds, which aims to lead to the long-term sustainability of public finances. At the same time, the government submits proposals for balanced budgets for health insurance companies, which may be deficit only in cases allowed by law, to the Chamber of Deputies. The municipalities must approve their budget for the following year as balanced or in surplus. Other public institutions are not allowed to make new commitments outside of projects co-financed by the EU. These measures are not applied when there is a significant deterioration in economic development, in the event of a state of emergency or war, during a period of emergency measures announced by the government to increase the state's defence capability owing to a deterioration in the security situation, or in the event of high expenditure in response to natural disasters.

If the public sector debt rises above 60% of nominal GDP, the government will seek options to reduce it. The phrasing of this rule has several critics. The measures the government must take to activate the debt brake are very vaguely worded. They also do not oblige the government, for example, to run a balance or surplus, but only to act in accordance with long-term fiscal sustainability, which can be interpreted in different ways. Conversely, in such a situation, municipalities are obliged to propose a balanced or surplus budget.

37 Dvořáková, 2018, p. 29.

Another rule at the municipal level is the fiscal rule concerning the gradual reduction of the existing debt in the event that the current debt of the municipality exceeds 60% of the average income for the last four years. In the following calendar year, the municipality is obliged to reduce the amount of its liabilities by at least 5% of the difference between the amount of debt and the average of its revenues for the last four financial years. If the municipality fails to do so, or if it continues to violate the fiscal rule during the next audit, the Ministry of Finance has the option to suspend the transfer of its share in the tax revenue. For the purposes of the Act on the Rules of Budgetary Responsibility, the municipality's debt includes liabilities from issued bonds, issued bills of exchange, loans received, loans and repayable financial assistance, and the realisation of payments from guarantees.³⁸

It should be noted that the general government debt of the Czech Republic consists mainly of the state debt, which has long accounted for more than 90% of the total. In this context, starting in 2028, when, according to our projections, the debt will breach the debt brake threshold, the growth of the debt would be accelerated compared with the baseline scenario. In 2042, the debt would become unsustainable, and the Czech Republic would fall into a debt trap as the implicit interest rate would exceed the growth rate of nominal GDP.³⁹

3. The Czech fiscal deficit in numbers

The Czech Republic's Fiscal Responsibility Act is not a constitutional law, although five proposals have been submitted. This fact had a negative experience in 2020 when two significant amendments⁴⁰ were made despite a number of experts. The root causes were the external shock of COVID-19 and an inappropriate approach to the fiscal rules, and from this time onwards, Czech public finance cannot be considered sustainable. Within the framework of these laws, the fiscal discipline that had been required until that point decreased. The first amendment was passed in April 2020, along with an increase in the government deficit in the year 2020 and an increase in the structural deficit limit from the original 1% of GDP to 4% for 2021. Simultaneously, a year-on-year consolidation of at least a rate of 0.5% of GDP was selected. According to the first amendment, the structural deficit should be returned to 1% in 2027. Changes to personal income tax were made in the autumn of 2020, with the Czech Parliament approving the abandonment of taxation of the super gross wage and simultaneously keeping a 15% marginal tax rate. Parliament also increased the basis of taxpayer relief in 2021 and 2022. The impact on public

³⁸ Act on the Rules of Budgetary Responsibility.

³⁹ Czech Fiscal Council, 2022.

⁴⁰ The first amendment was Act no. 207/2020 Sb., and the second was Act no. 609/2020 Sb.

finance was calculated as CZK 100 billion in 2021 and CZK 120 billion in 2022. However, approving these changes in public revenue would have significantly impacted the structural deficit for 2021 (4% of GDP, as stated above). Consequently, the second amendment to the Act on the Rules of Budgetary Responsibility was appended to this law. This amendment brought a complete release of the structural deficit for 2021, with the result that the limit was not determined and the estimated structural balance for 2021, improved by 0.5% of GDP, was to be used to derive the expenditure frameworks for 2022. As such, the structural deficit of 1% is likely to be achieved again only from 2031 unless further legislation is made. Although the Czech Fiscal Council made several comments on these two amendments, both were passed and entered into force. According to the Fiscal Council, the strategy and expenditure frameworks for the government budget and state funds budgets should be consistent with the targets presented in the Convergence Programme submitted to the European Commission in the spring of 2022. However, these amendments are not aligned with the rules stated by the Convergence Programme.⁴¹

4. Crisis management at the EU level and its relationships with crisis management in the Czech Republic

The EU has offered some instruments to support economic recovery through fiscal policy in times of crisis. The European Commission activated a general escape clause from 2020 to 2022. It was stipulated that that this clause should have a neutral setting in 2023 and that it should be deactivated in 2024. A NextGenerationEU instrument permits the allocation of over EUR 800 billion, which allows the EU Member States to respond flexibly to the current economic situation. In 2023, the EU Member States were required to inform the European Commission of how their fiscal policy would ensure compliance with the public deficit benchmark of 3% of GDP and their ongoing efforts for debt reduction or debt sustainability.⁴²

In February 2021, the Pandemic Act⁴³ was approved to amend the state of emergency during the COVID-19 pandemic and provide the government and the Ministry of Health with expanded powers to deal with the situation with effect for one year. Before and after the adoption of this law, the activities of the state, especially the Ministry of Finance, were extensively criticised. At the beginning of the pandemic, the Ministry of Health did not prepare information support for epidemic management. According to the Supreme Audit Office, '[t]his meant that the regional public health authorities were not prepared to deal with epidemic situations. Until the second half

⁴¹ Czech Fiscal Council, 2022.

⁴² Ministry of Finance of the Czech Republic, 2023.

⁴³ Act no. 94/2021 Sb.

of 2020, they lacked over 900 workstations and laptops'. The Supreme Audit Office also claimed the Ministry of Health had known about the lack of IT equipment at the Regional Hygiene Stations since at least mid-2017. A system that would allow unified departmental communication was also lacking. This system was originally supposed to be completed in 2019; however, the Ministry of Health postponed the deadline three times, and it was not ready when the COVID-19 pandemic was declared. After the declaration of the pandemic, the Ministry of Health did not respond according to the Pandemic Plan of the Czech Republic but, instead, created new bodies to manage the fight against its spread. According to the Supreme Audit Office, the responsibilities and competencies of these bodies were not clearly defined, or their activities were duplicated; for example, the newly established central management team was tasked with the same activities as the already existing Central Epidemiological Commission.⁴⁴

The total amount of funds paid for personal protective equipment and medical supplies (to a total of 148 suppliers) was CZK 7.5 billion. Funds directly spent on the air and rail transport of material to the Czech Republic, including the related services, totalled CZK 0.987 billion.⁴⁵ As a result of the pandemic, companies had the opportunity to draw a compensation bonus between 2020 and 2022. This compensation bonus is a tax bonus to compensate for certain economic consequences related to health threats, for example, the emergence and spread of COVID-19. The aim of this measure was to mitigate the effects of the pandemic and provide those affected by it with support to compensate for the resulting economic consequences. The initial requirement for implementing this measure was primarily speed and ease. The compensation bonus was assessed and paid via an application, and the total amount paid out came to approximately CZK 48.3 billion.⁴⁶

In addition to the above, two other programmes have been established. The first was a targeted employment support programme ('Antivirus') aimed at covering employers' wage costs. In total, this programme covered 80% of wages in the event of forced restrictions on operations and quarantine and 60% in the event of related economic difficulties. The estimated cost of this programme was CZK 17.1 billion. Another programme that was announced was the waiver of minimum social security and health insurance advances for the self-employed. The estimated costs amounted to CZK 15 billion.⁴⁷

According to the Supreme Audit Office, the expenditure related to the COVID-19 pandemic amounted to CZK 543 billion.⁴⁸ However, only part of these funds was used for the real fight against the pandemic: the Supreme Audit Office claims that almost 90% of the increase in total expenditure in 2021 was unrelated to expenditure

44 *IT řešení pandemie: Stát připravený nebyl. Následné budování IT provázal chaos a improvizace*, 2022.

45 Supreme Audit Office, 2023.

46 Supreme Audit Office, 2022.

47 Hlaváček and Pavel, 2020.

48 Šulc, 2022.

incurred in connection with the fight against COVID-19. During this period, current expenditure continued to increase enormously, while investment expenditure increased only slightly.⁴⁹

Although the Czech Republic had a relatively low public debt before 2020, this debt has increased significantly in recent years. Experts are calling for the consolidation of public finances. The Czech government aimed to reduce the state budget deficit by at least CZK 70 billion in 2023. Unfortunately, the requirement for the consolidation of public finances contained in the Act on the Rules of Budgetary Responsibility is insufficient: this Act does not determine a specific method for achieving the medium-term budgetary objective, which is a structural general government deficit of -0.75% of GDP. Public finances reached a deficit of 3.6% of GDP in 2022, mainly due to the government budget deficit. For 2023, the public finance deficit was forecast at 3.5% of GDP, with the largest share again being the state budget deficit. The deficit will increase the total state debt, which was expected to be 43.5% of GDP in 2023.⁵⁰

5. Conclusions and *de lege lata* recommendations

Public finance in the Czech Republic is defined in the same way as in the rest of the world: it comprises specific financial relations in the economic system between public law authorities (public bodies and institutions) and other subjects (e.g. natural persons and legal entities).⁵¹ The main functions of public finance are allocation, redistribution, stabilisation, control, regulation, and stimulation.⁵² From a legal viewpoint, the legislative function and corresponding regulatory function must also be taken into account.⁵³

In comparison with other EU Member States, public finance does not have a crucial role in the Czech Constitution and is not regulated in detail in this Constitution, *sensu lato*. Neither the Constitution *sensu stricto* nor the Charter of Fundamental Rights and Freedoms includes a specific part concerning public finance. However, a specific part of the Constitution for the Supreme Audit Office could be called ‘control power’, and another specific part for the Czech National Bank might be referred to as ‘bank power’. The bank power could also be easily transferred to the financial power, with the other (however rare) financial institutions named

49 Nejvyšší kontrolní úřad: Koronavirus byl jen za 10 procenty nárůstu loňských výdajů státního rozpočtu, 2022.

50 Ministry of Finance of the Czech Republic, 2023.

51 Tomášková and Pařízková, 2015, p. 11.

52 Tomášková, 2006; Tomášková and Pařízková, 2015, pp. 13–16.

53 Tomášková, 2006; Tomášková and Pařízková, 2015, p. 17.

in the Constitution.⁵⁴ The sixth power of the state could, then, be viewed as local self-government power as it deals with the fundamental aspect of local self-government units.

The constitutional regulation of the Czech tax law is also very limited, being covered by a single sentence in the Charter of Fundamental Rights and Freedoms, which states that taxes and fees can be imposed only by Acts. Interestingly, this principle, called '*nullum tributum sine lege*', is set in Art. 11 of the Charter of Fundamental Rights and Freedoms, which deals with ownership rights protection. According to the principle *nullum tributum sine lege* set in Art. 11 para. (5), taxes then limit ownership rights. The missing constitutional principles must be supplemented by the decision-making activity of the Constitutional Court. The court mainly considers extreme disproportionality (the so-called 'choking effect') and non-accessory and accessory equality.⁵⁵

As concerns public subsidies law, the Charter of Fundamental Rights and Freedoms guarantees the free provision of public goods in the field of education. This charter also establishes the existence of public health insurance, that is, the creation of specific public monetary funds for this purpose and the right to the free provision of healthcare as a public good.⁵⁶

The budget law is likely is the most comprehensively regulated at the constitutional level. The Constitution includes the basic principles for public budgets, setting out that the state budget is a legal Act. The government has a monopoly on drafting the state budget and the final state account, whereas the Chamber of Deputies of the Parliament of the Czech Republic has sole responsibility for discussing these proposals. This means the Senate has no rights in this field. However, there are no constitutional guarantees for fiscal federalism at the constitutional level.⁵⁷

De lege ferenda, it would be reasonable to be inspired by other (e.g. Polish) constitutions. It would also be advisable to adopt the principle that the state and local self-government units should be assured sufficient public funds for performing the duties assigned to them. This is connected with the rule that everyone shall comply with their responsibilities and public duties, including the payment of taxes, as specified by statute. Further, it would be appropriate to guarantee the revenues of local self-government units in the form of local taxes and charges at the constitutional level. The budget law is generally well regulated under the condition that the budgetary principles underlying the preparation, adoption, management, and control of public budgets are followed at both the central and local levels.

54 Hulkó and Radvan, 2022, p. 62.

55 Constitutional Court, Pl. US 29/08; Hulkó and Radvan, 2022, p. 62.

56 Hulkó and Radvan, 2022, p. 62.

57 Radvan, Mrkývka and Schweigl, 2018; Radvan, Mrkývka and Schweigl, 2021; Hulkó and Radvan, 2022, p. 62.

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CHAPTER 4

HUNGARY: REGULATION OF SUSTAINABLE FISCAL POLICY IN HUNGARY



ZOLTÁN NAGY

Abstract

This chapter presents and analyses the issue of sustainable fiscal management, focusing on the Hungarian budget. Sustainable fiscal management is closely linked to the principles of the European Union (EU); to this end, fiscal policy focuses on the issues of budget deficit and public debt. Adopting this perspective, this chapter presents the Hungarian fiscal framework and examines the rules and institutions that ensure the implementation of EU principles. As the debt of local governments forms part of public debt, the chapter analyses the issue of local government management, demonstrating the limits of excessive indebtedness. Fiscal policy must respond to economic changes; thus, this chapter also describes the fiscal policy instruments used during the economic crisis, which can be applied in accordance with the budgetary rules for dealing with exceptional situations.

Keywords: *budget, public debt, budget deficit, sustainable fiscal management, crisis management*

1. Introductory thoughts

This chapter aims to define the conditions for sustainable fiscal policy in line with European Union (EU) expectations. A central element of sustainable fiscal policy is

Zoltán Nagy (2024) 'Hungary: Regulation of Sustainable Fiscal Policy in Hungary'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 91–110. Miskolc–Budapest, Central European Academic Publishing.

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the enforcement of the budget deficit and debt rule. Hungarian legislation lays down detailed, precise principles and provisions on public finance and fiscal policy. The constitutional rules in the new Fundamental Law are broad and provide for the basic legal institutions of public finance. The details of the constitutional rules are also set out in high-level cardinal laws.

The chapter introduces the constitutional regulation of fiscal policy in Hungary, which comprises the starting point and framework for the whole public finance system. The defining elements of rules-based fiscal policy are presented, with a particular focus on the public debt rule. This and related provisions are the defining elements of the Hungarian fiscal system: provisions limiting the growth of public debt permeate the entire budgetary process. Important institutional frameworks ensure compliance with the rules. A good example is the Fiscal Council, which actively shapes the budgetary process, in particular, by playing an important role in the planning and adoption of the budget.

In addition to the central level of public finances, the budgets of local governments form part of the public debt. As such, the state must monitor the management of local governments, especially any increase in debt. To ensure compliance with the public debt rule, the legislation sets limits to avoid excessive indebtedness among local authorities. By authorising local government debt, the government directly intervenes in local government management. This enables it to control debt but, at the same time, naturally limits the financial autonomy of local authorities.

Public financial control is necessary to ensure that budgetary processes and rules are respected. This chapter briefly describes the structure of public finance control and its role in ensuring sustainable fiscal processes. Clearly, rules that operate in normal economic circumstances are not suitable for dealing with exceptional situations, and the rules must allow for this. Hungarian legislation allows for derogations from strict budgetary rules in emergency situations, for example, in the event of an economic crisis. The Hungarian government has taken advantage of this and has introduced fiscal policy rules to deal with exceptional situations. These provisions are outlined at the end of this chapter.

2. Constitutional regulation of budgetary policy

The constitutional foundations of financial law are not a new area of jurisprudence; however, the extent of regulation varies from one period to another.¹ In Hungarian regulation, the Fundamental Law of 2011 opened a new path by extending the constitutional rules of financial law.² The constitutional regulation

1 Nagy, 2022, pp. 88–91.

2 Fundamental Law of Hungary.

of public finance, the public finance constitution, forms part of a larger unit, the economic constitution. The economic constitution, in turn, is the part of the constitutional regulation that dictates fundamental economic rights and principles, provisions on the market economy, the duties and powers of the individual state bodies in relation to the economy, and the rules limiting them. Within the broadly interpreted economic constitution lies the public finance constitution, which primarily concerns monetary and fiscal policy. The literature emphasises that state power and public finance cannot be understood in isolation from each other, given that public finance is a condition and instrument of state power, and that, consequently, the provisions relating to it require constitutional regulation.³ Constitutions prescribe which financial relations are to be regulated by law. However, these norms have changed throughout history and have been expanded from specifying only legislative subjects to incorporate chapters on public finance, which define detailed rules.

This process has also taken place in Hungarian constitutional law. The current Fundamental Law now presents detailed financial law rules; as such, today's constitutional rules on public finance can be seen as public finance constitutional law.⁴ The public finance provisions define the legal institutions of public finance, the essential rules of money and property management, and public charges. Nevertheless, the constitutional law is not exhaustive, and the constitutional rules are laid down in detail in so-called cardinal laws adopted by a two-thirds majority. As a result, Hungarian constitutional law on public finance is two-tiered, with the cardinal laws also defining basic public finance rules of a constitutional nature.⁵ There are several relevant sources of law among the individual constitutional regulatory subjects; however, the Stability Act is particularly significant in terms of its comprehensive regulation in several areas.⁶

The financial regulatory method of the Fundamental Law is two-fold, setting out both principles and specific provisions. In general, the Fundamental Law sets the standards for balanced, transparent, and sustainable budget management. Additionally, in the context of fiscal management, this law also establishes prohibitive norms to help reduce public debt.⁷ Examining the structure of the constitutional rules of financial law reveals that many of these rules are presented in a separate chapter on public finance; however, public finance rules are also scattered throughout other chapters.

To sum up, the constitutional law on public finance in Hungary is regulated by the Fundamental Law in four areas: the management of public money and assets, public debt, public finance, and the monetary system.

3 Drinóczy, 2012, pp. 6–7.

4 Nagy, 2003, pp. 35–38.

5 Simon, 2019b, pp. 2–11.

6 Act CXCV of 2011 on the Economic Stability of Hungary, Act CXXXIX of 2013 on the National Bank of Hungary, Act LXVI of 2011 on the State Audit Office of Hungary.

7 Simon, 2019a, pp. 36–39.

3. Rules-based fiscal policy and the level of public debt

The fiscal sovereignty of nation-states is not absolute. The literature shows that at the global level, two important sets of rules affect the fiscal policies of nation-states: international standards set by standard-setting bodies and international sovereign debt rules.⁸ In the first set of rules, recommendations are made by international organisations and become part of domestic law, being either voluntarily incorporated by states, or directly or indirectly incorporated into domestic law through integration rules (EU rules). The second set severely constrains economic governance because public debt has to be financed. In this case, market players influence economic policy decisions as indebted countries become more vulnerable on the international financial market and obliged to finance debt. This is particularly true when countries are unable to finance their debt through market instruments and need direct financing from international financial institutions such as the International Monetary Fund (IMF). The IMF also intervenes directly in the economic policies of individual countries by imposing economic measures as a condition for lending. These measures aim to restore financial balance; however, they also impose austerity economic policies.⁹

All these international constraints push fiscal policy to regulate and set limits on the growth of the budget deficit and public debt. The level at which these rules are legislated may vary, but the constitutional level significantly increases their weight. The constitutional system of rules on public finances is not new in domestic Hungarian legislation, although the previous Constitution did not contain such detailed provisions. However, the 2008 financial and economic crisis forced the re-regulation of public finance. The new Constitution enshrines the essential provisions of rules-based fiscal policy. There have been many technical debates about its introduction and, as a solution, several countries have introduced rules on the size and limitation of deficits and public debt. These rules are expected to reverse fiscal overspending and the increase in public debt.¹⁰

The extant literature describes the essential elements of rules-based fiscal policy, including fiscal policy rules, planning requirements, procedural rules, transparency standards, accountability systems, and institutional guarantees for compliance.¹¹ The first issue is the constitutionalisation of public debt.¹² The fundamental objective of fiscal policy has become the achievement of a long-term sustainable level of public debt, which this policy seeks to ensure by guaranteeing a sustained close-to-balance status; in other words, the stabilisation of public debt is the main determinant of

8 Lőrinczné Istvánffy, 2004, pp. 602–612.

9 Simon, 2019b, pp. 8–9.

10 Bethlendi, Lentner and Póra, 2020, pp. 787–788.

11 Kovács, 2016, p. 321.

12 Varga, 2022, pp. 235–236.

fiscal policy.¹³ Moreover, public debt is linked to the budget deficit: as a general rule, public debt is created by financing the deficit.¹⁴ Strengthening fiscal discipline is a necessary step because the level of public debt has been rising steadily due to the large government deficit.¹⁵

The size of the budget deficit is governed by EU law in the form of the Maastricht Treaty, which sets the convergence criteria. An important condition for sustainable public finance management is that the annual general government deficit does not exceed 3% of the gross domestic product (GDP). If an EU country does not meet the criteria, it is subject to an excessive deficit procedure. Hungary was subject to an excessive deficit procedure from the time it joined the EU in 2004 until 2013, when the procedure was terminated. The basis for this termination was a budget deficit below 3% for two years that was likely to remain below 3% in the coming years.¹⁶

The systemic importance of public debt is justified by the implementation of the debt rule in the budgetary procedure, that is, the objective of a steady decline in the public debt, or at least no increase, and achieving the optimal debt ratio (50% of GDP) in the longer term. The debt rule has, thus, become a central legal instrument of fiscal policy.¹⁷ The provisions on the debt rule are explained in detail in the Stability Law, in addition to the Fundamental Law.¹⁸ The essence of the rule is that, in the interest of sustainable public finance management and responsibility for future generations, Parliament may adopt a fiscal law that results in a public debt not exceeding half of the total GDP; in other words, the optimal public debt level as defined by the Fundamental Law.¹⁹ This principle can be considered general because fundamental rights and the efficient functioning of the state can only be guaranteed if the social and economic balance of the country is not jeopardised by public finance problems.²⁰ Therefore, in budgetary management and planning, Hungary applies the basic general principle of balanced, transparent, and sustainable fiscal management, which all bodies operating in both subsystems of public finances are obliged to respect. Balance is intended to ensure predictable public operation, transparency aims to ensure democratic public life with the participation of informed and responsible citizens, and sustainability seeks to ensure responsibility for the fate of future generations.²¹ Sustainable public finance management encompasses a range of

13 Act LXXV of 2008 on Prudent Public Management and Budget Responsibility. The introductory provisions of this Act set out the expectation to establish and pursue a disciplined, transparent, and long-term sustainable fiscal policy while ensuring ongoing economic competitiveness.

14 Vígvári, 2005, pp. 175–178.

15 Sívák, Szemlér and Vígvári, 2013, pp. 49–51. In 2006, the general government deficit was 9.4% of GDP.

16 Sívák, Szemlér and Vígvári, 2013, p. 61.

17 Kovács, 2016, pp. 325–326.

18 Art. 36 paras. (4)–(5) of the Fundamental Law. Act CXIV of 2011 on the Economic Stability of Hungary Arts. 2 and 10/F.

19 Art. N of the Fundamental Law.

20 Nagy, 2014b, p. 5.

21 Drinóczi, 2012, pp. 2–6.

financial principles, although the above-mentioned public debt rule is of particular importance.²²

3.1. Rules limiting public debt

The Stability Law also sets out in detail the limits that govern the growth of debt. The regulatory objective of the Stability Law is economic stability, fiscal sustainability, and the reduction of public debt, based on the provisions of the Fundamental Law. The law explicitly refers to its compliance with EU rules. The regulation of public debt is divided into two parts: rules on debt reduction and rules limiting the creation and growth of debt.

The way in which the public debt indicator is calculated is also defined in the framework of the debt reduction rules.²³ In order to preserve the level of public debt, the law fixes the maximum level of the government sector balance at 3% of GDP. The legislation emphasises that the government sector balance must be consistent with medium-term budgetary objectives.

The rate of decline in public debt is also fixed: the government debt ratio must decrease by the rate set in the Budget Law, and by at least 0.1%, while respecting EU rules. However, this may change during the course of the budget year, and the legislator will, subsequently, formulate provisions to be applied in the budgetary procedure in order to reduce the debt. Such provisions include a review of the debt rule, a macroeconomic budget forecast, questioning the values not included in the debt indicator, and the suspension of debt reduction.

The government reviews the debt ratio during the budget year. As a result of this review, the Budget Law may be amended if, by the end of the fiscal year, the public debt ratio increases compared to the ratio set in the Budget Law. In the event of a persistent and significant downturn in the national economy and a decline in the real value of GDP, the rule on the budget deficit and the public debt does not apply. In such a case, the amendment of the Budget Law may be aimed at suspending the obligation to fulfil the value set in the central budget. Twice a year, the government prepares macroeconomic and budgetary forecasts for the four coming years. These forecasts assist with budget planning by identifying risks and expected trends in the economy, informing central budget planning.

The calculation of the debt indicator is defined by the legislator; however, certain items are excluded from the indicator by means of permissive regulation. An increase in debt due to delays in the disbursement of EU funds is not taken into account. In a situation where the stability of the financial system is threatened, a loan to a credit institution established in Hungary also cannot be included in the debt

22 Barcza, 2015, pp. 444–447. The author points out that economic theories differ in their assessment of the optimal level of public debt.

23 Art. 2 of Act CXCV of 2011 on the Economic Stability of Hungary. The government debt indicator is a ratio expressed as a percentage of government debt to GDP.

indicator. Furthermore, the indicator is not increased in a given financial year by any surplus of debt resulting from a change in the calculation methodology during the year or from exchange rate changes of foreign currency debt. These items soften the indicator and exclude issues that are temporary in nature and likely to change rapidly, such as the exchange rate.

Another area of public debt regulation comprises the rules limiting the creation and growth of debt. Such rules include the adoption of measures, the imposition of a public charge to balance the budget, restrictions on debt-creating transactions, restrictions on the expansion of EU resources, and provisions limiting municipal indebtedness.

In the course of annual budget management, expenditure may be charged to the state for which the budget does not provide. In this case, the public finance rules give the government the right to take extraordinary measures: it may block, reduce, or cancel budget appropriations. However, this right does not apply to expenditure appropriations of which the modification falls within the exclusive competence of Parliament. The government also has the right to introduce new taxes to finance new expenditures. The government used this instrument in 2022, introducing the special ‘extra-profit’ tax to balance public finances.²⁴ The tax affected several sectors, including credit institutions, insurance companies, pharmaceuticals, and telecoms. It is a temporary tax as the last date of payment is 2024 under the current rules.

To limit debt-generating transactions, the Stability Law stipulates that only with the prior approval of the Minister of Finance can such transactions be entered into for entities in the government sector. This, of course, applies to entities other than budgetary entities, which are prohibited from entering into this type of transaction. Such transactions include, *inter alia*, loans, the issue of bills of exchange, financial leasing, and deferred payments exceeding one year. The legislator precisely defines the scope of the transactions, aiming to prevent indebtedness and limit the financing of revenue from outside the budget.

In the case of EU grants, the legislator applies permissive rules. The law allows the pre-financing of this type of aid and the provision of the country’s own resources, even if this increases the public debt ratio. Thus, the law allows borrowing or additional financial commitments over and above the planned appropriations. Furthermore, the debt ratio does not consider any increase in public debt resulting from a delay in the disbursement of EU funds.

In the context of the common budget of the EU, domestic Hungarian legislation, as set out in the Public Finance Act, provides for the possibility of the government entering into a payment obligation with a Member State, on the basis of an individual decision. This can be done to meet a debt obligation entered into by the European Commission on behalf of the EU and to grant a loan or guarantee by a financial institution jointly owned by EU Member States. The provision allows this expenditure

24 197/2022 (VI. 4.) Government Decree on Extra Profit Taxes.

to be effected in the absence of an appropriation or in excess of the amount foreseen.²⁵ However, a restrictive rule on this provision was introduced in 2023, which stipulates that Hungary does not support an exceptional and temporary increase in the upper limit of the EU's own resources if it is intended to provide the guarantee or cover necessary for borrowing on the capital markets on behalf of the EU. Only an Act may allow an exception to this rule. The rule applies as long as domestic public debt exceeds half of GDP. In effect, this means that the Hungarian government does not want to contribute to EU common borrowing or to increase national contributions to this end, given the current high level of public debt.

3.2. Role of the Fiscal Council in enforcing the debt rule

The relationship between the executive power and the legislature plays a key role in the budgetary process. A balanced relationship between the two branches and the division of powers is particularly important. In the Hungarian system, the Fundamental Law and the Public Finance Act provide the appropriate legal framework, with fundamental decisions stemming from state sovereignty being made by Parliament.²⁶ However, it has become essential to also establish independent budgetary institutions that are able to exercise control over the budgetary process and public debt. The literature points out that rules alone may not be sufficient to ensure fiscal discipline. This was the basis of the establishment of the Fiscal Council as an independent institution in Hungarian legislation.²⁷

The role of the Fiscal Council is crucial in ensuring that Parliament can make an informed decision on the approval of the budget and that it is adopted by a professionally competent body independent from the executive power. The Council's involvement is essential in the budgeting process and to ensure compliance with the public debt rule.

The Fiscal Council is the body that supports the legislative activity of Parliament and examines the soundness of the central budget. The Council contributes to the preparation of the law on the central budget, and its prior approval is required for the adoption of this law. Using the powers it has been given, the Council exercises a substantive influence on the budget's compliance with the requirements of the Fundamental Law, in particular, by monitoring compliance with the rules on the level of public debt. Its organisation and functioning are regulated in detail in the Act on the Economic Stability of Hungary.²⁸

25 Art. 95 of Act CXCV of 2011 on Public Finances.

26 Sivák and Vígvári, 2012, p. 108.

27 Bethlendi, Lentner and Póra, 2020, pp. 790–794.

28 Arts. 15–27 of Act CXCV of 2011 on the Economic Stability of Hungary. The members of the Council are the President of the Fiscal Council, the President of the National Bank of Hungary, and the President of the State Audit Office of Hungary. The President of the Council is appointed by the President of the Republic for a term of six years.

The Council's duties and competences cover three areas: giving an opinion on the central budget, deciding on the ex-ante contribution, and examining the level of public debt. Its opinion is expressed at several stages of the budgetary procedure. The Council's right to give its opinion is not simply a right to give advice or comment; in many cases, the legislator also attaches consequences to the order of the procedure. The decision to give prior consent is also a strict power of veto. The Fundamental Law gives the Council this power, stating that the adoption of a central Budget Law requires the prior consent of the Council in order to comply with the public debt rule. The Council's main task is to monitor compliance with the debt rule.²⁹ The essence of this rule is that, in the interests of sustainable public finance management and responsibility for future generations, the National Assembly may adopt a Budget Law that results in a public debt not exceeding half of the total GDP. At present, however, the public debt is significantly above this level; therefore, until the optimal level of public debt is reached, the National Assembly must adopt a budget that aims at reducing the public debt. The Council acts to this end throughout the budgetary procedure.

4. Curbing excessive indebtedness in local government management

Local government budgets are the local level of public finances and are closely linked to the central level (i.e. the central budget). Local government management is autonomous, and the central budget is not responsible for loss-making management.³⁰ Although the state is not directly responsible for the management of local governments, as local government debt forms part of the public debt, local government indebtedness has an impact on the overall management of public finances. In any case, responsibility for public debt obliges the state to monitor local government management closely and to prevent municipalities from becoming over-indebted.

There is a close link between central and local government through the financing of public service provision,³¹ which is shared between the state and local governments. Over the last decade, there has been a change in both the division of tasks and the financing, with the state taking over more tasks from the municipalities and introducing task funding. Centralisation has, thus, led to a reduction in public tasks but also to a reduction in the level of state support.

29 Art. 36 paras. (4)–(5) of the Fundamental Law.

30 Simon, 2019a, pp. 137–138.

31 Horváth, 2016, pp. 25–33.

One of the reasons for the new financing method was the debt crisis in local government.³² Municipal operational and management disturbances increased municipal debt. The 1990s witnessed decentralisation, with a high degree of municipal economic autonomy. However, municipal responsibilities increased without adequate funding from the central budget, resulting in an operational deficit. In addition, there were problems with financing for development and investment, not to mention the exchange rate risk of foreign currency loans. Furthermore, the financing of municipal-owned enterprises was also problematic, with an increase in debt in this area. As a result, the fiscal stability of local governments was weakened.³³

Against this background, the state decided to assume the municipal debt in several phases (2011–2014). The debt assumption, which ended in 2014, only covered debts owed to financial institutions. Such transactions included loans, debt securities, bills of exchange, financial leasing, deferred payments of at least 365 days, and instalment payments.³⁴

In parallel with the assumption of debt, the legislator limited the reproduction of debt. One of the reasons for this is that the government's primary objective in rules-based budgeting is to reduce public debt, which can only be achieved by limiting municipal indebtedness. This is also allowed by the Fundamental Law, which states that in order to maintain a balanced budget, it may, by an Act, make municipal borrowing or other commitments subject to a condition or the consent of the government.³⁵ This debt brake significantly restricts local governments' financial autonomy: in the case of large borrowing operations, the government shapes the financial possibilities of each municipality on the basis of individual decisions and actively intervenes in municipal finances.³⁶ Based on the mandate of the Fundamental Law, the debt brake is regulated in detail by two pieces of legislation: the Stability Act³⁷ and the Government Decree laying down the detailed rules.³⁸ Generally, the legislator stipulates that local authorities may only enter into guarantees, sureties, and debt-generating transactions with the prior consent of the government. This rule covers both a company wholly owned by the municipality and any company wholly owned by such a company.

Two absolute limits or conditions are also formulated in relation to debt-creating transactions, both of which require the government's consent. One condition is that if a municipality does not introduce a local business tax, a property type tax, or a personal municipal tax, it cannot enter into a debt-increasing transaction. The other condition is that the total amount of payment obligations arising from the debt-creating transaction in the reference year must not exceed 50% of the municipality's

32 Horváth, Péteri and Vécsei, 2014, pp. 121–147.

33 Bethlendi and Lentner, 2019, pp. 1020–1023.

34 Lentner, 2019, pp. 64–70.

35 Art. 34 para. (5) of the Fundamental Law.

36 Bencsik, 2017, pp. 64–66.

37 Arts. 10–10/F of Act CXCV of 2011 on the Economic Stability of Hungary.

38 Arts. 1–11 of 353/2011 (XII.30.) Government Decree.

own revenue. The regulation contains exceptions where the government's consent is not required to enter into the transaction. Such cases include, *inter alia*, statutory guarantees and indemnities, the pre-financing of EU or international aid, debt maturing within a calendar year, and limited debt for development purposes as defined by law. It is, therefore, clear that the government wants municipalities to rely primarily on their own revenues rather than borrowing.

Another condition is compliance with the public debt rule in public finance management. The government will agree to the deal if, provided the conditions are met, the local government debt does not jeopardise the annual public debt target and the financing creates the sufficient capacity to perform the municipal functions. The government may also approve or reject the debt rescheduling transaction in part. The regulations provide guidance on this, but the government essentially has discretionary powers in such cases.³⁹

5. The public finance control system as a guarantee of the sustainability of public finance management

The public finance control system serves to balance public finance management by identifying problems in the course of the control process that, if corrected, can prevent the budget deficit from increasing. At the same time, the conclusions and lessons learned from the audit will also allow for sound budgetary planning and implementation in the coming years. Public funds used in the management of public finances must be accounted for and reported to the government on the implementation of the budget after the close of the financial year. Budgetary reporting is a technical and legal act, the conditions for which are laid down in several legal acts in addition to the Fundamental Law.⁴⁰ The government is obliged to implement the central budget lawfully and expediently, manage public funds effectively and ensure transparency, and report to Parliament. The National Assembly approves the report and the implementation of the budget, while at the same time supervising its implementation. The responsibility for the implementation of the budget lies with the government; therefore, by approving the budget, the National Assembly accepts its implementation and relieves the government of its responsibility.

Additionally, the reporting system allows for monitoring the implementation of the budget, although it is also necessary to establish a system of control for public

³⁹ Art. 10/B of Act CXCV of 2011 on the Economic Stability of Hungary. The Act sets out the circumstances that the government shall consider when assessing a municipality's debt write-off transaction. Thus, the government may refuse to make a contribution if the municipality intends to finance a non-mandatory municipal task, if the municipality's own resources are sufficient for the development objective, or if the development objective and its implementation are not financially sound.

⁴⁰ Győrffi, 2009, p. 639.

finances. The purpose of public finance controls is to ensure the regular, economic, efficient, and effective management of public funds and national assets by guaranteeing that reporting and data reporting obligations are properly fulfilled. The public finance control system covers both subsystems, which in theory are divided into external control and internal financial control.⁴¹ The Public Finance Act, in contrast, divides the public finance control system into three areas: the external control of public finances, the control of public finances at the government level, and the internal control of public finances.

The State Audit Office of Hungary is responsible for the external audit of public finances.⁴² This Office is the main financial and economic audit body of the National Assembly and is independent of any other organisation in its audit activities. It has general powers to control the responsible management of public funds and state-owned assets. An explanatory memorandum also points out that the legislator has opted for the office model of the Court of Auditors, instead of the court and authority models. Thus, the State Audit Office has no direct sanctioning powers, and its recommendations and findings are implemented through the activities of other bodies.

Controls at the government level are carried out by the government audit body, the European aid control body, and the Treasury. The government audit body is the Government Audit Office, which is a central budgetary body operating as a central office. It is managed by the Minister in charge of the Prime Minister's Office.⁴³ The Office's audit powers are wide-ranging, covering the audit of the management of all budgetary bodies, appropriations, and other organisations belonging to the government. This government audit body is empowered to impose fines in the event of failure to cooperate or comply with obligations that prevent control. With certain exceptions, it can also request the blocking of payment accounts in the event of the illegal, improper, or wasteful use of public funds or public property. The European aid control body (DG AUDIT) has control powers over budget aid from EU funds. It may carry out audits on the organisations involved in the implementation, beneficiaries, and the contractors responsible for delivering the scope of contracts in the context of budget aid.

As the government-level control body of public finances, the Hungarian State Treasury performs control activities in relation to budget appropriations and budget subsidies, in addition to implementation and management tasks. The system of internal control in public finances is implemented through the internal control system and internal audit of budgetary bodies. The processes of this internal control system are designed to manage risks and obtain objective assurance. The internal control system's purpose is to ensure that the auditee carries out its activities in an orderly, economical, efficient, and effective manner; that it fulfils its accountability

41 Sivák, Szemlér and Vígvári, 2013, p. 152.

42 Act LXVI of 2011 on the State Audit Office of Hungary.

43 Government Decree 355/2011 (XII. 30.) on the Government Audit Office.

obligations; and that the auditee is protected from losses and damage. The head of the budgetary authority is responsible for establishing and operating the internal control system.

6. Hungarian fiscal policy in times of economic crisis

Fiscal policy processes are affected by economic crises, while fiscal policy also affects these crises, meaning that the role of the state as an economic regulator is enhanced.⁴⁴ A low unemployment rate, economic growth, and stable, low inflation are important objectives of economic policy.⁴⁵ Governments are addressing the consequences of the economic crisis with these objectives in mind and are in the process of reducing the adverse effects of the crisis on their nations' economies. Fiscal policy instruments act on the economy in conjunction with the fiscal rulebook. The instruments can adopt different approaches, both *indirect and direct*,⁴⁶ or *affect budget revenue and expenditure*.

The economic crisis created a double challenge for fiscal policy on both the revenue and expenditure side, and the tools to address this challenge are presented here by examining both segments.⁴⁷ On the revenue side, the crisis led to decreasing tax revenues, rising unemployment, and falling consumption due to underinvestment, among other factors. On the other side, expenditure rose due to an increase in subsidies. At the same time, transfers and structural changes restructured the budget, which was reflected in the amendment of the Budget Law. From 2008 onwards, Hungarian fiscal policy set the objective of sound public management and responsible fiscal policy.

At present, however, public debt is significantly above the stipulated level; therefore, until the optimal debt is reached, Parliament must adopt a budget focusing on the reduction of public debt.⁴⁸ Obviously, factors affecting the management of public finances may be subject to exceptional situations, such as serious problems arising from external causes that cannot be avoided. To remedy such issues, the Fundamental Law allows derogations from the strict rules (permanent decline in the national economy, restoration of the balance of the national economy). The rule referring to the economic crisis is interpreted in an expansive way by the Stability Law, which states that any case of a permanent and significant decline in the national economy shall be interpreted as a decline in the real value of the annual GDP. In this

44 Horváth and Nagy, 2022, pp. 361–365.

45 Samuelson and Nordhaus, 2012, p. 570.

46 Simon, 2019a, pp. 31–32. 'Direct instruments' refer to a specific decision related to the budget, whereas indirect instruments, such as taxes, have effects without specific intervention.

47 Horváth and Nagy, 2022, pp. 175–179.

48 Nagy, 2014a, p. 12.

case, the Stability Law allows the government sector deficit to exceed 3% of GDP and the public debt ratio to fall.⁴⁹ The economic crisis resulting from the COVID-19 pandemic, therefore, justified a derogation from the public debt rule. An increase in public debt is a natural process in the event of an economic crisis as government overspending and budget support increase the budget deficit. More important than the size of the deficit is the absorption of the extra resources because if budget money is spent efficiently, it lays the foundations not only for recovery from the crisis but also for future economic growth.⁵⁰

Both a significant fall in GDP and a rebalancing of the economy will increase public debt: as the debt ratio is linked to GDP, a fall in GDP alone will increase the debt ratio without changing the budget deficit. The budget could be affected on the revenue side by a crisis due to revenue shortfalls and on the expenditure side due to an increase in central budget support.

The Public Finance Act provides a solution to the unfavourable development of the central budget in the form of extraordinary measures aimed at implementing government tasks undertaken during the year and maintaining balanced budget management. The legislator supplements the previous legislation with temporary measures related to the emergency situation. Through these measures, the legislator gives the government broad powers to make budgetary expenditures not provided for in the Budget Law and to impose extraordinary payments. The special legal order provision provides for a relaxation of the public expenditure rules, that is, a derogation from the strict procedural and substantive rules establishing the payment obligations, the extent of which is determined by law as necessary to restore the economic downturn and equilibrium.⁵¹ The assessment of the necessary level has been a matter of debate, given the unprecedented nature of a health emergency affecting the whole country. The literature also points to the need to use a different scale of necessity and proportionality because of the different economic and life situations. It is very difficult to assess the degree of necessity as it is only after a crisis that it can be judged whether a derogation from the rules was necessary. The question is, therefore, what is meant by an emergency situation?⁵² The legislator has taken account of the emergency situation in the provisions of the Fundamental Law, which states that in a special legal order, fundamental rights may be restricted beyond the limits of necessity and proportionality.⁵³ Every crisis is different, and it

49 Art. 7 of Act CXCV of 2011 on the Economic Stability of Hungary.

50 *Modern monetáris elmélet: Mi a probléma vele? Mit jelent?* [Online]. Available at: <https://elemzeskozpont.hu/modern-monetaris-elmelet-mi-problema-vele-mit-jelent> (Accessed: 15 January 2024). This study points out that there is good and bad public debt. If the government uses the resources for investment, economic growth, or laying the foundations for future economic growth, then there is no problem for public finance management.

51 Art. 38/A of Act CXCV of 2011 on the Economic Stability of Hungary.

52 Salgó, 2020, pp. 15–16.

53 Art. 54 para. (1) of the Fundamental Law. In a special legal order, the exercise of fundamental rights may be suspended or restricted beyond the limits laid down in Art. I para. (3), with the exception of the fundamental rights laid down in Arts. II and III and Art. XXVIII paras. (2)–(6).

is, consequently, difficult to dose solutions with the ‘pharmacopoeia’ of law. If the management of a crisis is successful, the government’s efforts will be judged positively by the electorate, who would otherwise suffer the negative effects of the crisis. Excessive legal restrictions on economic instruments may prevent the government from managing a crisis effectively. This is illustrated by the law adopted to combat the COVID-19 pandemic, which strengthened and temporarily extended the government’s emergency powers.⁵⁴

Fiscal instruments in Hungary can be divided into *tax instruments, which affect the revenue side of the budget, and subsidy instruments, which affect the expenditure side*. Some of these instruments were already in place in 2020, while others only came into force and began to have an impact from 2021 onwards. Support instruments have a faster impact on the economy, whereas tax instruments have a longer-term impact on economic agents, with some exceptions, such as the introduction of a new tax. The economic problems caused by the crisis resulting from the COVID-19 pandemic made it necessary to amend the 2020 budget.⁵⁵ As part of the economic protection measures, the legislator reallocated several thousand billion forints in budget appropriations, creating two separate funds in the budget for epidemiological expenditure and economic protection.⁵⁶

In addition to the transfers affecting the central budget sub-system, legislative changes were also made to the *local government sub-system*. The purpose of these amendments was two-fold: on the one hand, they aimed to transfer resources to the central budget as revenue from the motor vehicle tax, and on the other hand, they sought to reduce municipal fees and taxes, with the government, thus, indirectly subsidising entrepreneurs and individuals.

Economic autonomy is an indispensable condition for local government autonomy, which is supported by constitutional provisions.⁵⁷ Resource regulation is closely linked to the provision of public services.⁵⁸ Although the state has gradually taken over tasks from local authorities, with centralisation thus taking place in this area, basic public services have remained with the municipalities. Local government revenues are essential for the financing of these public services.⁵⁹ However, the emergency situation overrode these principles, and the state sought to centralise resources, redirecting them to emergency defence and economic protection. This, in turn, put local authorities in a difficult budgetary situation. The government tried to remedy this by making up the shortfall automatically in the case of smaller

54 Act XII of 2020 on the Protection against Coronavirus. Art. 2 of this Act stipulates that in order to guarantee the stability of the national economy, the government may, by decree, suspend the application of certain laws, derogate from statutory provisions, and take other exceptional measures.

55 Government Decree 92/2020. (IV.6.) on the different rules of the 2020 central budget of Hungary related to the emergency.

56 Act XC of 2020 on the 2021 Central Budget of Hungary.

57 Lentner, 2017, pp. 136–137.

58 Horváth, Péteri and Vécsei, 2014, pp. 121–123.

59 Horváth, 2014, pp. 185–188.

municipalities, and discretionally in the case of large cities, examining the short-falls on an individual basis. In doing so, the government imposed a kind of equalisation mechanism, taking resources away from better-off municipalities and giving resources to worse-off ones.

The *rules and measures taken to tackle the economic crisis* caused by the COVID-19 pandemic can be broken down into several areas, such as job preservation and creation, support for priority sectors and domestic businesses, support for families, maintaining the security of supply, the application of official prices, and extra profit taxes.⁶⁰ Preserving jobs and creating new jobs was a priority in the government's programme. The fall in demand forced workers to take redundancy or reduce their working hours. The government introduced a subsidy of up to 70% of the net wage for the working time lost in the event of reduced working hours. In addition, in priority sectors, no employer contributions were required and employee contributions were reduced, meaning that no pension contributions were paid, and health insurance premiums were reduced to the statutory minimum. The 2% reduction in social contribution tax also promoted employment, as did tax cuts. Special payment relief and tax mitigation options, such as the temporary abolition of the labour market contribution, were available for employers. Among entrepreneurs active in certain priority sectors (tourism and hospitality, health, food, etc.), the government applied tax reductions and tax holidays for small taxpayers.⁶¹ Investment and technological development were promoted to create jobs. In addition to the environment, priority was given to industries with a promising future, such as artificial intelligence and quantum technologies, and to sectors that were particularly affected by the economic crisis. To ensure sufficient human resources, the programme provided support for retraining and further training. For families, a moratorium on loan repayments was introduced to support housing investment, and expiring social benefits were extended during the emergency.

The COVID-19 pandemic was followed by a period of high inflation on both the demand and supply side, which represented the main economic policy challenge. The Russo-Ukrainian War further increased inflation in the world economy. The Hungarian government adopted price control measures to react to this economic challenge. In 2021, a fuel price freeze was introduced, with a gradual change in personal scope to avoid abuses and preserve stocks and the security of supply. However, the intervention in the market price led to a fall in supply as distributors were not compensated. Before the market collapsed and supply problems increased, the government had withdrawn price fixing. A different regime was introduced for energy prices. The energy crisis sent market prices out of control and, in order to keep prices low for the public, the government introduced official prices for electricity and gas. The eligibility for the reduced residential tariff was linked to the level of consumption, above which the market price had to be paid. In this case, the government

⁶⁰ Government of Hungary, 2020.

⁶¹ Act CXLVII of 2012 on the Itemized Tax on Small Taxable Enterprises and Small Business Tax.

compensated the supplier for its losses. However, inflationary pressures not only affected prices for energy and fuel but also for food. Price controls were introduced for basic foodstuffs, with the price of some having to be fixed by retail suppliers at a lower level than in previous periods, which became the prevailing gross retail price. An interest rate freeze on variable-rate loans was introduced to safeguard both the economic situation of households and that of small and medium-sized enterprises. The fixed interest rate prevented loan contracts from enforcing interest rates that had risen significantly as a result of inflation.⁶²

In addition to all these measures, the budget sought to find resources to finance the official price of energy and reduce the budget deficit by introducing special taxes and increasing their rates. The surcharges and tax increases affected several sectors, such as banks, oil producers, power plants, retailers, insurance companies, telecoms, and airlines. The fiscal policy objective of taxation is to divert the excess profits generated by inflationary price rises into public spending.

Additionally, fiscal developments in 2023 were not favourable, as Hungary did not comply with the EU requirements.⁶³ This is likely to result in an EU excessive deficit procedure for Hungary. Under this procedure, the EU rules set out a timetable for deficit and debt reduction. The Hungarian government seems committed to complying with the rules but has taken slower steps to improve the balance indicators to preserve economic balance and ensure economic growth. To strengthen disciplined fiscal management, a new government decision-making forum, the Government Budget Preparation Task Force, has been established. Chaired by the Minister of Finance, this task force is responsible for maintaining a balanced budget and preparing the government's decisions from a budgetary perspective. This policy-making forum has special powers and may issue a dissenting opinion, or its head may issue a veto.⁶⁴

7. Summary

This chapter analysed one aspect of Hungarian fiscal policy. An important factor for sustainable fiscal policy is the budget deficit and debt. This is the main focus of EU regulation as the framework of EU economic policy may be threatened by the excessive indebtedness of individual Member States. Fiscal policy, the definition of the regulatory framework for public finances, has been given special importance in

62 Czegezli et al., 2023, pp. 86–128.

63 According to the Central Statistical Office, the budget deficit was 5.4% and GDP was 0.9%, based on the first three-quarters of the year. These figures are subject to change based on fourth-quarter data.

64 Government Decision 1529/2023 (XII.5.).

the Hungarian legal system as is clearly shown by the detailed public finance regulation in the country's Fundamental Law. The central provision of the public finance constitution is the definition of public debt below the level required by the EU.

Hungary's commitment to reduce the level of public debt permeates the entire public finance framework and is applied at all levels of the budgetary process. The rules-based fiscal policy sets a strict framework for fiscal management; however, this strict regime has been lifted by the economic crisis through the exceptional rules. The legislator is right to allow flexibility in the rules to deal with extraordinary economic situations, though it is not right for the government to apply the exceptional rules in the longer term. This softens the original legislative and economic policy intentions in favour of a committed sustainable fiscal policy.

It can be concluded that the Hungarian legislation is capable of complying with EU rules. However, the question is whether the budget deficit and the level of public debt alone are sufficient to judge the state of the national economy. How and for what purpose the state and local governments use the budget resources are also important, in other words, whether the resources have been used in a purposeful, efficient, and effective manner, and whether the long-term sustainable functioning of society has been achieved.

In the Hungarian legislation, the debt rules also apply to the municipal level of public finances. The state prevents the excessive indebtedness of local governments through direct rules. These are good instruments to prevent indebtedness in the local government sector, but they limit the financial autonomy of local governments.

There are many more public finance issues that could arise in relation to fiscal policy; however, the scope of this chapter does not allow for a detailed discussion of all the related issues. Other areas of fiscal policy are analysed in separate chapters on public revenue and public expenditure issues.

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CHAPTER 5

POLAND: PUBLIC FINANCES EVEN MORE COMPLICATED



AGNIESZKA MIKOS-SITEK

Abstract

The issue of public finance in Poland has been regulated on the grounds of numerous legal acts and considering various hierarchical levels of law sources. In relation to the financial management of both state and local government units, public finance has its essential foundations in the Constitution of the Republic of Poland. Recent events related to the COVID-19 pandemic and the ongoing economic crisis have resulted in a great deal of attention being paid to broader issues relating to public finance in Poland, including fiscal sustainability, public debt, and budget balance. This comprised activity in the field of new legislative solutions, as well as a different approach to the application of specific solutions in the practice of shaping and implementing the budget of the state and budget local government unit. The changes that were introduced were aimed at mitigating the economic consequences of the pandemic; however, it should be assumed that many of them will become a permanent feature of the legal order in Poland.

Keywords: *public finances, budget, fiscal rule, budget balance, public debt deficit*

1. Introduction

Legal regulations relating to the issues of public finance and the public finance sector in Poland constitute a large group of legal acts located at various levels of the hierarchy of legal sources. The provisions covered in Chapter X, 'Public Finances',

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of the Constitution of the Republic of Poland of 2 April 1997¹ refer to the basic principles and institutions underlying the functioning of public finances. The regulations covered by the Constitution are detailed and supplemented by numerous provisions of the rank of Acts and the executive Acts issued to them.² The Act of 27 August 2009 on Public Finance is of fundamental importance in this respect.³ The scope of this regulation covers the following issues: public funds, their classification and management principles, the catalogue of public finance sector units and the rules underlying their functioning, the issues of openness and transparency of public finance, the objectives and coordination of management control, and internal audits in public financial sector units. The Public Finance Act also regulates the issue of public debt and deficit, the rules for financing the borrowing needs of the state budget, the applied prudential and remedial procedures, the rules for incurring liabilities by public finance sector entities (excluding the State Treasury), and the rules for issuing treasury securities. In addition, the scope of the Act covers the issues of long-term planning and the principles of shaping the content of the budget, the level of detail required in this case, and the procedure for its development, adoption, and implementation. A separate part of the Act covers the provisions regulating state budget expenditures, their classification, and their purpose. Another subject of regulation by the Public Finance Act is the budget of European funds and the rules for its implementation. The provisions specifying the principles of providing banking services to the state budget and public finance sector entities should also be mentioned. Further, the Act regulates the principles of financial management for local government units, including the principles of shaping the budget's content and adopting and implementing the budgets of communes, powiats, and voivodeships.⁴

It should be highlighted that the term 'sector of public finance' first appeared in Polish law in the Act of 26 November 1998 on Public Finance,⁵ in which the entities constituting this sector were indicated. However, the term and essence of the public finance sector were not explicitly defined in this Act. Moreover, the provisions of the Public Finance Act that is currently in force focus only on the catalogue of entities included in this sector. The term 'public sector' has also not been unambiguously defined. However, there is no doubt that it constitutes, *inter alia*, a category with a broader scope of entities given that it includes public institutions and associations that use public funds in their activities, as well as non-public institutions

1 Journal of Laws, No. 78, item 483 as amended.

2 See: Borodo, 2010, pp. 28–29; Ofiarski, 2010a, pp. 11–18; Ofiarski, 2010c, pp. 175–176; Ruśkowski, 2010b, pp. 16–20.

3 Consolidated text: Journal of Laws of 2023, item 1270 as amended (hereinafter: p.f.a.).

4 Kosikowski, 2007, pp. 13–16; Kosikowski, 2010a, pp. 17–23; Lipiec-Warzecha, 2011, pp. 17–25; Dzwonkowski, 2014, pp. 17–19; Nowak-Far and Frysztak, 2019, pp. 6–16; Mierzwa, 2012, pp. 11–12.

5 Consolidated text: Journal of Laws of 2003, No. 15, item 148 as amended.

that are oriented primarily toward meeting public needs in addition to for-profit activities.⁶

The Public Finance Act also includes provisions explaining the meaning of basic concepts, including the normative definition of public finance. According to Art. 3 of this Act, public finance includes processes related to the collection of public funds and their distribution, in particular: (i) the collection of public revenue and income, (ii) spending public funds, (iii) financing the borrowing needs of the state budget, (iv) incurring liabilities involving public funds, (v) the management of public funds, (vi) public debt management, and (vii) settlements of the budget of the European Union.

The current Public Finance Act is the third consecutive regulation adopted in this respect, with the normative concept of public finance being similarly defined in the previously applicable laws.⁷ In individual regulations, the mechanism of collecting public funds and their distribution was indicated as the basis for the overall definition, whereas the differences concern the processes indicated in the more detailed definitions.⁸ What is subject to criticism in the literature on the subject is that uniform terminology has not been maintained.⁹ At the same time, it should be noted that the above-mentioned definition of public finance remains open and indicates only some of the activities covered by the process of collecting and distributing public funds. As such, this definition does not sufficiently specify these activities and does not fully take into account the economic essence of public finance.¹⁰ In the Polish literature on the subject, there are also arguments that the Public Finance Act's provisions do not, in fact, contain a definition of public finance but only define their objective scope. At the same time, however, they emphasise the nature of these provisions as it relates to the bilateral processes of collecting and distributing public funds.¹¹

Polish literature on this topic is characterised by a diverse approach to defining public finance.¹² In addition to the frequent references to the normative definition quoted above, attention is also paid to definitions developed by the economic sciences. In the latter case, public finance regulations refer to specific money flows in the economy. Subjecting money flows to these regulations aims to ensure, on the one hand, the possibility for the public budget to obtain funds to finance goods and services, and on the other hand, to define the principles of its operation, including those related to the execution of expenses.¹³ Emphasising the economic aspect of

6 Mikos-Sitek, 2010, pp. 35–37.

7 Public Finance Act of 26 November 1998 (consolidated text: Journal of Laws of 2003, No. 15, item 148 as amended), Art. 3, and Public Finance Act 30 June 2005 (Journal of Laws of 2003, No. 249, item 2104 as amended), Art. 6.

8 Differences in this respect occur primarily in relation to the Public Finance Act of 1998.

9 See: Ruśkowski, 2010a, p. 31.

10 Mierzwa, 2012, pp. 63–66; Kosikowski, 2010a, p. 34; Kosikowski, 2007, p. 18.

11 See: Chojna-Duch, 2010, pp. 11–12; *Łipiec-Warzecha*, 2011, p. 31; *Sołtyk*, 2017, pp. 10–11.

12 For example, see: Chojna-Duch, 2010, pp. 9–10.

13 See: Nowak-Far and Frysztak, 2019, pp. 17–18, and the literature cited therein. See also: Majchrzycka-Guzowska, 2016, p. 13.

public finance is related to the frequently appearing definition that stipulates it as public monetary resources and operations undertaken with these resources, as well as to references to legal regulations that define the rules for performing these operations.¹⁴

Referring to several basic aspects of the definitions of public finance that appear in the related Polish literature, attention should also be paid to inseparable issues regarding planning, recording, reporting, and control. The importance of these processes in defining public finance is emphasised by Ruśkowski, who draws attention to the particular complexity of the issue. Defining finance as the phenomena related to the collection and spending of funds, Ruśkowski emphasises that only when the listed financial operations are carried out by public law entities can we talk about the concept of public finance.¹⁵

Dębowska-Romanowska also highlights the complexity of the currently formulated definitions of public finance, analysing them jointly on three levels, as follows: (i) a group of legal institutions (public finance legal system), (ii) a mechanism for collecting and spending public resources (i.e. a management mechanism), and (iii) a financial resource that actually exists and is subject to distribution (centralised public financial resources).¹⁶

Aligning the definition of public finance with the process of collecting revenues and making expenditures by public entities, Dębowska-Romanowska also notes the state coercion that accompanies the process of collecting revenues, which is applied to the extent and in the manner specified by law.¹⁷

Public finance is, therefore, an important element of a state's fiscal policy. It comprises the process of collecting public funds and spending them by public entities for purposes related to the focus of their activity. It is characterised by an element of coercion that is present in the process of collecting public revenue. The processes typical of public finance in Poland are shaped by the provisions of law in force at various levels of the hierarchy of sources of law, including the provisions of the Constitution.

14 See: Dębowska-Romanowska, 2010, p. 7; Lipiec-Warzecha, 2011, p. 31. See also: Gaudemet and Molinier, 2000, p. 17.

15 See: Ruśkowski, 2008, p. 21. See also: Kosikowski, 2007, pp. 18–21; Maśniak, 2009, pp. 128–132.

16 Dębowska-Romanowska, 2010, p. 8.

17 Dębowska-Romanowska, 2010, p. 7.

2. Constitutional foundations of the functioning of public finance

2.1. Range of adjustment

Provisions concerning the issue of public finances are contained in various parts of the Constitution of the Republic of Poland of 2 April 1997, with Chapter X, entitled 'Public Finances' (Arts. 216–227) being entirely devoted to them. The provisions of the Constitution of the Republic of Poland regulate several issues, including, above all, cases in which the issues of public finance require the regulation of the rank of an Act. They also regulate issues related to the state budget, the Budget Act, and the procedure for its adoption, as well as the financial management of local government units. In this case, another subject of regulation is the matter of public levies, including, above all, taxes. In addition, the Constitution's provisions refer to basic issues related to the functioning of the state's central bank.¹⁸

2.2. Public debt and the budget deficit

The Constitution of the Republic of Poland covers the institution of public debt and the budget deficit. The relevant regulations primarily address issues related to the shaping of principles that are the basis for a safe financial economy. According to Art. 216 para. 5 sentence 1 of the Constitution of the Republic of Poland, it is forbidden to take out loans or grant financial guarantees and sureties as a result of which the state public debt will exceed three-fifths of the value of the annual gross domestic product (GDP). As such, this provision establishes the permissible limit of state public debt and, at the same time, introduces a ban on exceeding it, assuming the relation to the value of annual GDP as the basis for assessing an acceptable level.

An extension of the regulation covered by Art. 216 para. 5 of the Constitution of the Republic of Poland is Art. 220, which details solutions that are important from the perspective of the principle of budgetary balance and its protection. According to the jurisprudence of the Constitutional Tribunal, the balance of public finances is a constitutionally protected value, and the measures taken by the state to protect it must comply with the rules set out in the Constitution.¹⁹ At the same time, the Constitutional Tribunal emphasises that the targets of these norms are

¹⁸ See: Kosikowski, 1997, p. 157; Dzwonkowski and Gliniecka, 2013, pp. 14–18; Mikos-Sitek and Zapadka, 2021, pp. 3–5.

¹⁹ Judgement of the Constitutional Tribunal of 4 December 2000, K 9/00, Jurisprudence of the Constitutional Tribunal 2000, No. 8, item 294; See also: Judgement of the Constitutional Tribunal of 27 February 2002, K 47/01, Jurisprudence of the Constitutional Tribunal, Series A, 2002, No. 1, item 6; Judgement of the Constitutional Tribunal of 24 November 2009, SK 36/07, Jurisprudence of the Constitutional Tribunal, Series A, 2009, No. 10, item 151.

public authorities, which are obliged to manage the condition of public finances, an important determinant of which is the level of public debt in relation to GDP as a significant factor determining the state's economic condition. Underlining public authorities' obligation is the establishment of a constitutional debt limit. Taking into account various factors affecting this limit, the legislator indicates additional prudential procedures in the provisions of the Public Finance Act. The above-mentioned provisions of the Constitution of the Republic of Poland, therefore, prohibit public authorities responsible for taking out loans and granting financial guarantees and sureties from taking these actions if they would lead to exceeding the constitutional debt limit (Art. 216 para. 5 of the Constitution of the Republic of Poland). These norms are also addressed to the Sejm, which cannot establish a budget deficit greater than that provided for in the draft Budget Act (Art. 220 para. 1 of the Constitution of the Republic of Poland). In the context of the case under consideration, the Constitutional Tribunal also emphasises that the above-mentioned provisions do not imply a prohibition of undertaking 'savings' activities that would precede exceeding the constitutional debt limit, nor a prohibition of undertaking such activities before exceeding other established prudential thresholds (see: Art. 86 of the Public Finance Act). However, this thesis should be considered applicable to all activities of public authorities related to shaping the level of budget deficit and public debt.²⁰

However, Art. 220 para. 2 of the Constitution of the Republic of Poland introduces the principle according to which the Budget Act may not provide for covering the budget deficit by incurring liabilities with the state's central bank. Consequently, the above-mentioned provision constitutes a protection against excessive deficit – for this reason, the said rule has been included in the Constitution of the Republic of Poland in one provision – in conjunction with the principles discussed above, resulting from Art. 220 para. 1. On the other hand, the provision refers to another constitutionally protected value as it relates to the financial independence of the central bank of the state, which is one important aspect of the bank's implementation of its primary objective related to responsibility for the value of Polish currency (see: Art. 227 para. 1 of the Constitution of the Republic of Poland).²¹ Art. 220 of the Constitution of the Republic of Poland, therefore, refers to the principle of budgetary balance and the rules strengthening its protection. Meanwhile, para. 1 of the above-mentioned provision is related to the course of work on the Budget Act and its planning nature. It also refers to the role of the Council of Ministers in this process, which is related to the exclusive legislative initiative the Council has in this case, as well as its responsibility for the state budget implementation stage. Apart from the protective function related to maintaining budget balance, para. 2 is also important

20 Judgement of the Constitutional Tribunal of 12 December 2012, K 1/12, Jurisprudence of the Constitutional Tribunal, Series A, 2012, No. 11, item 134.

21 See: Dębowska-Romanowska, 2016, pp. 1534–1535; Banaszak, 2009, pp. 944–946; Kosikowski, 1997, p. 159.

in the process of guaranteeing the independent monetary policy of Poland's central bank.²²

2.3. Local government units

The provisions of the Constitution of the Republic of Poland primarily provide for the competences of local governments related to participation in the exercise of public authority. At the same time, Art. 16 para. 2 states that a significant part of public tasks vested in local government under the laws should be performed on its own behalf and under its own responsibility. This is confirmed by the content of further provisions of the Constitution of the Republic of Poland that concern the functioning of local government in Poland and specify the scope of public tasks entrusted to it (see: Arts. 163 and 166).²³ Marking the organisational and functional separation of local government, the provisions of the Constitution of the Republic of Poland guarantee its independence within the framework of statutory public tasks, including financial independence.²⁴

Consequently, Art. 16 results in the principle of decentralising public authority and is the basis for the functioning of local government in Poland. Regulations in force in this regard at the Act level, which specify the tasks of local government units in detail, create a framework for their activity. This also applies to other aspects of their functioning.²⁵

The consequence of the division of public tasks between government administration bodies and local government units is the division of public revenues. As indicated above, one of the manifestations of the independence of local government units is financial independence, which can be guaranteed to these units by providing them with sufficient financial resources for the tasks they perform. In this case, financial resources are one of the measures ensuring local government units' ability to perform the entrusted public tasks, in addition to appropriate systemic solutions and administrative tools.

At the same time, attention should be paid to the key relationship between the amount of public income at the disposal of local government units and their ability to perform their tasks.²⁶ If local government units undertake a significant part of public tasks, the performance of which depends on the state of their public funds, it is necessary to consider the scope of the entrusted tasks and ensure sufficient income when defining the rules for operations at each level of local government.

22 The issue of public debt and budget deficit is discussed in detail later in this chapter.

23 See also: Decision of the Constitutional Tribunal of 30 November 1999, TS 104/99, Jurisprudence of the Constitutional Tribunal 2000, No. 1, item 21.

24 Banaszak, 2009, pp. 114–115.

25 Banaszak, 2009, p. 114.

26 Judgement of the Constitutional Tribunal of 20 February 2002, K 39/00, Jurisprudence of the Constitutional Tribunal, Series A, 2002, No. 1, item 4.

Taking the above into account, the provisions of the Constitution of the Republic of Poland guarantee that local government units share in public income in accordance with the tasks assigned to them (Art. 167 para. 1). These provisions also establish the principle according to which changes in the scope of tasks and competences of local government units should be accompanied by appropriate changes in the distribution of public revenue (Art. 167 para. 4). Similar regulations are also included in the constitutional laws in force in Poland.²⁷

In circumstances when the scope of tasks performed by local government units changes, the legislator may make changes guaranteeing the possibility of increasing the income of these units, depending on the nature of the tasks. The legislator may also provide funds in the form of a special-purpose subsidy. As such, a reduction in the income of local government units may occur in the event of a decrease in the scope of tasks they perform. Disputes regarding the adequacy of changes in the distribution of public revenues introduced by the legislator as a consequence of a change in the scope of tasks are to be resolved by the Constitutional Tribunal, which should take into account the principles discussed above, as well as the level of available resources in the context of the current situation of the state.²⁸

Art. 167 para. 2 of the Constitution of the Republic of Poland lists the basic categories of local government unit income, which include: own income, general subsidies from the state budget, and targeted subsidies from the state budget. Attention should be paid to the interpretation problems that arise in the classification of the individual income categories of local government units in the context of Art. 167 para. 2, which provides for subsidies from the state budget only. The provision referred to in para. 3 specifies that the sources of local government unit income are defined by law.²⁹ However, an open catalogue of the incomes of these units covered by the provisions of the Act on the Income of Local Government Units does not solve this problem given that not all local government unit income categories can be considered as own income, and subsidies used by local government units are not always special-purpose subsidies from the state budget.³⁰ Taking into account

27 See: Act of 8 March 1990 on commune self-government (consolidated text, Journal of Laws of 2023, item 40, as amended); Act of 5 June 1998 on powiat self-government (consolidated text: Journal of Laws of 2022, item 1526, as amended); Act of 5 June 1998 on voivodeship self-government (consolidated text: Journal of Laws of 2022, item 2094, as amended).

28 See: Judgement of the Constitutional Tribunal of 23 October 1995, K 4/95, Jurisprudence of the Constitutional Tribunal 1995, No. 2, item 11; Judgement of the Constitutional Tribunal of 23 October 1996, K 1/96, Jurisprudence of the Constitutional Tribunal 1996, No. 5, item 38; Judgement of the Constitutional Tribunal of 12 April 2005, K 30/03, Jurisprudence of the Constitutional Tribunal, Series A, 2005, No. 4, item 35; Judgement of the Constitutional Tribunal of 31 May 2005, K 27/04, Jurisprudence of the Constitutional Tribunal, Series A, 2005, No. 5, item 54. See also: Banaszak, 2009, pp. 758–759.

29 See: Act of 13 November 2003 on the income of local government units (consolidated text: Journal of Laws of 2022, item 2267).

30 For example, subsidies from the National Fund for Environmental Protection and Water Management.

the above doubts, it would be advisable to clarify the wording of Art. 167 para. 2 because it does not sufficiently refer to the applicable law in this respect. The provision of Art. 167 para. 3 of the Constitution of the Republic of Poland requires that the sources of local government unit income be specified in the Act; however, this does not mean that the content of this Act may be inconsistent with Art. 167 para. 2.³¹

Art. 168 of the Constitution of the Republic of Poland expresses the tax authority of local government units, granting them the right to determine the amounts of local taxes and fees. This provision is, therefore, a supplement to the above-mentioned constitutional provisions concerning the financial independence of local government units as the ability to levy tax is an important element of financial power. However, the right to determine the amount of local taxes and charges is not unlimited in this case because, in accordance with the above-mentioned provisions, it must be exercised within the limits set by the Act. This is consistent with the interpretation of this provision in connection with Art. 217 of the Constitution of the Republic of Poland.³²

3. Financial management of the state and financial management of local government units

Financial management by public entities is related to the implementation of specific public tasks at both the government and local government administration levels. The goal of the activity of the state and local government units in this area is to satisfy social needs. This requires appropriate financial outlays, the accumulation of which is based on the implementation of public tasks that aim to meet this goal. However, the scope of the tasks entrusted and performed has a significant impact on the amount and structure of the income collected and the expenses incurred. Financial management by public entities takes place on the basis and within the limits of the law (Art. 7 of the Constitution of the Republic of Poland), which, while determining their competences, leaves a certain scope of freedom to make decisions and creates conditions for operating on the basis of financial independence.³³

Resulting from the above-mentioned Art. 7, the principle of legalism requires that the activities of public authorities be based on specific legal provisions. As

³¹ See: Mikos-Sitek, 2019, p. 733.

³² See: Skoczylas and Piątek, 2016, p. 933, and the literature cited therein. See also: Judgement of the Constitutional Tribunal of 28 November 2013, K 17/12, Jurisprudence of the Constitutional Tribunal, Series A, 2013, No. 8, item 125. At this point, reference is made to the constitutional foundations of financial management by local government units. This issue is discussed in detail later in this chapter.

³³ Dębowska-Romanowska, 2010, pp. 21–23.

such, activities related to the exercise of public authority require specific legal bases that provide legitimacy for the exercise of the granted competences.³⁴ In the Polish literature on this subject and the jurisprudence of the Constitutional Tribunal, it is noted that from Art. 7 implies the obligation to define the competences of public authorities within the provisions of generally applicable law, which cannot be presumed. Attention is also drawn to the prohibition of their arbitrary execution.³⁵ The public authorities that are the targets of these provisions should be understood broadly in this case: they comprise all entities exercising public authority, including local government units.³⁶ The principle of legality resulting from these provisions and the taking of actions by public authorities according to the existing legal basis should also be referred to the principle of exclusivity of the act (see, primarily: Art. 216 para. 1 of the Constitution of the Republic of Poland).³⁷

In discussing financial management by the state and local government units, in addition to the applicable legal norms defining their competences and the rules for their implementation (statutory competence norm), we should also consider the planning basis for financial management in the form of a public financial plan (Budget Act,³⁸ budget resolution of local government units³⁹). Attention should also be paid to the state's position as the primary and independent entity of public finances, which means that the financial authority of other public entities derives from the state. In accordance with the generally accepted assumptions in the science of financial law, the provisions of the Republic of Poland's current Constitution define the rules for dividing financial power between the state and local government and the main attributes related to deciding on and collecting income, implementing expenses, and conducting financial management.⁴⁰

Art. 15 of the Constitution of the Republic of Poland emphasises that the territorial system of the state should ensure the decentralisation of public authority (the

34 Banaszak, 2009, p. 57; Judgement of the Constitutional Tribunal of 21 February 2001, P 12/00, Jurisprudence of the Constitutional Tribunal 2001, No. 3, item 47, decision of the Constitutional Tribunal of 4 October 2011, P 9/11, Jurisprudence of the Constitutional Tribunal, Series A, 2011, No. 8, item 86.

35 Banaszak, 2009, pp. 57–58; Resolution of the Constitutional Tribunal of 10 May 1994, W 7/94, Jurisprudence of the Constitutional Tribunal 1994, No. 1, item 23; Judgement of the Constitutional Tribunal of 14 June 2006, K 53/05, Jurisprudence of the Constitutional Tribunal, Series A, 2006, No. 6, item 66; Judgement of the Constitutional Tribunal of 4 December 2001, SK 18/00, Jurisprudence of the Constitutional Tribunal 2001, No. 8, item 256.

36 See: Decision of the Constitutional Tribunal of 22 May 2007, SK 70/05, Jurisprudence of the Constitutional Tribunal, Series A, 2007, No. 6, item 60; Judgement of the Constitutional Tribunal of 29 October 2009, K 32/08, Jurisprudence of the Constitutional Tribunal, Series A, 2009, No. 9, item 139.

37 Dębowska-Romanowska, 2010, pp. 116–117; Banaszak, 2009, pp. 57, 927–928; Ofiarski, 2016, pp. 1465–1466.

38 See: Art. 219 of the Constitution of the Republic of Poland and Art. 109 p.f.a.

39 See: Art. 211 p.f.a.

40 Dębowska-Romanowska, 2010, pp. 29–33.

principle of the decentralisation of public authority). The basic territorial division of the state should consider existing social, economic, and cultural ties and ensure that territorial units are able to perform the tasks assigned to them. As emphasised above, the division of public tasks between government administration and local government, and thus the participation of local government units in the exercise of public authority, is also related to their share of public revenues in accordance with the scope of the tasks they perform (principle of adequacy). Providing financial resources is one of the basic elements for guaranteeing the ability to perform public tasks. Pursuant to Art. 16 para. 2 of the Constitution of the Republic of Poland, local government in Poland performs a significant part of the public tasks assigned to it by law on its own behalf and under its own responsibility. This is important in the context of local government units conducting independent financial management, which is manifested by the annual setting of budget assumptions, as well as the decisions taken by local government bodies regarding budget resolutions and the implementation of the budget in accordance with the rules deriving from the regulations in force.⁴¹

Regarding the legal personality of local government units, Art. 165 para. 1 of the Constitution of the Republic of Poland is of particular importance. This article grants local government units legal personality and the right to property and other property rights, thus guaranteeing their implementation of public tasks. Granting legal personality and property ownership is the basis for separating local government units from other public law entities and an important element of recognising their independence, which is subject to judicial protection (Art. 165 para. 2 of the Constitution of the Republic of Poland).⁴²

Local government in Poland operates on three levels: commune, powiat, and voivodeship. The basis for its functioning is specified in the provisions of the Constitution of the Republic of Poland (Arts. 163–172) and political Acts.⁴³ In terms of financial management, the Public Finance Act of 27 August 2009⁴⁴ and the Act of 13 November 2003 on the Income of Local Government Units are especially significant.⁴⁵

41 Szewczuk, 2008, pp. 217–221.

42 See: Bach-Golecka and Golecki, 2016, p. 892.

43 Act of 8 March 1990 on municipal self-government (consolidated text: Journal of Laws of 2023, item 40, as amended); Act of 5 June 1998 on powiat self-government (consolidated text: Journal of Laws of 2022, item 1526, as amended); Act of 5 June 1998 on voivodeship self-government (consolidated text: Journal of Laws of 2022, item 2094, as amended). See also: Borodo, 2008b, pp. 36–37.

44 Consolidated text: Journal of Laws of 2023, item 1270, as amended.

45 Consolidated text: Journal of Laws of 2022, item 2267, as amended.

4. Public debt and budget deficit – current regulations and the state of affairs

4.1. *National public debt*

Polish literature points out that the issue of finances is fundamental for the functioning of the state. Consequently, appropriate importance should be attached to the level of regulation at which the application of the basic principles, as well as key solutions and institutions in this area, is recognised. Such regulation should be durable and based on constitutional provisions.⁴⁶ Public debt in Poland had, and still currently has, its basis in constitutional regulations, which, over time, have increasingly referred to the fundamental issues relating to public debt.

The Constitution of 3 May 1791 highlighted the powers of the Sejm in the scope of incurring public debt, excluding them in relation to the executive power.⁴⁷ Art. 8 of the Act of 17 March 1921 of the Constitution of the Republic of Poland,⁴⁸ however, it only contained a provision according to which the manner of exercising parliamentary control of state debt is determined by a separate Act, and referred in this respect to the Act of 25 September 1922 on control over the state's debts.⁴⁹ A similar scope of regulations existed in the Constitutional Act of 23 April 1935,⁵⁰ which determined participation in exercising control over the state's debts (Art. 31) and the Senate's right to take part in this process (Art. 46) as aspects of the Sejm's control over the government. In the post-war period, constitutional regulations did not consider the issue of public debt, which appeared – to a limited extent – at the level of statutory regulations.⁵¹

Of particular importance for the legal regulation of public debt and the budget deficit was the adoption of the Constitution of the Republic of Poland of 1997, which introduced significant regulations to protect the state against excessive debt for the first time. The provisions of the Constitution of the Republic of Poland include the requirement to regulate the rank of the Act in relation to taking out loans and the granting of financial guarantees and sureties by the state (Art. 216 para. 4).⁵² They also define the permissible limit of state public debt, which is tantamount to the practical prohibition of exceeding, in this case, three-fifths of the value of the annual GDP (Art. 216 para. 5 of the Constitution of the Republic of Poland).⁵³ It should

46 Ofiarski, 2010c, p. 175.

47 Sarnecki, 1997, pp. 24–25.

48 Journal of Laws, No. 44, item 267, as amended.

49 Journal of Laws, No. 89, item 805.

50 Journal of Laws, No. 30, item 227, and the Act of 2 January 1936 on the exercise of parliamentary control over the State's debts (Journal of Laws No. 2, item 3).

51 Ofiarski, 2010a, p. 139; Ofiarski, 2016, p. 1466.

52 See: Act of 8 May 1997 on sureties and guarantees granted by the State Treasury and certain legal persons (consolidated text: Journal of Laws of 2023, item 926, as amended).

53 Dębowska-Romanowska, 2010, pp. 118–119.

be noted that these provisions fulfil an important function related to preventing excessive state debt in the following years. With regard to the issue of calculating the value of annual GDP, the Constitution of the Republic of Poland introduces the requirement for regulation at the statutory level.⁵⁴

Pursuant to Art. 221 of the Constitution of the Republic of Poland, legislative initiative in the Act on Contracting Public Debt and the Act on Granting Financial Guarantees by the State is vested exclusively in the Council of Ministers. The basis for this solution is its constitutional responsibility for protecting the interests of the State Treasury, including the implementation of competences related to the preparation of the annual draft Budget Act and the implementation of the budget. Within 5 months following the end of the budget year, the Council of Ministers submits a report to the Sejm on the implementation of the Budget Act, together with information on the state's debt. After considering the submitted report and hearing the opinion of the Supreme Audit Office, the Sejm adopts a resolution on granting or refusing to discharge the Council of Ministers (Art. 226 of the Constitution of the Republic of Poland). The provisions of the Constitution of the Republic of Poland also introduce mechanisms that provide protection against an excessive deficit. In this respect, Art. 220 para. 1 prohibits increasing expenditure or limiting revenues planned by the Council of Ministers, which results in the Sejm establishing a larger budget deficit than that provided for in the draft Budget Act. However, according to the principle introduced in para. 2 of this article, the budget law cannot provide for covering the budget deficit by incurring a liability with the central bank of the state. It should be noted that while Art. 220 para. 2 of the Constitution of the Republic of Poland only mentions the Budget Act, the prohibition covered by this provision applies to all Acts.⁵⁵

The regulations and principles covered by the provisions of the Constitution of the Republic of Poland have been detailed in Poland in the public finance laws in force over the years. Following the establishment of the current Constitution, the Public Finance Act of 26 November 1998 was adopted,⁵⁶ with issues related to state's public debt being covered by Chapter II (Arts. 36–47). This Act was in force until the end of 2005 and was replaced by the Act of 30 June 2005 on public finances,⁵⁷ which retained a similar division of the matters covered by its regulation (Arts. 68–94). Since 1 January 2010, the Act of 27 August 2009 on public finances, which, like previous Acts, regulates the issue of state public debt under Chapter II (Arts. 72–102), has applied.⁵⁸

There is no uniform definition of public debt in the Polish literature. This issue is related to the complex nature of public debt and the need for analysis in both the legal and economic fields. However, its essence should be seen as a lack of

54 See: Act of 26 October 2000 on the method of calculating the value of the annual gross domestic product (consolidated text: Journal of Laws of 2021, item 151).

55 Ofiarski, 2010a, p. 145.

56 Consolidated text: Journal of Laws of 2003, No. 15, item 148, as amended.

57 Journal of Laws No. 249, item 2104, as amended.

58 Journal of Laws No. 157, item 1240, as amended – original text; consolidated text Journal of Laws of 2023, item 1270, as amended.

adjustment to public needs and the ratio of the related expenses to the amount of financial resources at the state's disposal. The phenomenon of public debt is also related to the situation of limited sources of income and the inability to reduce public expenditure.⁵⁹ According to the definition most often proposed in the literature, public debt comprises the total financial liabilities of public sector entities due to legal and financial events, which are diversified from an economic and legal perspective, as well as shortfalls resulting from financing the surplus of public expenditure over and above public revenues that has been accumulated in previous periods.⁶⁰ It is rightly pointed out that most definitions of public debt formulated in the Polish and foreign literature emphasise its connection with taking out public loans, which are an important source of debt, although not the only source.⁶¹

In the current Public Finance Act of 2009, the legislator did not include a legal definition of state public debt, unlike both the Public Finance Act of 1998 (see Art. 9) and the Public Finance Act of 2005 (see Art. 10).⁶² Art. 72 of the current Public Finance Act defines the material scope of state public debt and lists the debt titles that constitute it. Pursuant to this provision, state public debt covers the various liabilities of the public finance sector, as follows: (i) issued securities covering monetary receivables, (ii) credits and loans taken out, (iii) accepted deposits, and (iv) due liabilities: (iva) resulting from separate Acts and final court judgements or final administrative decisions, (ivb) recognised as undisputed by the relevant public finance sector entity that is the debtor.

As a result of the amendment to Art. 72 of the Personal Income Tax Act, which entered into force on 1 January 2019, a new Section 1a was added to this provision. This section clarifies that the debt titles listed in points 1–3 above include financial liabilities arising from legal relationships whose name corresponds to these debt titles and from other legal relationships that produce economic effects similar to those arising from securities relating to monetary receivables, credit and loan agreements, and accepted deposits.⁶³

The provisions of the Public Finance Act include the definition of the deficit and surplus of the public finance sector. In general terms, the difference between public

59 Chojna-Duch, 2010, p. 259.

60 See: Panfil, 2009, pp. 79–80; Chojna-Duch, 2010, p. 260; Kosikowski, 2010a, pp. 218–219.

61 See: Owsiak, 1993, p. 330; Panfil, 2009, pp. 79–80; Borodo, 2010, pp. 211–212; Gaudemet and Molinier, 2000, pp. 371–372.

62 Pursuant to Art. 9 of the Public Finance Act of 1998: '1. State public debt is understood as the nominal debt of entities from the public finance sector, determined after eliminating financial flows between entities belonging to this sector. 2. The debt of the State Treasury means the nominal debt of the State Treasury'. However, in accordance with Art. 10 of the Public Finance Act of 2005: '1. State public debt is understood as the nominal value of the debt of the public finance sector units, determined after eliminating mutual obligations between the units of this sector. 2. The State Treasury debt is understood as the nominal value of the State Treasury debt'.

63 See: Act of 14 December 2018 amending the Public Finance Act and certain other acts (Journal of Laws of 2018, item 2500); para. 3 of the Regulation of the Minister of Finance of 28 December 2011 on the detailed method of classifying debt titles included in the state public debt (consolidated text: Journal of Laws of 2023, item 58). See also: Ofiarski, 2010a, pp. 165–167.

revenues and public expenditure determined for the accounting period is called the budget result (balance). Pursuant to Art. 7 para. 1 p.f.a., a positive difference in this case is a surplus, whereas a negative difference is a deficit of the public finance sector. Public revenues and public expenditures, as well as the surplus or deficit of the public finance sector, are determined after eliminating financial flows between the units of this sector (principle of consolidation, Art. 7 para. 2 p.f.a.).

However, it should be noted that the concepts of the deficit and surplus of the public finance sector have a broader scope than those of budget deficit and surplus, which refer to public funds collected and spent within a specific budget (state or local government unit).⁶⁴ Art. 113 para. 1 p.f.a. concerns the method of calculating the level of deficit and surplus in relation to the state budget. It also determines the sources of financing the state budget deficit and other borrowing needs in the state budget, including revenues from: (i) the sale of Treasury securities on the domestic and foreign markets; (ii) loans taken out from domestic and foreign banks; (iii) loans; (iv) the privatisation of State Treasury assets; (v) amounts derived from repayments of credits and loans granted; (vi) state budget surpluses from previous years; (vii) a surplus of the European funds budget, which is the source of the repayment of state budget liabilities incurred to cover the European funds budget deficit (Art. 118 para. 4 p.f.a.); and (viii) other financial operations (Art. 113 para. 2 p.f.a.).

The modern understanding of the principle of budget balance, which is based on the postulate of pursuing a rational financial policy and intermediate concepts such as the deadlock theory, assume the existence of a budget deficit while considering the application of specific rules related to shaping the level of this deficit, including maintaining a specific limit. This issue was discussed above in relation to public debt, where the limit is set at 60% of annual GDP. This rule is a constitutional principle in Poland (Art. 216 para. 5 of the Constitution of the Republic of Poland) but is also included in the provisions of the Public Finance Act (Art. 74 para. 1). According to the standards applicable in the European Union, in the event of a budget deficit, the limit is 3% of the annual GDP. This value has not been transcribed directly in Polish regulations and is in accordance with the provisions of Art. 126 of the Treaty on the Functioning of the European Union (TFEU) and Art. 1 of the Protocol on the Excessive Deficit Procedure Annexed to the Treaty.⁶⁵ Art. 126 of the TFEU and the provisions of the Protocol define the excessive deficit procedure and impose an obligation on EU Member States to avoid it. Competences related to supervising the development of the budgetary situation and the amount of deficit and public debt in these countries have been imposed on the European Commission, which is guided in its activities by the assessment of the criteria listed in Art. 126 para. 2 of the TFEU.

⁶⁴ Kornberger-Sokołowska, 2019, pp. 37–39.

⁶⁵ See also: Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union, OJ L 174, 26.6.2013, 1–727.

The current Public Finance Act also allows for the possibility of a deficit in the budget of European funds. Pursuant to Art. 117 para. 1 p.f.a., this budget is an annual plan of income and refundable expenses intended for the implementation of programmes financed with European funds, excluding funds intended for the implementation of technical assistance projects and specific categories included among agricultural funds (expenditures under the European Agricultural Guarantee Fund⁶⁶). The plan includes income from the implementation of programmes financed with European funds and expenses for the implementation of such programmes – which are in part subject to reimbursement (Art. 117 para. 2 p.f.a.). The budget of European funds constitutes part of the state budget (Art. 110 points 4–6 p.f.a.).

Neither the budget deficit nor the surplus of European funds are included in the deficit or surplus of the state budget, respectively. Despite the legal separation of the European funds budget deficit, no own sources of financing have been introduced for it: the budget deficit of European funds is financed as part of the borrowing needs of the state budget. Consequently, the costs of servicing liabilities incurred to cover them will comprise expenses of the state budget as costs of servicing the debt of the State Treasury (see: Art. 76 point 1b and Art. 124 para. 5 p.f.a.).⁶⁷

Art. 118 para. 4 p.f.a. determines the allocation of the surplus of the European funds budget, indicating the repayment of state budget liabilities incurred to cover the deficit that occurred in the European funds budget. This provision has been criticised in the literature because the consequence of its application may be a situation in which free funds on the European funds budget accounts (resulting from a surplus) cannot be used to repay previously incurred liabilities of the State Treasury. This, in turn, creates a need to incur further obligations. The issue of keeping separate records of liabilities incurred to finance the budget deficit of European funds also seems to be a problem.⁶⁸

In the scope of the issues discussed, public debt management is also of particular importance. The literature on the subject indicates three basic models of solutions used in practice in this area. The government (ministerial) model is characterised by locating the public debt management process within the structures of one of the ministries (applicable in Poland but also, for example, in Spain and Greece). In the case of the banking model, public debt management is delegated to the central bank (e.g. Cyprus, Denmark). The agency model, in contrast, assumes entrusting public debt management to specialised institutions that exercise a high degree of autonomy in the scope of tasks performed, while also maintaining government control (e.g. Belgium, France, Germany).⁶⁹

In connection with the public debt management model adopted in Poland, the provisions of the Public Finance Act provide for several competences of the Minister

66 See: Art. 5 para. (3) of Regulation (EU) 2021/2116 of the European Parliament and of the Council of 2 December 2021 on the financing, management, and monitoring of the common agricultural policy and repealing Regulation (EU) No 1306/2013, OJ L 435, 6.12.2021, 187–261.

67 Misiąg, 2019, pp. 428–429; Tyniewicz, 2010, p. 388; Mikos-Sitek, 2020, pp. 278–279.

68 Misiąg, 2019, p. 429.

69 Lipiec-Warzecha, 2011, pp. 403–404.

of Finance. These competences are primarily related to control over the public finance sector in terms of compliance with the principle that holds that the state public debt cannot exceed 60% of the value of the annual GDP. The Minister of Finance also supervises the status of the State Treasury debt (Art. 74 paras. 1 and 2 p.f.a.). However, the competences entrusted to the Minister of Finance as a whole are much more complex. Their scope also includes developing a four-year strategy for managing the State Treasury debt and influencing the state public debt. This strategy is presented to the Council of Ministers for approval, and the Council of Ministers then presents it to the Sejm along with a justification for the draft Budget Act. Pursuant to Art. 75 para. 1 p.f.a., the Minister of Finance prepares the strategy while considering, in particular: (i) debt management conditions related to the macroeconomic stability of the economy, (ii) analysis of the level of state public debt, (iii) forecasts of the level of state public debt and State Treasury debt, (iv) forecasts of the costs of servicing the State Treasury debt, (v) shaping the debt structure, and (vi) forecasts and analyses of undue liabilities under State Treasury sureties and guarantees.

The Minister of Finance is also authorised to take actions to finance the borrowing needs of the state budget, which, based on applicable regulations, can be understood as the need for the financial resources required to finance the deficit (state budget and the budget of European funds) and expenditures of the state budget (see: Art. 76 p.f.a.). The borrowing needs of the budget are, therefore, related to the budget policy pursued in the state, and their financing has a direct impact on the public debt.⁷⁰

To finance the borrowing needs of the state budget, and in connection with managing the debt of the State Treasury, the Minister of Finance is authorised to carry out specific financial operations, including: (i) incurring financial liabilities on behalf of the State Treasury, in particular by issuing securities and taking out loans and credits on the domestic and foreign markets; (ii) repayment of the liabilities referred to in point 1 above; (iii) carrying out other financial operations related to debt management, including operations related to financial derivative instruments; and (iv) management of the budget surplus of European funds (see: Arts. 77 et seq. p.f.a.).

Prudential and restructuring procedures are instruments aimed at controlling the size of the state public debt. They define the rules of conduct in the event of an increase in the state public debt and reaching a level that may affect compliance with the limit set by the provisions of the Constitution of the Republic of Poland (Art. 216 para. 5; see also Art. 74 para. 1 p.f.a.). The factor that determines the application of a specific procedure is the value of the ratio of state public debt to GDP at the end of the budget year (in accordance with the annual announcement of the Minister of Finance, see: Art. 38 p.f.a.). Subsequent procedures provide for obligations to take specific actions that reduce the ratio of state public debt to GDP.⁷¹ The provisions of the Polish Public Finance Act currently provide for two ranges for this ratio, designating the necessary actions and measures. If the ratio of the amount of

⁷⁰ Szmaj, 2019, p. 291.

⁷¹ Mikos-Sitek, 2011, p. 85.

state public debt to GDP is greater than 55% and less than 60%, then: (i) For the next year, the Council of Ministers adopts a draft Budget Act in which: (ia) no state budget deficit is expected, or the level of difference between the state budget's revenues and expenditures is assumed to ensure that the ratio of the State Treasury debt to GDP expected at the end of the financial year covered by the draft Act will be lower than the ratio announced by the Minister of Finance in accordance with Art. 38 of the Public Finance Act, there is no increase in the remuneration of employees in the state budget sphere, including employees of the units referred to in Art. 139 para. 2 p.f.a. (Chancellery of the Sejm, Chancellery of the Senate, Chancellery of the President of the Republic of Poland, Constitutional Tribunal, Supreme Audit Office, Supreme Court, Supreme Administrative Court together with voivodeship administrative courts, National Council of the Judiciary, common judiciary, Ombudsman, Ombudsman for Children, National Broadcasting Council, President of the Office for Personal Data Protection, Institute of National Remembrance – Commission for the Prosecution of Crimes against the Polish Nation, National Electoral Office, and the National Labour Inspectorate), (ib) the indexation of annuities and pensions cannot exceed the level corresponding to the increase in prices of consumer goods and services announced by the Central Statistical Office for the previous financial year, (ic) a ban on granting loans and credits from the state budget is introduced, with the exception of instalments of loans and credits granted in previous years, (id) no increase in expenses is expected in the units referred to in Art. 139 para. 2 p.f.a. (listed above) at a level higher than in government administration; (ii) The Council of Ministers reviews state budget expenditure financed with funds from foreign loans and multi-annual programmes; (iii) The Council of Ministers presents a restructuring programme, which is aimed at reducing the ratio of state public debt to GDP, to the Sejm; (iv) The expenditure of a local government unit's budget, specified in the budget resolution for the following year, may be higher than the revenues of this budget increased by the budget surplus from previous years and free funds, only by the amount related to the implementation of tasks co-financed from European funds; (v) The Council of Ministers reviews the applicable regulations in order to present proposals for legal solutions affecting the level of state budget revenues, including those regarding the application of tax rates on goods and services; (vi) The State Fund for the Rehabilitation of Disabled Persons receives a targeted subsidy from the state budget for the implementation of a task related to the reimbursement of costs to employers who employ disabled persons within a specified scope (Art. 26a of the Act of 27 August 1997 on the vocational and social rehabilitation and employment of disabled persons),⁷² to the amount of up to 30% of the funds planned for the implementation of this task for a given year; (vii) Government administration bodies may enter into new obligations for the preparation of investments if they are provided with financing using public funds from the European Union budget, non-repayable funds from aid granted by Member States of the European Free Trade Association,

72 Consolidated text: Journal of Laws 2022, item 100 as amended.

and funds other than those mentioned above from non-refundable foreign sources, at the maximum allowable level specified in the regulations or procedures relating to a given type of investment, not less than 50% of the total costs. These limitations do not apply to: (viiia) construction or reconstruction of national roads in order to remove the threat of road safety violations, (viiib) investments financed from the National Road Fund and intended to finance the renovation, construction or reconstruction of national roads destroyed or damaged due to floods, carried out by the General Director of National Roads and Motorways in the years 2010–2012,⁷³ (viiic) the preparation, implementation, construction, or operation of electronic toll collection systems referred to in Art. 13i of the Act of 21 March 1985 on public roads,⁷⁴ (viid) liabilities due to compensation for real estate taken over under the Act of 10 April 2003 on special rules for the preparation and implementation of investments in the field of public roads.⁷⁵

However, in a situation where the ratio of the amount of state public debt to GDP is equal to or greater than 60%: (i) The solutions listed in points 1 and 2 and 5–7 above apply; (ii) No later than one month from the date of announcing the ratio of state public debt to GDP, the Council of Ministers presents a restructuring programme, which is aimed at limiting this ratio to below 60%, to the Sejm; (iii) The expenditure of a local government unit's budget, specified in the budget resolution for the following year, may not be higher than the revenues of this budget; (iv) Starting from the seventh day after the date of announcement of the ratio of state public debt to GDP, public finance sector units may not grant new sureties and guarantees.

Another instrument aimed at maintaining the level of state public debt at an appropriate level is the restructuring programme prepared by the Council of Ministers. This programme is initiated when the ratio of state public debt to GDP exceeds the designated limits (see: Art. 86 para. 1 points 2c and 3b, in connection with Art. 87 p.f.a.). The provisions of the Public Finance Act do not stipulate the exact form in which the restructuring programme should be prepared, although they do specify its content.

The restructuring programme should indicate the reasons for the change in the ratio of state public debt to GDP and define a programme of actions aimed at reducing this ratio. The requirements set out in the provisions of the Public Finance Act in relation to this programme concern, in particular, proposals for legal solutions affecting the level of expenses and expenditures in the public finance sector. In addition to delineating the causes and corrective measures, the recovery programme should also include a three-year forecast regarding the ratio of state public debt to GDP, along with the expected development of the country's macroeconomic situation.

Art. 88 p.f.a. specifies cases where the procedures discussed above are not followed. This article applies to exceptional situations in the country, which are most

73 See: Art. 37 para. 1 of the Act of 24 June 2010 on special solutions related to removing the effects of the flood of 2010 (Journal of Laws No. 123, item 835, as amended).

74 Consolidated text: Journal of Laws of 2023, item 645 as amended.

75 Consolidated text: Journal of Laws of 2023, item 162.

often related to additional expenses in the state budget. Exclusions concern the introduction of martial law, a state of emergency, and a state of natural disaster across the entire territory of the Republic of Poland (see: Arts. 228 et seq. of the Constitution of the Republic of Poland).⁷⁶

The Minister of Finance's competences on the sphere of managing public debt also involve exercising control by checking the implementation of the obligations arising from Art. 86 p.f.a. In this case, the Minister has the right to request additional information from public finance sector entities about their current and forecast debt and debt structure. However, if he detects any irregularities, he informs the authorities supervising the activities of these entities (Art. 74 paras. 3–5 p.f.a.).

In the case of the implementation of prudential and restructuring procedures, it is of particular importance to establish uniform rules for calculating the value of liabilities covered by the state public debt (debt titles, Art. 72 paras. 1 and 2 p.f.a.). This applies primarily to reporting obligations on public debt, including those related to the publication of information on the amounts and ratios of public debt to GDP.⁷⁷ Pursuant to Art. 73 para. 1 p.f.a., state public debt is calculated as the nominal value of liabilities of public finance sector units after eliminating mutual liabilities between units of this sector (consolidation of liabilities).

The nominal value of liabilities constituting the debt titles comprising state public debt is calculated as the amount of the principal benefit under any securities issued or loans and credits taken out, payable on the date of their redemption or on the due date of the liability. Where mature liabilities are indexed or capitalised, the nominal value corresponds to the initial nominal value, taking into account the capital increase resulting from indexation or capitalisation. The value of accepted deposits is calculated according to the nominal value understood as the amount of capital that the debtor is obliged to pay to the creditor, in accordance with the conditions specified in the contract, in the event that the deposit is liquidated. The nominal value of the deposit is the value on which interest is calculated. The value of liabilities due includes the amount of liabilities whose payment deadline has expired and are not time-barred or cancelled, excluding interest. However, this value does not apply to liabilities arising from the granting of sureties and guarantees due to the addition of interest to the amounts of the sureties and guarantees granted.⁷⁸ Art. 73 p.f.a., which specifies the rules for calculating the nominal value of liabilities constituting debt titles, also applies to calculating the amounts of undue liabilities under sureties and guarantees that are not included in the state public debt (Art. 73 para. 4 p.f.a.).⁷⁹

76 See: Tyniewicz, 2020, pp. 288–289; Borodo, 2008a, pp. 116–117; Ofiarski, 2010a, pp. 139–140; Lipiec-Warzecha, 2011, p. 450.

77 Szmaj, 2019, pp. 282–283.

78 See: paras. 2–4 of the Regulation of the Minister of Finance of 30 March 2010 on the detailed method of determining the value of liabilities included in the state public debt, State Treasury debt, and the value of liabilities under sureties and guarantees (Journal of Laws No. 57, item 366).

79 Para. 5 of the Regulation of the Minister of Finance of 30 March 2010.

The value of liabilities denominated in foreign currencies is converted into Polish currency in such a way that their nominal value is determined by conversion into Polish currency at the average exchange rate of foreign currencies announced by the National Bank of Poland, applicable on the last business day of a given reporting period.⁸⁰

The category of tools used to limit the increase in state debt and maintain an acceptable level of public finance sector deficit also includes the so-called ‘stabilising expenditure rule’ (Art. 112aa p.f.a.), which was introduced by the Act of 8 November 2013 amending the Act on public finances and amending certain Acts.⁸¹ The primary goal of implementing this solution into the Polish legal system was to expand the catalogue of tools for strengthening macroeconomic stability on subsequent levels of practical solutions.⁸² This complemented the existing system of fiscal rules based on the constitutional debt limit and prudential thresholds regulated by the provisions of the Public Finance Act. The basis for introducing these changes was the implementation of the provisions of Council Directive 2011/85/EU of 8 November 2011 on the requirements for the budgetary frameworks of the Member States into Polish law.⁸³

By establishing detailed rules regarding the properties of the budgetary framework of EU Member States, this directive obliges them to introduce a numerical fiscal rule into their national legal orders. The rule is intended to effectively support, from a multi-annual perspective, the general government sector’s implementation of the obligations regarding budgets arising from the Treaty on the Functioning of the European Union (maintaining the level of the general government sector’s deficit and debt below the reference values of 3% and 60% of the annual GDP, respectively) while creating conditions conducive to economic growth (Art. 5 of Directive 2011/85/EU). Pursuant to Art. 6 of Directive 2011/85/EU, numerical fiscal rules for individual countries should include: (i) a definition of the purpose and scope of the rules; (ii) effective and timely monitoring of compliance with the rules, based on credible and independent analysis carried out by independent bodies or bodies that are functionally independent from the budgetary authorities of the Member States; (iii) the consequences of failure to comply with these rules.

The stabilising expenditure rule determines the method of calculating the maximum limit of public finance sector units’ expenditure for each financial year (Art. 112aa para. 1 p.f.a.). It should be noted that the scope of operation of the expenditure rule in the Polish Public Finance Act is limited in terms of both its subject (see: Art. 112aa para. 3) and objective (see: Art. 112aa para. 3).

With the Act of 13 July 2023 amending the Public Finance Act and certain other acts,⁸⁴ Art. 112a¹ was also newly added to the Public Finance Act. This article

80 Para. 6 of the Regulation of the Minister of Finance of 30 March 2010.

81 Journal of Laws of 2013, item 1646 as amended.

82 See: Justification for the draft act of 8 November 2013 amending the Public Finance Act and amending certain acts, Sejm of the 7th term, Sejm Form No. 1789 of 3 October 2013.

83 OJ L 306, 23.11.2011, 41–47.

84 Journal of Laws of 2023, item 1641.

introduced a mechanism relating to the result and debt of the general government sector into the Polish fiscal framework. The mechanism is activated if, in one of the years n or $n-1$, the most up-to-date forecast of the European Commission suggests that the reference value for at least one of the values indicated in the provision has been exceeded. The concept of fiscal adjustment, expressed as a percentage of GDP, was also established.

As part of this amendment to the Public Finance Act, other significant changes to the treatment of defence expenditure were introduced. In accordance with the ‘defence clause’ added in the algorithm for determining the expenditure limit that cannot be exceeded, these expenditures will be reflected in the result of the general government sector only at the time of the delivery of military equipment (see: Art. 112aa paras. 4a–4c p.f.a). The above rules apply for the first time to the draft Budget Act for 2024.

4.2. Public debt of local authorities

It is assumed that the main source of public debt of local government units is incurring long-term liabilities in the form of loans and credits and issuing securities. In addition, it is a consequence of the budget deficit and the lack of funds to cover it. Also important in this case are the rules of the functioning of the modern state; these rules assume the greater availability of high-quality public services, which is associated with increased investment expenditure.⁸⁵

As indicated above, local government units incur liabilities in the form of credits, loans, and the issuing of securities. The provisions of the Public Finance Act also specify a closed list of purposes for which these liabilities may be incurred, as follows: (i) covering the local government budget deficit occurring during the transitional year, (ii) financing the planned budget deficit of local government units, (iii) repayment of previously incurred liabilities arising from the issue of securities and loans and credits taken out, and (iv) advance financing of activities financed from funds from the European Union budget.

The implementation of legal activities related to incurring obligations takes place in accordance with the jurisdiction of local government authorities adopted in this case and the principles of the representation of local government units.

The provisions of the current Public Finance Act of 2009 specify several important solutions and mechanisms intended to serve the ongoing control and reduction of the deficit and debt of local government units. First, the sum of credits and loans taken out, other liabilities included in the debt title referred to in Art. 72 para. 1 point 2 p.f.a., and liabilities arising from the issued securities may not exceed the amounts specified in the budget resolution of the local government unit (Art. 91 para. 1 p.f.a.). The indicated limit is determined annually in the obligatory part of

⁸⁵ Ofiarski, 2010a, pp. 148–149; Borodo, 2008a, pp. 225–229; Sawicka, 2011, pp. 534–536; Owsiak, 2018, pp. 157–158.

the budget resolution of each local government unit (Art. 212 para. 1 points 6 and 6a p.f.a.). In addition, when incurring obligations to finance the planned budget deficit of local government units, repay previously incurred liabilities related to securities and incurred loans and credits, and pre-finance activities financed from funds from the EU budget, the executive body of local government units must obtain the opinion of the regional chamber of audit on the possibility of repaying the obligation (Art. 91 para. 2 p.f.a.). This obligation also applies to taking out loans from state special purpose funds and from state and local government legal persons for expenses related to investments and investment purchases (Art. 90 p.f.a.). The opinion of the regional chamber of audit is not required in the case of short-term liabilities if they are subject to repayment or redemption in the same year in which they were incurred or issued, and liabilities with a value not exceeding 0.5% of planned current income, provided that the sum of liabilities incurred in this respect in the budget year did not exceed 1% of planned current revenues (Art. 91 para. 3 p.f.a.). Further, the opinion of the regional chamber of audit regarding the possibility of repaying a credit or loan and purchasing securities is not binding for the executive body of a local government unit, which means that a negative opinion does not constitute an obstacle to incurring a financial obligation. This opinion is considered to be of a rather informative nature, which does not mean, however, that the applications it covers may be treated marginally by local government units in practice.⁸⁶

Pursuant to Art. 92 p.f.a., local government units may only incur liabilities whose servicing costs, if any, are incurred at least once a year provided that the discount on securities issued by local government units does not exceed 5% of the nominal value and that the capitalisation of interest is prohibited. These restrictions also apply to the case of taking out loans from state special funds and from state and local government legal persons for expenses related to investments and investment purchases (Art. 90 p.f.a.). However, they do not apply to situations where the purpose of incurring a liability is to cover the temporary budget deficit of local government units occurring during the year.⁸⁷

The provisions of the Public Finance Act also include the principle according to which public finance sector entities, excepting the State Treasury, may not incur financial liabilities in the form of loans or credits, issue securities, or grant sureties and guarantees whose nominal value due for payment on maturity, expressed in PLN, was not determined on the date the transaction was concluded. This restriction, covered by Art. 93 para. 1 p.f.a., is intended to reduce the risks associated with underdetermination of the nominal value of financial liabilities incurred by public finance sector entities, including local government units. The cases in which this limitation does not apply are determined by the Council of Ministers by way of a regulation (e.g. in the case of credits or loans denominated in foreign currencies taken out from international financial institutions of which the Republic of Poland

⁸⁶ Stupienko, 2014, p. 239; Trykozko, 2010, pp. 187–188; Mikos-Sitek, 2023, commentary to Art. 91.

⁸⁷ See: Trykozko, 2010, pp. 240–241.

is a member or with which it has signed a cooperation agreement, or those taken out from governments or government institutions of foreign countries, pursuant to agreements concluded by the Council of Ministers with the relevant government or government institution).⁸⁸

The Public Finance Act of 2009 also introduced significant changes in the debt and deficit of local government units. It primarily formulates the principle related to the need to balance the budget in its current part (the so-called ‘golden rule of public finances’). Pursuant to Art. 242, the decision-making body of a local government unit cannot adopt a budget in which the planned current expenses are higher than the planned current revenues plus revenues from: (i) the budget surplus of the local government unit from previous years, reduced by the funds specified in point 3 below; (ii) repayment of loans granted in previous years or funds from investments made in previous years; (iii) unused funds in the current account of the budget, resulting from the settlement of income and expenses financed therewith related to specific rules for budget implementation specified in separate Acts, and resulting from the settlement of funds from the European Union budget and subsidies for the implementation of a programme, project, or task financed with the participation of these funds.

Similarly, at the end of the financial year, the current expenses incurred cannot be higher than the current revenues increased by the categories of revenues listed above. The Public Finance Act establishes certain exceptions in this respect: in accordance with Art. 242 para. 3, the current expenditure incurred may be higher than the current revenue increased by the budget surplus from previous years only by the amount related to the implementation of current expenditure with the participation of funds from the European Union budget if these funds were not transferred in a given financial year. The provisions of the current Public Finance Act also resulted in a departure from quantitative debt limits and a transition to an individual debt ratio (see: Art. 243).⁸⁹

In the scope of the discussed issues, solutions related to long-term financial planning are also important. Local government units adopt a long-term financial forecast in the form of a resolution of the decision-making body of the local government unit, the obligatory part of which is the forecast of the debt amount. The multi-annual financial forecast is adopted for the period of the budget year and at least three subsequent years; in accordance with Art. 227 para. 2 p.f.a., the forecast of the debt amount is prepared for the period for which liabilities have been incurred and are planned to be incurred. This provision indicates the separation of the projected implementation time of projects and the repayment time of the debt incurred for their implementation. This is related to the possible longer repayment period for

88 Regulation of the Council of Ministers of 17 December 2010 on cases in which restrictions do not apply to incurring certain financial liabilities by public finance sector entities, with the exception of the State Treasury (Journal of Laws No. 250, item 1678).

89 Puchacz, 2009, pp. 53–54.

local government units' liabilities in relation to the deadline for completing individual tasks.⁹⁰ The period for which the forecast of the debt amount is prepared depends on the liabilities already incurred in the forecast, as well as on those indicated as planned to be incurred (which may be related, for example, to the sources for covering the local government unit's budget deficit). This approach to the objective scope of forecasting the amount of debt of specific local government units enables an assessment of their ability to repay the debt within the time horizon specified in the forecast and in relation to both existing and new debt (planned to be incurred in the base year). The forecast of the debt amount also takes into account all the data necessary to determine the permissible debt limit. The calculation of this limit for specific years is made in accordance with the formula specified in Art. 243 p.f.a.⁹¹

In terms of the debt management of a local government unit, solutions related to internal control are also important, with management control being particularly pertinent. Pursuant to Art. 68 p.f.a., management control in public finance sector units (including local government units) constitutes all activities undertaken to ensure the implementation of goals and tasks in a legal, effective, cost-effective, and timely manner. Its purpose is to ensure, in particular: (i) the compliance of activities with legal provisions and internal procedures, (ii) the effectiveness and efficiency of operation, (iii) the credibility of reports, (iv) resource protection, (v) the observation and promotion of the principles of ethical conduct, (vi) the efficiency and effectiveness of information flow, and (vii) risk management.

Competences related to the coordination of these activities lie with the relevant ministers and managers of individual units of the public finance sector, and in the case of local government units, the commune head, mayor, city president (in a commune), and the chairman of the management board of local government units (in a powiat or voivodeship).⁹² Management control standards provide for internal auditing. The related obligations do not apply to all local government units in Poland: audits are conducted in those units for which the amount of income and revenues or the amount of expenses and expenses included in the budget resolution exceeds PLN 40,000,000 (Art. 274 para. 3 p.f.a.).⁹³

In the case of the issues discussed, attention should also be paid to the activities of regional audit chambers, which supervise local government units' operations in the fields of financial matters and control financial management and public procurement.⁹⁴ Pursuant to Art. 11 para. 1 of the Act on Regional Chambers of Audit, their jurisdiction in the scope of supervisory activities includes resolutions and orders adopted by local government bodies regarding: (i) procedures for adopting the

⁹⁰ Leńczuk, 2012, pp. 1021–1022.

⁹¹ Lachiewicz, 2010, p. 404.

⁹² See: Arts. 70–71 and Art. 276 p.f.a.

⁹³ Poniatowicz, Salachna and Perło, 2010, pp. 175–184.

⁹⁴ See: Art. 1 para. 2 of the Act of 7 October 1992 on Regional Chambers of Audit (consolidated text: Journal of Laws of 2023, item 1325) and Art. 171 para. 2 of the Constitution of the Republic of Poland.

budget and its amendments, (ii) the budget and its changes, (iii) incurring liabilities affecting the amount of a local government unit's public debt and granting loans, (iv) the principles and scope of granting subsidies from the budget of a local government unit, (v) local taxes and fees to which the provisions of the Tax Ordinance Act apply, (vi) discharge, and (vii) the multi-annual financial forecast and its changes.

The Public Finance Act provides for the issuance of opinions by regional audit chambers at the stages of creating and implementing local government unit budgets. The fundamental criterion for the operation of the regional chamber of audit in the course of analysing materials and shaping the content of opinions is compliance with the law (legality).⁹⁵

During supervisory proceedings, the board of the locally competent regional audit chamber may rule on the invalidity (in whole or in part) of the budget resolution. This occurs when the competent authority fails to remove the irregularities identified by the regional audit chamber within the prescribed deadline. If the budget resolution is declared invalid, the entire budget or the part affected by the invalidity is determined by the board of the chamber (see Art. 12 paras. 1–3 of the Act on Regional Chambers of Audit).⁹⁶

Negative opinions of the regional audit chamber on the draft budget of a local government unit and the budget implementation report are not binding; however, the executive body of the local government unit is obliged to present such opinions to the unit's decision-making body, together with a response to the allegations contained therein. It is possible to make an appeal regarding the opinion of the regional audit chamber to the executive body of the local government unit (see Art. 20 of the Act on Regional Chambers of Audit).

5. Management in crisis

The provisions of the Public Finance Act provide for mechanisms whose practical application depends on the occurrence of special circumstances. These solutions are of a diverse nature, which means their use also has significantly different premises. This applies, for example, to the institution of transferring expenses (Arts. 171–172 p.f.a., Art. 180 p.f.a. – Introduction of a state of emergency in the territory of the state or its part, Art. 180a p.f.a. – Declaration of a state of epidemic threat or a state of epidemic, Art. 180b – Initiation of the Security Plan needs of the Armed Forces implemented by entrepreneurs), blocking planned budget expenditures (Arts. 177–179 p.f.a. – Threat to the implementation of the Budget Act), the stabilising expenditure rule (Art. 112d p.f.a. – Exclusion of application in the event of, for example,

⁹⁵ See: Art. 171 para. 1 of the Constitution of the Republic of Poland.

⁹⁶ For more, see: Borodo, 2008a, pp. 252–254.

martial law and a state of emergency, a state of natural disaster, a state of epidemic throughout the territory of the Republic of Poland, Art. 112aa para. 4 letters a–d p.f.a. – Defence clause), and the application of prudential and sanitation procedures (Arts. 86–87 p.f.a., Art. 88 p.f.a. – Exclusion of the application in the event of the introduction of martial law, a state of emergency, and a state of natural disaster throughout the territory of the Republic of Poland).⁹⁷ These solutions also apply to the financial management of local government units.

The period of the COVID-19 pandemic and the ensuing economic crisis resulted in several changes to the application of the provisions of the Public Finance Act, in addition to many other legal Acts covering various spheres of the functioning of the state and local government units, including issues related to their financial management. The Act of 2 March 2020 on special solutions related to the prevention, counteracting, and combating of COVID-19, other infectious diseases and crisis situations caused by them is of key importance in this case.⁹⁸ The amendment of 31 March 2020⁹⁹ of this Act introduced multiple legal solutions to mitigate the economic effects of the pandemic. The amending Act also provided for the application of protective mechanisms targeting entrepreneurs that resulted from the introduced restrictions (e.g. standstill benefit, co-financing of employee remuneration and business costs, loans, tax facilities, and facilities related to the payment of social security contributions).¹⁰⁰

As a consequence of the above-mentioned provisions being in force, the Public Finance Act temporarily introduced numerous exemptions to the requirements applicable, for example, to changes in the financial plans of public finance sector entities that are intended to increase flexibility in managing public funds. These exclusions also concern the rules for awarding subsidies, including those awarded to local government units; the use of funds from the general reserve; the creation and allocation of funds from specific reserves; and the rules for transferring and blocking expenses. In addition, the changes applied to local government units, including, for example, the deadlines for adopting local government budget resolutions, increases in the limit of liabilities to cover the transitional budget deficit of local government units occurring during the year, balancing the budget in the current part, and the principles of shaping the individual debt ratio.

97 See also: Dębowska-Romanowska, 2010, p. 119.

98 Consolidated text: Journal of Laws of 2023, item 1327 as amended.

99 Act of 31 March 2020 amending the Act on special solutions related to the prevention, counteracting and combating of COVID-19, other infectious diseases and crisis situations caused by them and certain other acts (Journal of Laws of 2020, item 568, as amended).

100 See: Justification of the draft act of 31 March 2020 amending the act on special solutions related to the prevention, counteracting and combating of COVID-19, other infectious diseases and crisis situations caused by them and certain other acts, Sejm of the 9th term, Sejm Form No. 299 of 26 March 2020.

6. Conclusions

The current Public Finance Act has introduced several significant changes in the field of public finances, in addition to completely new solutions, often dictated by the requirement to implement European Union law. The new solutions, which are discussed above, concerned long-term planning (at the level of the state and local government units), the application of a stabilising expenditure rule, changes in the construction of regulations relating to the definition of state public debt, and the budget of European funds, among other issues. The Public Finance Act of 2009 also introduced noteworthy changes regarding the debt and deficit of local government units, the adoption of the principle of balancing the budget in the current part, and the move away from quantitative debt limits toward an individual debt ratio.

The events of recent years related to the COVID-19 pandemic and the war in Ukraine, as well as the ongoing economic crisis, have resulted in even more attention being paid to issues of fiscal stability, public debt, and budget balance, which are of fundamental importance for the functioning of the state. As discussed above, fiscal stability is a constitutionally protected value in Poland (Art. 216 para. 5, Art. 220 of the Constitution of the Republic of Poland), and detailed regulations are covered by the provisions of the current Public Finance Act of 2009. The inclusion of the fiscal rule in the provisions of the Constitution means that exceeding the established level of 60% of annual GDP must be treated as a violation of the Constitution and, therefore, gives rise to specific obligations and liability among specific entities. The provisions of the Constitution of the Republic of Poland do not provide for any exceptions to the prohibition covered by Art. 216 para. 5 and should be understood as an absolute prohibition.¹⁰¹ As such, the provisions of the Public Finance Act that specify the rules for calculating the state public debt constitute the implementation of the obligation specified in Art. 216 para. 5 of the Constitution of the Republic of Poland. It should also be considered correct – in the discussed context – to indicate the debt of the public finance sector (Art. 9 p.f.a.) as an element of the definition of state public debt.¹⁰² It should be noted here that the limit for the budget deficit adopted in the European Union, set at 3% of annual GDP, is not expressly included in the provisions of Polish regulations and remains in accordance with the provisions of Art. 126 of the TFEU and Art. 1 of the Protocol on the Excessive Deficit Procedure.¹⁰³

The concept of the debt of the general government sector, which is a fiscal convergence criterion and is important for the issue of public debt, is included in Art. 1 para. 5 of Council Regulation (EC) No. 479/2009 of 25 May 2009 on the application of the Protocol on the Excessive Deficit Procedure Annexed to the Treaty

101 Dębowska-Romanowska, 2010, p. 119; Szmaj, 2019, p. 265; Bożek, 2021, pp. 73–75. See also: Art. 228 of the Constitution of the Republic of Poland.

102 Szmaj, 2019, p. 265.

103 Poland was subject to this procedure in 2004 and 2009. For more details, see: Kargol-Wasiluk, 2011, pp. 81–96.

Establishing the European Community.¹⁰⁴ Reference should also be made to the provisions of Regulation (EU) No. 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union (ESA 2010) in the context of the importance of the subjective and objective scopes of the mentioned concept due primarily to the existing differences in national regulations.¹⁰⁵

Pursuant to Art. 1 para. 5 of Regulation No. 479/2009, public debt means the total gross debt at the nominal value remaining at the end of the year in the public administration sector (S.13), excluding those liabilities that correspond to financial assets held by the public administration sector (S.13). In addition, Art. 1 para. 5 sentence 2 defines the scope of public debt (with an indication of the classification of ESA 2010 codes), stipulating that it consists of public sector liabilities in the following categories (debt titles): cash and deposits (AF.2), debt securities (AF.3), and loans (AF.4). In this case, public debt should, therefore, be understood as the gross debt of the general government sector, expressed as a nominal value, existing at the end of the year and consolidated within this sector. While it can be concluded that the provisions of the Polish Public Finance Act are largely consistent with the above definition of public debt (recognition of debt at a nominal value, gross recognition, consolidation of liabilities), several differences should be noted. In the field of debt titles, the Public Finance Act additionally lists liabilities arising from separate Acts and final court judgements or final administrative decisions that are recognised as undisputed by the relevant public finance sector entity that is the debtor. These liabilities are laid out in Art. 72 para. 1 point 4, which is related to the adopted cash method of calculating public debt. This method involves recording only those financial operations that result in the actual inflow and outflow of money from public authority accounts, as opposed to the ESA 2010 methodology that uses the accrual method, where the size of the transaction is determined at the time the liability arises or its due date.¹⁰⁶

As far as the scope of the definition of public debt is concerned, there is also a difference in the recognition of liabilities under guarantees and sureties. In the cases of both the cash method and the accrual method, potential liabilities arising from the above-mentioned debt titles do not constitute public debt. However, under the ESA 2010 methodology, after meeting certain criteria, the potential debt may become the debt of the entity that provides the guarantee or surety (the so-called ‘presumption of debt assumption’). This usually occurs with a request to execute a guarantee or surety covering all or part of the guaranteed amount. Such an obligation may be treated as a debt title in accordance with the ESA 2010 methodology.¹⁰⁷

104 OJ L 145, 10.6.2009, 1–9, as amended.

105 OJ L 174, 26.6.2013, 1–727. See also: Walczak, 2017, p. 298; and in the previous legal status, Dębowska-Romanowska, 2010, pp. 120–121.

106 See: Pomorski, 2012, p. 482 and the literature cited therein.

107 Szmaj, 2019, p. 268. See also: Marchewka-Bartkowiak, 2013, p. 2.

However, the subjective scope of the concept of public debt in national and EU law shows differences in how the public finance sector is approached. Poland's Public Finance Act (Art. 9) indicates a catalogue of units constituting this sector. On the other hand, in accordance with the provisions of Regulation No. 549/2013, the general government sector includes all units of the general and local government sector and all non-market, non-commercial institutions that are controlled by these units. It also covers other non-market producers. These units are legal entities created through a political process with legislative, judicial, or executive powers over other institutional units in a given area. Their primary function is to provide goods and services to society and households on a non-market basis and to redistribute income and assets.

The provisions of Regulation No. 549/2013 also refer to the issue of financial management by general and local government units, which are usually entitled to obtain financial resources through mandatory transfers from other institutional units. In addition, to meet the basic requirements for an institutional unit, a general and local government unit must have its own financial resources obtained from income from other units or received in the form of transfers from other units of the sector and must be authorised to expend such financial resources in order to achieve its objectives. It must also be able to take out loans on its own account (points 20.05 – 20.07 of Annex A to Regulation No. 549/2013). From the above, it follows that the approach to the general government sector was based on the criterion of the activities conducted and the adopted method of financing the units constituting this sector. It should be acknowledged that the Public Finance Act provides for specific organisational and legal forms in which public finance sector units are created, which are characterised by specific rules for financing their activities, subject to the reservation introduced by Art. 8 para. 2 p.f.a. that they may be created on the basis of this Act or separate Acts.¹⁰⁸

However, full adaptation to the methodology covered by EU regulations would require a qualitatively significant change in the scope of national regulation, considering the fiscal rule arising from the Constitution of the Republic of Poland and the assessment of the effects of its compliance when changing the provisions of the Public Finance Act, including those regarding prudential and remedial procedures. Undoubtedly, such a change would increase the practical implementation of the principle of the transparency of public finances, but it would also mean the Polish legislator has less influence in determining the level of public debt and would reduce the possibility of taking into account specific national conditions.¹⁰⁹

108 Sawicka, 2010, pp. 35–80; Chojna-Duch, 2010, pp. 173–209; Borodo, 2010, pp. 47–54; Mikos-Sitek, 2010, pp. 301–312.

109 Szmaj, 2019, p. 266.

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CHAPTER 6

ROMANIA: NATIONAL IDENTITY AND EU'S COMMON VALUES. VISION, REALITY, EXPECTATION



DIANA CÎRMACIU

Abstract

Concepts such as financial policy and finance have always been emotionally charged. Some people are fascinated and guided by this field; others are frightened by the possible foreboding of dark days. Some hold notions that burden these concepts with all the sins that have arisen since the 'creation of the world' to the present day; others attribute to them the qualities of a universal panacea for all the problems of mankind. Examining these attitudes indicates that no one treats the issues of finance and financial policy with carelessness, despite their damaged behaviour. When the concept of finance is enriched by becoming public finance, interest is heightened. Each citizen, as a taxpayer or even if not a taxable person, forms their own perception of the concept of public finance and financial policy. In fact, the terms 'budget', 'finance', 'austerity budget', 'rectification', and 'public debt' are part of our everyday language, whether or not we are specialists in the field. Financial policies, and implicitly public finances, have always been seen as essential elements of the social and economic life of every nation; however, they are becoming increasingly prominent today. Public finances now occupy this important position because, in many countries of the world, a large part of the gross domestic product is channelled through financial instruments to central and local public authorities. Public finances exist to serve specific objectives and fulfil certain tasks that could not be achieved by any other means. They achieve their social mission through the distribution and control functions they perform. Though we cannot exhaust all sides of the

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complex issue of national financial policy and the relationship with European Union law in this chapter, we believe that solutions must combine orderly finances and well-thought-out policy that ensures a legal framework and human resources that understand and support general interests.

Keywords: *financial policy, public finance, state budget, strategies, financial balance*

1. Introduction – approach to the concept of financial policy in Romanian financial science doctrine. Formal sources – the Romanian Constitution

1.1. Financial policy – general concepts

Financial or public finance policy is part of both economic policy and the general policy of the state, with economic objectives also playing an important role in the latter. In a market economy, public financial resources provide the state with a wide range of services, including social, economic, law and order, and national security-related actions. The role of public finances is mainly two-fold¹ (i) the redistribution of GDP to provide the necessary funds for the broad-based reproduction of GDP, the human factor, the organisational-social framework, and its relations with the environment; and (ii) ensuring the funds for the restructuring, consolidation, development, and improvement of the superstructure of society, and state intervention to regulate economic and social life. Finance plays an important role in the economic and social sphere, and the extent of this role depends on the degree of the country's economic development and the participation of finance in the processes of the primary distribution and redistribution of GDP, particularly net domestic product.

Each political party designs its own political programme. If the party is victorious in the elections (or enters a victorious coalition), it submits this programme to Parliament for debate, and it becomes a government programme. Formulae that are accepted by the legislature also contain financial policy coordinates. In Romania, the aim of the last few programmes of this kind has been the cohesive, balanced development of the country. The current domestic and international situation necessitates the promotion of government programmes in which financial policy is aimed at economic development, progress, social protection, support for social and cultural activity, the integrity of public wealth, and raising the standard of living of the Romanian population.

¹ Boța et al., 2002, p. 32.

In defining the concept of financial policy, we must bear in mind that it is the set of goals, instruments (institutional component), methods, and means for the mobilisation, distribution, and use of the financial resources needed to achieve economic and social objectives. We should also consider that the directions of financial policy have always been a challenge for decision-makers at the state level and beyond. As such, the financial sciences – the purpose of which is to regulate the relations of the constitution, distribution, and use of state and public institution funds in order to meet society's social and economic needs – have registered doctrinal concerns in this area.² Financial policy in all its complexity has been the subject of research by numerous theorists and practitioners, and the presence of concerns can be observed in both financial science and legal doctrine.)³. In conclusion, the financial policy promoted by state decision-makers also includes public expenditure, public revenue, and public credit relations. In this chapter, we analyse the features of these main coordinates in relation to EU rules.

1.2. The Constitution and regulations on financial relations

Our approach starts from the fact that the main sources of Romanian tax law are the Constitution, the fundamental Treaties of the European Union, the Conventions for the Avoidance of Double Taxation, the European Court of Human Rights jurisprudence, the Fiscal Code, and the Fiscal Procedure Code. An important role is also played in this field by the secondary normative Acts that apply the codes in fiscal matters as methodological norms, orders, instructions, and decisions.⁴

To ensure compliance with the laws (including in economic-financial matters), with all the rights provided by them, it is necessary to establish certain obligations

2 Cîrmăciu, 2015, p. 47.

3 For example, looking to the past, it is worth mentioning the rich research activity and foray into financial issues by Professor G. N. Leon (Professor of Financial Law at universities in Cluj and Bucharest, former member of the Romanian Parliament, and former Minister of National Economy and Finance). Given his concrete interaction with social-economic and political realities, Leon made his mark on the literature with works such as *Problematica financiară și cheștiunea banului* [Financial Problems and the Question of Money, n.t.], *Istoria economiei publice la români* [History of the Romanian Public Economy, n.t.], *Elemente de știință financiară* [Elements of Financial Science, n.t.], *Politica economică a Partidului Național Liberal* [Economic Policy of the National Liberal Party, n.t.], and *Politica noastră financiară* [Our Financial Policy, n.t.], in which he also addressed aspects of financial policy in Romania at that time. In the contemporary period, financial policy has an important place in studies and treatises. Cf. Leon, 1918, p. 15; Leon, 1924, p. 37; Leon, 1925, p. 45; Leon, 1932, p. 11; Leon, 1934, p. 26. For example, Professor I. Lazăr presents the objects of the study of public finance, which comprise public revenue and expenditure, public debt, and budgetary and fiscal policy. Cf. Lazăr, 2013, p. 36. The profound transformations that Romania's financial policies have undergone have also been summarised under the direction of Professor I. Văcărel, who considered that 'financial policy acts directly in the sphere of distribution, on the relationships that arise in the process of forming and directing public funds of financial resources to meet social needs'. Cf. Văcărel et al., 2001, p. 127.

4 Șova, 2014, p. 143.

and fundamental duties, the purpose of which is to defend the state in its capacity as guarantor of the legal order. From this perspective, we must also take into account the duty stipulated by the Romanian Constitution⁵ for citizens to contribute to public expenses through taxes and fees. It is also ordered that the fair settlement of fiscal burdens should be ensured through the legal system of taxation (we consider that equality before tax, on the one hand, and equality through tax, on the other hand, should be taken into account). The Constitution also prohibits any other benefits, apart from those stipulated by law, in exceptional situations.

Post-communist Romania's budget reform was initiated in 1991. The constitutional provisions related to the economy and finance represented a significant step in the budget reform. These constitutional provisions covered the formation, administration, use, and control of the financial resources of the state and administrative-territorial units. The term 'national public budget' was established and covered the state budget, the state social insurance budget, and local budgets.⁶ The Constitution also provides the general basis of the budget annuality, with the government having the obligation to prepare the draft state budget and the state social insurance budget annually.⁷ Along with these aspects, the fundamental law regulated the applicable solution in the event that the budget cannot be adopted within the legal term, entrusting the government to conduct economic and social activities according to the income and expenses of the previous financial year.⁸

The principle of the legality of taxes is regulated in Art. 139 of the Romanian Constitution, indicating that taxes, fees, and any other revenues of the state budget can only be established by law. At the local level, taxes and fees are established by decisions of the local or county councils. Finally, Art. 140 of the Constitution is also of interest for the topic under analysis and provides the general legal basis for the control exercised by the Court of Accounts, including the execution of budgets and external financial audit attributions.

2. Romania's financial policy – a strategy for resilience, development, and prosperity?

Romania's financial policy, as well as its entire fiscal-budgetary strategy, in the current period has been developed in accordance with the internal and international context, considering the fact that we live in complex times. Healthy, sustainable development is pursued based on the stimulation of investments, the development

5 Art. 56 of the Romanian Constitution.

6 Art. 138 para. 1 of the Romanian Constitution.

7 Art. 138 para. 2 of the Romanian Constitution.

8 Art. 138 para. 3 of the Romanian Constitution.

of human resources (including in the public sector), and the support of Romanian companies. In addition, emphasis is placed on the role of digital transformation⁹ and the efficiency of public administration.

After the challenges generated by the COVID-19 pandemic,¹⁰ a health crisis that doubled as an economic crisis, and the war on Romania's border, economic recovery focused on domestic production, workers, companies that provide jobs, and the sovereign debt. On the agenda are reforms and the multi-year programming of public sector investments, supported by attracting European funding. The promoted policy on public spending complies with the rules arising from legal regulations, such as (i) their precise and limited destination, according to the annual budget law; (ii) the impossibility of registering in the budget or hiring and paying from a budget an expense for which there is no legal basis and no budgetary provisions; and (iii) monitoring the multiplier effect of public expenditures and their efficiency. In addition, the effective management of the public debt must also be taken into account, with the aim being to maintain the sustainability of this debt.

Thus, macroeconomic stability, ensuring the multiplier effect of public spending, and maintaining the public debt at sustainable levels are the elements that can bestow Romania the status of a state with healthy public finances. Further, through its financial policy, Romania will have to intensify measures to reduce the gaps with the economies of Western European states in the medium and long term, with the priorities being education,¹¹ health, digitalisation, innovation, and infrastructure investments. Along with these targeted directions, the ultimate goal of any policy will be to pursue the maximum good for national interests. The defined goal, thus, becomes a lasting notion, and only the means of achieving it are variable.

2.1. Coordinates of the financial policy in the field of public spending

In the current period, governors have the obligation to develop and implement a fiscal-budgetary policy characterised by prudence in budget expenditures, considering the Council Recommendation of 3 April 2020 with a view to bringing an end to the situation of an excessive government deficit in Romania 2020/C 116/01¹² and

⁹ Mihăilă, 2021, p. 61.

¹⁰ Cîrmăciu, 2021, pp. 67–68.

¹¹ In the draft budget for 2024, the government allocated 4.3% of GDP for education. We are witnessing historic growth in education; however, the structure of this budget also includes the National Recovery and Resilience Plan component, which means that the amounts in the form of budget credits from the actual state budget will be reduced. European funds are, thus, included in the packaging of the budget projection. For the year 2024, see: *Legea bugetului de stat pe anul 2024* [Online]. Available at: <https://mfinante.gov.ro/static/10/Mfp/buget2024/proiectbuget2024/proiectlegebugetdestat2022024.pdf> (Accessed: 15 December 2023).

¹² Council of the European Union, 2020.

the Commission Staff Working Document 2023 Country Report – Romania.¹³ The basic pillars of the fiscal-budgetary policy consist of the reform of public finances¹⁴ and companies with state capital, the management of public debt, the tax system, and policies in the field of state aid. During this period, several measures have been targeted that were quickly implemented, including measures to adapt to the current state of affairs generated by the conflict on the Romanian border, reduce inflation, increase the purchasing power of the population, respond to the trends in the pricing policy in the energy sector, and implement the recommendations from the European Commission and the International Monetary Fund.

In the period 2021–2023, the objectives of Romania’s fiscal and budgetary policy were established in a context marked by the crisis resulting from the COVID-19 pandemic, during which, in a lockdown unprecedented in modern history, there were even orders to suspend fiscal rules. Let us not forget that before the pandemic, Romania already had the largest current account deficit in the area and the largest budget deficit, which had the effect of obvious economic imbalances. The Ministry of Finance published the fiscal-budgetary strategy for the 2024–2026 horizon, the strength of which was considered to be its focus on public policies designed as a strategic response to the current economic problems, economic development, social protection, human capital, the field of European funds, and policies formulated in the context of the commitments assumed within the National Recovery and Resilience Plan (NRRP).

It seems that the problem of the relationship between politics and economics is topical, given that they have common elements as a basis, for example, human action. Economic facts must be directed toward collective interests, harmonising individual interests with the collective interest. Even if politicians often ‘blame’ economists for not formulating effective solutions to correct difficult public finance situations, they do not notice that, often, they themselves do not follow the economists’ recommendations because political motivations require the selection of other formulas. The balance between the political and the economic is the foundation of the problem, which also lies in the complicated external and internal conjuncture of the crises faced by economies that require paradigm changes in the global economy’s model of evolution. In this context, Romania has established the following objectives for budget construction for the year 2024 and the 2025–2026 horizon:¹⁵ (i) the continuation of measures for economic recovery; (ii) acceleration of economic growth, maintaining and supporting a new sustainable, fair and inclusive development framework that ensures an economically efficient transition, socially

13 European Commission Staff Working Document, 2023 Country Report – Romania, Accompanying the document Recommendation for a Council Recommendation on the 2023 National Reform Programme of Romania and delivering a Council opinion on the 2023 Convergence Programme of Romania, SWD(2023) 623 final of 24 May 2023.

14 Actions to ‘rewrite’ the laws regarding public finances and fiscal-budgetary responsibility have also been considered.

15 *Proiectul Strategiei fiscal-bugetare pentru perioada 2024–2026, in public debate, 2023.*

bearable and focused on competitiveness, innovation and decarbonization leading to the elimination of vulnerabilities in the economy and ensure a decent standard of living; (iii) continuation of the gradual implementation of fiscal consolidation, contributing, in this way, to the decrease of inflation, interest rates, the trade and current account deficit of the balance of payments, as well as to the stability of the exchange rate of the leu, taking into account the fragility of the internal and external environment, the budgetary effort that must be allocated to the new law on the pension system and the implementation of the PNRR reforms that must be completed by 2026; (iv) reform, prioritization and multi-year programming of public investments in an efficient, professional and transparent manner with a multiplier effect and direct contribution to the gross formation of fixed capital, by increasing the contribution of European funds related to the 2021–2027 financial framework and those related to the Recovery Mechanism and Resilience that finances the reforms and investments established through the PNRR, the largest stimulus package from the European resources allocated to Romania; (v) consolidation of a predictable fiscal policy committed to reducing the budget deficit, for supporting and adapting the business environment to the challenges raised by the series of crises facing society, simplifying taxation and perfecting legislation according to evasive phenomena, in order to create the premise for a healthy and sustainable economic growth.

Other aspects identified in the scope of the commitments to be assumed for the development of the Romanian society refer to the development and diversification of public debt management tools to maintain the public debt at a sustainable level; making measures to create and consolidate public finances through the qualitative efficiency of public expenditures; improving budget programming with an emphasis on the identification and financial support of active economic measures to assist the most vulnerable groups; reforms in the fields of work and pensions; support for small and medium-sized enterprises whose supply chain has been heavily affected by the Russo-Ukrainian conflict; strengthening budgeting on programmes based on result indicators, which can allow for credible and responsible budget construction and full transparency of public spending; improving the clarity and coherence of the budget process; prioritising sectoral policies; and ensuring real competition between proposed projects to finance and support performance.

The distribution of expenses in the budget must be planned with more care than in other years. Considering the government's obligation to conduct the fiscal-budgetary policy in a prudent manner that ensures the sustainability of the country's fiscal position in the medium and long term, the following measures will be taken into account when estimating expenses for 2024: abolishing vacancies; increasing the norms for establishing structures at the level of service/direction/general direction; reducing the proportion of public management positions at the main authorising level of credits from 12% to 8%; granting holiday vouchers and the food allowance only for civil servants with an income below 8.000 lei net per

month;¹⁶ capping the increase of harmful conditions at 15% of the basic salary but no more than 1.500 gross lei per month for all areas of activity in the budget sector; the approval or modification of expenditure norms for institutions and public authorities regarding the provision of cars and fuel consumption; and reducing the public dignity functions of the Secretary of State, State Councilor, Undersecretary of State, and Vice President by 25%.

Other measures taken into account in the area of budget expenditures mainly aim at (i) increasing social security pensions by 13.8% starting in January 2024 and granting recalculated pensions according to the new pension law starting in September; (ii) a 5% increase in the basic salaries of staff paid from public funds, with the exception of education staff, who will benefit from a 20% increase granted in two instalments on 1 January and 1 June; (iii) compensating overtime work by staff assigned to executive or management functions in the budgetary sector, as well as work performed on weekly rest days, public holidays, and other days upon which there is no work in accordance with the regulations in force, only with additional free time, with certain exceptions provided by law; (iv) mandating institutions and public authorities not to award bonuses their staff; (v) suspending the filling of vacant or temporarily vacant positions by competition or examination; and (vi) the non-granting of benefits, compensatory payments upon retirement, etc. Investment expenses must also be taken into account: the proposals for 2024 amount to RON 120,081 million, representing approximately 6.93% of GDP. The investment estimates for the years 2025 and 2026 are RON 111,930 million¹⁷ and RON 129,221 million, respectively.¹⁸

2.2. Coordinates of the financial policy in the field of achieving budget revenues

Within the distribution of the social product, during each year, the funds necessary to cover the financing of development and consumption are established and accumulated. The highest weight is given to those intended for social-economic development, which are, thus, included in the state's revenues. One perspective considers that the factors of an increase of budgetary resources are influenced by the action of the economic factors that contribute to the increase of public revenues; monetary factors such as interest and credit; demographic factors, which are reflected in the increase in the number of taxpayers; the various geopolitical contexts (i.e. events that can lead to the increase of military expenditure); and social factors, which involve the redistribution of resources in areas such as health and social security.¹⁹

In 2023, the EU's excessive deficit procedure was launched for Romania. The country's fiscal-budgetary situation was analysed during meetings between officials

16 The value of the holiday voucher will increase from 1.450 lei/year to 1.600 lei/year so that officials are not affected by the introduction of the 10% social health insurance contribution to holiday vouchers.

17 The amount represents approximately 5.95% of GDP. See: Guvernul României, 2023.

18 The amount represents approximately 6.40% of GDP. See: Ibid.

19 Postolache, 2009, p. 149.

from the European Commission, ECOFIN, and the Romanian government. In these discussions, it was concluded that it is necessary to adopt a package of measures to contribute to the reduction of the budget deficit in order to avoid possible sanctions, for example, the suspension of European funds allocated to Romania. The Commission also warned representatives of the Romanian government that if the situation does not improve by implementing these measures, there will be no other option but to conclude that Romania has not made the appropriate efforts and has not responded effectively to the Council's recommendations, and, thus, must assume all the associated consequences. This was the context upon which the adoption of a package of fiscal-budgetary measures on 26 October 2023 was based. The application of this package aims to meet the budget deficit targets.²⁰

To ensure Romania's long-term financial sustainability, the measures within the aforementioned law (Law no. 296/2023) include the establishment of a minimum tax of 1% on turnover for companies that register a turnover of over EUR 50 million in the previous year and that determine a profit tax lower than the minimum tax on turnover in the calculation year (this tax is applied to total income adjusted for non-taxable income, investments, and depreciation). Among the measures ordered, an additional tax for credit institutions is established. This tax is calculated by applying a tax rate to the turnover as follows: 2% between 1 January 2024 and 31 December 2025, and 1% starting from 1 January 2026. The turnover includes income from interest, dividends, taxes, and commissions, as well as other categories of income.

Going further, in the aforementioned legal text, we can also identify a measure regarding the establishment of an additional tax for operators in the oil and natural gas sectors that register a turnover of over EUR 50 million in the previous year. This additional tax is set at 0.5% of the total income adjusted with non-taxable income, and investments and depreciation are imposed. Another measure concerns implementing two tax rates on the incomes of micro-enterprises, as follows: (i) 1% for micro-enterprises that achieve incomes that do not exceed EUR 60,000, and (ii) 3% for micro-enterprises that (iia) achieve incomes over EUR 60,000 or (iib) carry out primary or secondary activities in the fields of publishing software products, accommodation facilities, restaurants, catering for events, bars, legal activities (companies with legal personality that are not fiscally transparent entities, constituted by lawyers), general or specialised healthcare activities, and dentistry.

Finally, with all the opposition, the inclusion of the amounts representing the nominal value of meal vouchers and holiday vouchers granted according to the law in the monthly calculation of the social health insurance contribution for natural

20 Law no. 296/2023 regarding some fiscal-budgetary measures to ensure Romania's long-term financial sustainability, published in the Official Gazette of Romania no. 977/27.10.2023. As their general objective, the measures ordered by the Romanian legislator must address the fiscal-budgetary consolidation of Romania through the efficient administration of public revenues, as well as the efficient use of the resources allocated for the financing of public expenses. They include measures to fight tax evasion and those that seek to achieve the efficient management of patrimony and the mineral and natural resources owned by the Romanian State.

persons who obtain income from wages and salary-related income was regulated.²¹ Also regulated was the modification of the regime applicable to the social health insurance contribution due in the case of natural persons who earn income from self-employed activities. According to this legal provision, individuals who earn income through independent activities from one or more sources owe the social health insurance contribution for each source of income at an equal annual basis of calculation, which cannot be higher than that corresponding to an annual calculation equal to the level of 60 gross minimum wages of the country.

Other directions refer to the field of VAT and excise duties, as set by the legal provisions regarding the increase of the VAT rate from 5% to 9% for the delivery of social housing (retaining the ceiling of RON 600,000); high-quality food; the delivery and installation of photovoltaic panels, solar thermal panels, heat pumps, and other systems of high-efficiency heating for fitness centres/sports facilities; and recreational activities (amusement and recreational parks, swimming pools) and entrance to sporting events. Also included are the transition from the application of the reduced VAT rate of 9% to the standard VAT rate for alcohol-free beer and foods with added sugar, the total sugar content of which is at least 10g/100g product, and the 10% increase in the excise duty for alcohol products from 1 January 2024.

The fiscal legal framework did not regulate aspects regarding taxation in the case of the ownership of immovable and movable assets of high value. Thus, in states where such provisions exist, the Romanian legislator also introduced a 0.3% taxation for residential buildings that fall into the category of high-value real estate and movable properties. The rate is applied to the difference between the taxable value of the building communicated by the local fiscal body through the taxation decision and the ceiling of RON 2,500,000. In the case of cars, this rate is applied to the difference between the purchase value and the ceiling of RON 375,000.

To conclude this first part of our analysis, we must specifically highlight the idea that through the financial policies promoted and, implicitly, through the budget construction of the current year,²² the governors propose a transition from a consumption economy to the one based on investments. The budget is centred on the investment sector, showing political commitment in this regard.

In addition, the public finance reform also aims to increase the efficiency of public finances and improve the likelihood of achieving medium-term budgetary objectives. An overview of the reform's objectives shows us that they can be achieved by evaluating the current legislative and institutional framework of financial transfers between the state budget and local budgets, creating statistical data infrastructure for analysing the impact of financial transfers on local budgets and local public

21 The measure entered into force starting with revenues related to January 2024.

22 Law no. 421/2023 of the state budget for 2024, published in the Official Gazette of Romania no. 1187/29.12.2023. According to Art. 2 para. 2 of the law, the state budget is established for revenues to the amount of RON 308,205 million, and for expenses to the amounts of RON 655,825 million in commitment credits and RON 404,238 million in budget credits, with a deficit of RON 96,033 million.

services, and reforming the system of financial transfers between the state budget and local budgets, including impact analyses and proposals for legislative changes.

Also of note is the modernisation of the budget by simplifying the budget architecture, financially supporting activities that generate positive outsourcing (research, energy efficiency), and maximising the coherence between basic government policies and budget planning systems. In the same vein, through the prism of the diversity of the problems of economic life, the reform of public finances must also aim at strengthening corporate governance at state-owned companies in order to improve their performance, as well as the generalisation of the rule regarding the registration of work points, regardless of the number of employees.²³

3. Fiscal-budgetary responsibility in 'Romania's financial disorder'

As we have shown, the 2024 budget was voted without problems, with the opposition not having the number of MPs required to refer the Constitutional Court of Romania. However, it is believed that though the governors have expressed optimism, several difficulties will make their presence felt from the beginning of the year. For example, many economic agents are not prepared to deal with the IT and administrative procedures that the implementation of the e-invoicing system entails. Moreover, some IT specialists have raised concerns that the systems of the National Agency for Fiscal Administration (NAFA) are not ready to handle such a large flow of invoices from across the country. The Romanian e-invoice system will, indeed, be an endurance test for the NAFA servers.²⁴

Without insisting on this topic, we must accept that, whether we consider the budget good or not necessarily the one we wanted, the circumstances and conditions in which it was drawn up did not allow for a better structure. Yet, regardless of the budget, the fiscal-budgetary responsibility law²⁵ and the Fiscal Council must play important roles in ensuring fiscal discipline. In Romania, through the adoption of the fiscal-budgetary responsibility law in 2010, the creation of the legal framework

23 In this view, the threshold of five employees per point of work will be removed, with the income tax being transferred to the local budget where the employee works.

24 'NAFA's servers will probably not be ready to receive the huge number of bills from taxpayers. For example, last year there were taxpayers who received a message from NAFA that they were going to be blocked on the server (so any information NAFA received from them would have been seen as spam). After numerous discussions with NAFA's IT specialists, it was discovered that NAFA's servers were set to receive a certain number of invoices per minute or per hour. [...] It is not clear if NAFA was prepared, did simulations and piloting for e-invoicing. Or he went with the cowardly idea, we'll see, we'll manage in some way'. See: Vlaston, 2023.

25 Law no. 69/2010 regarding the fiscal-budgetary responsibility, republished in the Official Gazette of Romania no. 472/04.06.2020.

was aimed at supporting decision-making regarding fiscally sustainable policies by stipulating fiscal principles and rules related to revenues, public debt, deficit, expenses, and risk management.²⁶ This law seeks to ensure predictability in spending public money.

The law established several fiscal rules to ensure a budget balance that does not exceed the ceilings of total and personnel expenses and maintains the rate of the growth of expenses below the level of GDP growth, in accordance with the fiscal-budgetary strategy. It also provided for the establishment of a Fiscal Council.²⁷ This Council is an institutional transposition of European fiscal legal provisions into Romanian national legislation.²⁸ In carrying out its mission, the Fiscal Council fulfils a wide range of duties, including (i) evaluating the macroeconomic projections taken into account when substantiating the revenue forecast of the general consolidated budget, (ii) estimating the impact of the packages of measures likely to influence the budget balance, (iii) analysing the budget execution and the extent to which it corresponds to the proposed targets, (iv) monitoring compliance with fiscal rules, and (v) issuing recommendations regarding current and future fiscal policy.

According to the provisions of Law no. 69/2010, the fiscal-budgetary policy promoted by the governors must be based on compliance with certain principles. The first of these principles relates to transparency regarding the establishment of fiscal-budgetary objectives and the development of fiscal and budgetary policy: the government and local public authorities must make public, and maintain in public debate for a reasonable period of time, all the necessary information that allows for an evaluation of the way fiscal and budgetary policies are implemented, their results, and the state of central and local public finances.

To meet the need for constants that function regardless of the pace of legislative changes or other reasons, the principle of stability is introduced (a principle according to which the Government must conduct the fiscal-budgetary policy in a way that ensures its predictability in the medium-term in order to maintain macroeconomic stability).

Finally, the principle of fiscal responsibility deserves special appreciation. This principle imposes on the governors the duty to conduct fiscal-budgetary policy prudently and to manage budgetary resources and obligations, as well as fiscal risks, in a way that ensures the sustainability of the fiscal position in the medium- and long-term. In addition, the principle of equity stipulates that the government will carry out the fiscal-budgetary policy while taking into account the potential financial impacts on future generations and on economic development in the medium- and

²⁶ Ardeleanu-Popa and Cîrmaciu, 2010.

²⁷ The Fiscal Council is composed of five members appointed by a decision of the Parliament at the proposal of the National Bank of Romania, the Romanian Academy, the Academy of Economic Studies, the Romanian Banking Institute, and the Romanian Association of Banks. It aims to ensure support for achieving the quality of macroeconomic and budgetary forecasts and budget policies established in accordance with the principles of fiscal responsibility. See: Cîrmaciu, 2010, p. 79.

²⁸ Costaş and Tofan, 2023, p. 85.

long-term, respecting the principle of efficiency and the effective management of personnel expenses paid from public funds. All these principles also apply to local public administration authorities.²⁹

Since its establishment, the Fiscal Council, as an independent institution, has developed documents through which it expresses its opinion on the fiscal-budgetary strategy defined through, for example, the annual budget laws and budget rectification laws.³⁰ Among the Fiscal Council's duties is the publication of an annual report that analyses the development of the fiscal-budgetary policy from the previous year compared to that approved by the fiscal-budgetary strategy and the annual budget. The Council must also evaluate the macroeconomic and budgetary trends included in the fiscal-budgetary strategy and the annual budget, as well as the objectives, targets, and indicators established by this strategy and budget.

Operational, administrative, and technical activities are ensured by the Technical Secretariat of the Fiscal Council. Fiscal Council meetings are held whenever necessary; however, a meeting will usually take place at least once a month. The meetings are convened by the president, or in his absence, by the vice-president of the Fiscal Council. These meetings are not public, but external experts can participate in them to the extent that their participation is approved by Fiscal Council members. The decisions of the Fiscal Council will be adopted by voting, with a simple majority of the participating members of the Council.

The Advisory Committee of the Fiscal Council was established on 20 September 2020 to align with the OECD principles regarding Independent Fiscal Institutions. This committee consists of three members and has a two-year mandate. Members are elected by consensus, based on the criteria of competence and expertise set by members of the Fiscal Council.

Yet, the question is still raised about the efficiency of an institution that has only an advisory role, which it plays through issuing opinions and recommendations. The literature³¹ also claims that this institution, which brings together valuable specialists in the field, fails to add value in the matter of public finances, precisely because of its lack of institutional strength and the impossibility of issuing decisions through which to resolve the disputes that arise in the complex sphere of public finances.

The Fiscal Council has reiterated the 'sensitive' situation that Romania's economy is experiencing, with a budget deficit of around 6% of GDP (also during 2023), emphasising that the country remains under the excessive deficit procedure. Even in 2023, the Fiscal Council 'amended' the annual budget construction, given that

29 Art. 4 para. 1. of Law no. 69/2010.

30 For example: The opinion of the Fiscal Council on the State Budget Law for 2024, the State Social Insurance Budget Law for 2024, and the fiscal-budgetary strategy for the period 2024–2026 (19 December 2023); The opinion of the Fiscal Council regarding the draft of the first rectification of the consolidated budget for 2022 (18 August 2022); The opinion of the Fiscal Council on the legislative proposal regarding the establishment of measures to stimulate activity and reduce the effects of the health crisis in the tourism sector (14 July 2020); etc.

31 Costaş and Tofan, 2023, p. 86.

revenues were overestimated and expenses were underestimated, resulting in an unrealistic budget projection.

For the 2024 budget, the Fiscal Council specified that fiscal-budgetary measures should favour the downward trajectory of the budget deficit toward 3% in the following years. Inevitably, this is where the eternal turmoil between the political (with specific ideologies, sometimes detached from reality) and the economic appears; often, an economic problem does not have a purely economic character. Moreover, even when considering the actions of the politician in power, we cannot always distinguish which interest prevailed in making a decision. However, it is certain that we cannot improve the deficit without effort or ‘pain’.³² The Fiscal Council also argues that adjustments should be made on the revenue side and that Romania must spend public money much more efficiently. Nevertheless, the Council warns the authorities that it does not support a massive, unjustified cut in public spending because the effects can be negative, instead of resulting in the efficiency of budget construction. This is because, in Romania, there is a shortage of goods and services that citizens can enjoy and from which they can benefit in the necessary quantity and quality.

References to the continuation of the tax reform, the increase of the collection rate, and the efficiency of the NAFA activity (not only through the oft-invoked digitisation) are also not omitted. In addition, there is a need to continue the fight against tax fraud, and efforts to tackle the phenomenon of fiscal optimisation must continue.

European funds (NRRP and the Multiannual Financial Framework) have an essential role in the activity of resolving Romania’s so-called ‘financial mess’. This European money is needed to start reforms and support various projects, including digitisation, energy transition, and infrastructure efforts.

An additional obstacle to the correction of the budget deficit is the impact of the new legislation in the field of pensions. Here, we are not referring to the expediency of the law, which was clearly necessary to eliminate inequities in the social assistance system. The problem is generated by the direct application of the text of the law in its entirety from 1 September 2024, rather than in stages: staggering would have ensured that there would not have been so much pressure on the budgetary resources of 2024.

Summarising these aspects, although the objectives set for the coming years can be categorised as ‘bold’, if the targeted reforms are implemented, tax evasion is reduced, and the level of tax revenue collection increases, they can be achieved. The absorption of European funds and budgetary consolidation must both be continued. Let us also not forget yet another advantage of being a member of the European Union is benefiting from mechanisms for monitoring imbalances.

³² *Romania Fiscal Council – Opening remark* [Online]. Available at: <http://www.fiscalcouncil.ro/index.html> (Accessed: 30 December 2023).

4. Final considerations

4.1. Public credit, or the 'engine' that must be operated with utmost caution

Lorenz von Stein considered that 'without resorting to public credit, a state has little achievements for the future and much too great claims from the present'. Starting from this point, we highlight that public borrowing is a way of attracting financial resources to the state with the aim of using them to cover the budget deficit, temporary treasury gaps,³³ and some public expenses, including interest payments. Even if public lending presents some advantages (in that it is sometimes easy and more convenient for the governors), a cautious approach is needed. It is also necessary to prevent, as much as possible, the situation of the unjustified recourse to credit out of the simple desire to ease the act of governance. Beyond the advantages and disadvantages, in the current period, the objective aim of 'productive' interests rather than consumption (especially when no other possibilities for economic-financial recovery can be found) must be supported.³⁴

The objectives of the Ministry of Finance³⁵ in the administration of the governmental public debt for the period 2023–2025 are set as follows: (i) to ensure the financing needs of the central public administration against the background of cost minimisation in the medium- and long-term; (ii) to limit the risks associated with the

33 Boța et. al., 2002, p. 95.

34 According to the regulations in force in Art. 4 para. 1 of Government Ordinance no. 64/2007, published in the Official Gazette of Romania no. 439/28.06.2007, the government is authorised to engage in the name of, and on the account of, the state obligations regarding the nature of government public debt only through the Ministry of Finance, for the following purposes: (i) the financing of the state budget deficit, the temporary financing of deficits from the previous years of the state social insurance budget until the allocation of amounts for this purpose, and the financing of the temporary deficits of the state budget and of the state social insurance budget from the current year; (ii) refinancing and early repayment of the governmental public debt; (iii) permanently maintaining a corresponding balance in the general current account of the State Treasury; (iv) the financing by law of some programmes/projects or other priority needs for the Romanian economy; (v) maintaining the balance of payments in accordance with the Regulation of the Council of the European Union no. 332/2002, which establishes a medium-term financial assistance mechanism for Member States' balances of payments; (vi) joining guarantee mechanisms or financing instruments established at the level of the European Union, that is, at the level of the international financial institutions of which Romania is a member; (vii) the financing necessary to secure the collateral related to transactions with derivative financial instruments; and (viii) financing projects/expenditures that are intended to protect the environment and combat climate change, as well as those in the social and sustainable development fields, based on a special framework approved by government decision. The Ministry of Finance has the right to contract government loans in support of the previously mentioned purposes under the conditions stipulated by the legal documents it concludes with creditors. The exception is reimbursable financing that is contracted from various international financial bodies with the purpose of financing the budget deficit, in which case approval is required by decision of the government. Costaș and Tofan, 2023, p. 267.

35 *Program de Guvernare 2023-2024* [Online]. Available at: https://gov.ro/fisiere/pagini_fisiere/23-06-16-12-32-52Programul_de_Guvernare_2023-2024.pdf (Accessed: 30 December 2023).

government public debt portfolio; and (iii)) to develop the internal market of state securities. These objectives will be achieved through the use of specific instruments for the administration of government public debt and liquidity management, under the conditions of the risks shown (refinancing risk, interest rate risk related to the debt denominated in the national currency, currency risk³⁶).

In the 2023–2025 period, Romania aims to cover its financing needs by issuing government securities launched on the domestic market, issuing Eurobonds on the international capital markets, and contracting external loans from international financial institutions.

The competent ministry is considering ensuring the financing of the budget deficit and the refinancing of the public debt mainly in national currency in order to continue the development of the internal market, correlated with the internal market's capacity to absorb state securities in lei. This will be undertaken in parallel with accessing external capital markets in EUR, USD, and other currencies, depending on the opportunities offered on these markets, with the aim of extending the average maturity of the total debt and diversifying the investment base. It should be noted that in the event that the public administration debt shows constant growth trends,³⁷ the government is called to apply the legal measures imposed by the provisions of Law no. 69/2010.

With the entry into force of the provisions of Emergency Ordinance no. 64/2007 on public debt, the practical usefulness of the distinction between internal and external public debt has been lost, with the legal text distinguishing only between governmental public debt and local public debt (this approach is common to all EU Member States). When contracting public debt, a certain limit is taken into account. This limit is known as the 'public debt ceiling' and represents the set of financial obligations that can be contracted and guaranteed by the relevant ministry and the local public administration authorities for a period of one year. From 2006–2010, the Parliament annually approved the public debt ceiling by law. For the years after 2010, the debt ceiling was contained in various normative Acts.

Government securities, namely treasury certificates and bonds, are predominant in the structure of the internal debt.³⁸ To develop the domestic market of government securities in the next period, the Ministry of Finance has outlined an action plan that refers to increasing the efficiency of the government securities market by consolidating and expanding the yield curve on the domestic market of government securities, developing government securities programmes for the population, and diversifying and broadening the base of potential investors.³⁹

36 Exposure to currency risk can be kept under control by benefiting from the lower volatility of the leu/euro exchange rate.

37 Registering 58.0% of GDP on 31 October 2023. See: *Datoria publica* [Online]. Available at: https://mfinante.gov.ro/static/10/Mfp/buletin/executii/Structuradatorieiipublice2000-2020Ro_102023.pdf (Accessed: 30 December 2023).

38 Ministerul Finanțelor, 2023.

39 Ibid.

4.2. General aspects of the legal regime of public debt in Romania

As can be seen from the above analysis, public loans have an indissoluble relation with the budgetary component of public finances and have been subject to distinct regulations over time. Currently, the legal framework is represented by GEO no. 64/2007 on the public debt and its subsequent amendments and additions. This normative Act contains the principles of public debt administration. The unitary application of the provisions of GEO no. 64/2007 is ensured by secondary legislation, primarily Decision no. 1470/2007.⁴⁰

Public loans are under the power of public law provisions (imperative norms) that establish certain conditions regarding their contracting and/or guarantee, their capping, the purpose for which they can be contracted, and the methods of approving public debt contracting operations. According to the legal regulations in force, the financial conditions regarding the issuance of state guarantees and the granting of subloans in the form of government public debt obligations are approved by the Interministerial Financing, Guarantees, and Insurance Committee.⁴¹

Public loans are monitored through their reporting.⁴² Peculiarities arise with regard to the repayment of public loans. The repayment of the governmental public debt is an obligation of the state, unconditional and irrevocable, consisting of the payment of capital, interest, commissions, and various other related costs.

The legal regulation establishes the permanent budget authorisation mechanism, which authorises the government to always provide resources in the budget of the central state administration for the payment of the public debt service. In exceptional situations, the responsible Ministry can call on sums from privatisation revenues, using them to cover interest payments, commissions, and costs related to the governmental public debt.⁴³

Lastly, we must remember that among the various sources of payment for public debt service is the risk fund,⁴⁴ which is managed by the Ministry of Finance through the general current account of the State Treasury, thus ensuring the safety, liquidity, and profitability of the funds.

Regarding the issue of loans to administrative-territorial units, local councils, county councils, or the General Council of the Municipality of Bucharest can approve the contracting or guaranteeing of internal or external loans in the short-, medium-, and long-term. The purpose of these loans must be to finance public investments of

40 Government Decision no. 1470/2007 for the approval of the methodological rules for the application of GEO no. 64/2007 on public debt, published in the Official Gazette of Romania no. 870/19.12.2007.

41 Art. 2 point b of Government Emergency Ordinance no. 64/2007.

42 According to the provisions of Art. 8 of GEO no. 64/2007: 'The Ministry of Finance annually prepares the report on the governmental public debt and submits it to the government for approval. The approved form of the report is sent for information to the Parliament, but no later than 30 July of the year following the reporting year'.

43 Art. 5 para. 2¹ of Government Emergency Ordinance no. 64/2007.

44 Art. 2 point f of Government Emergency Ordinance no. 64/2007. See also: Cîrmaciu, 2015, p. 88.

local interest and to refinance local public debt. The legal framework is represented by Law no. 273/2006 on local public finances.⁴⁵

Local public debt includes both direct local public debt and guaranteed local public debt. Following the proposal of the main credit authoriser, local councils decide to contract or guarantee loans with a vote of at least half plus one of the number of councillors in office. According to the law, loans can be contracted or guaranteed only with the Commission's approval for the authorisation of local loans.⁴⁶ Local councils can also benefit from external loans contracted or guaranteed by the state.

The law expressly and exhaustively lists the instruments of local public debt, namely securities, loans from commercial banks or other credit institutions, supplier credits, financial leasing, and local guarantees.⁴⁷ Securities can be issued and launched directly by the local public administration authorities or through agencies or other specialised institutions.

Some legal provisions govern the capping of local public loans. According to these provisions, administrative-territorial units are prohibited from accessing loans or guaranteeing any kind of loan if the total annual debts representing the instalments due on contracted and/or guaranteed loans, interest, and commissions, including the loan to be contracted and/or guaranteed in the respective year, exceed 30% of the arithmetic average of own incomes, reduced by the incomes from the capitalisation of some goods, for the last 3 years prior to the year in which the request is made for the authorisation of repayable financing to be contracted and/or guaranteed.⁴⁸ Those administrative-territorial units that registered overdue payments on 31 December of the previous year, unpaid until the date of requesting the opinion of the Local Loans Authorisation Commission, or that registered a deficit of the operating section at the end of the year prior to the request, are not entitled to contracting or guaranteeing loans.

In the event that, during the execution, temporary cash gaps appear as a result of the gap between the revenues and expenses of the local budget, they can be covered by loans granted by the Ministry of Finance from the general current account of the State Treasury, but only after using the surplus from previous years. In this context, the total amount of the loan that can be committed by the local public administration authorities shall not exceed 5% of the total revenue estimated to be collected during the budget year in which the loan is made. In addition, local public administration authorities cannot borrow more than the funds they can repay during the same budget year.

According to the law, the activity of local public administration authorities will be subject to an exceptional audit by the Court of Accounts if the authority does

45 Law no. 273/2006 on local public finances, published in the Official Gazette of Romania no. 618/18.07.2006. Reference to Law no. 273/2006 is made by the provisions of Art. 13 of GEO no. 64/2007.

46 The composition and mode of operation of this commission is approved by a decision of the government.

47 Art. 62 para. 2 of Law no. 273/2006.

48 Art. 63 para. 4 of Law no. 273/2006.

not repay all its short-term payment obligations by the end of the budget year in which the loans were committed; if at a certain moment during the budget year, the short-term debts of the authority exceed the established legal limit; or at the motivated notification of at least one-third of the members that make up the deliberative authority. The Court of Accounts will request that local public administration authorities in one of the previously mentioned situations draw up and submit a recovery plan to the Court of Accounts and to the General Directorate of Public Finances. Through this plan, local public administration authorities oblige themselves to comply with legal provisions for 12 months.

In a derogatory regime from the restrictive legal provisions, the Ministry of Finance can grant interest-bearing loans to a local public administration authority from the available funds of the general current account of the State Treasury as part of the recovery plan on the condition that the authority undertakes to repay these funds within a set term by the Ministry of Finance, which cannot exceed 2 years.

4.3. Special situations regulated by Law no. 273/2006

The legislator considers two exceptional situations: a crisis⁴⁹ and a state of insolvency⁵⁰ in an administrative-territorial unit. The general regulation can be found in Arts. 74–75 of Law no. 273/2006; however, the provisions of Art. 85 of the same law indicate that the Ministry of Finance and the Ministry of Administration and Interior should prepare a special draft law regarding the mentioned procedures. As a result, the government established Emergency Ordinance no. 46/2013 regarding financial crises and insolvency in administrative-territorial units,⁵¹ a normative Act that was initiated in the context of a large volume of arrears registered by administrative-territorial units.

49 A financial crisis is defined through the state of the patrimony of the administrative-territorial unit, characterised by the existence of financial difficulties and an acute lack of cash availability, which leads to the non-payment of payment obligations, liquid and due, for a certain period. According to the provisions of Art. 74 of Law no. 273/2006, a financial crisis is presumed in one of the following situations: non-payment of payment obligations, liquid and due, older than 90 days and exceeding 15% of the expenses provided for in the general budget of the respective administrative-territorial unit, except for those in commercial litigation; or the non-payment of salary rights provided for in the local revenue and expenditure budget or in the budgets of institutions or public services of local or county interest for a period longer than 90 days from the due date.

50 Insolvency is defined through the state of the patrimony of the administrative-territorial unit, characterised by the existence of financial difficulties and an acute lack of cash availability, which leads to the non-payment of payment obligations, liquid and due, for a certain period. Insolvency is presumed in one of the following situations: non-payment of payment obligations, liquid and due, older than 120 days and exceeding 50% of the expenses provided for in the general budget of the administrative-territorial units, without taking into account those in commercial litigation; or non-payment of salary rights arising from employment relationships and provided for in the income and expenditure budget, for a period longer than 120 days from the due date. See also: Moroza, 2014, pp. 276–277.

51 Published in the Official Gazette of Romania no. 299/24.05.2013.

5. Conclusions

Regarding Romanian public finances, the year 2024, a year of both electoral tensions and renewed hopes, is dedicated to actions aimed at predictability in fiscal matters, in addition to ‘zero tolerance’ for tax evasion and avoiding the waste of public financial resources. These actions will also seek to reduce bureaucracy in spending public money and promote modern mechanisms for managing public expenses. Only in this way can public finances be strong and modern, and provide citizens with quality public services.

The control function will continue to be manifested with the aim of ensuring compliance with laws and increasing economic efficiency through the better administration of public money and ensuring monetary, currency, and financial balance in the economy. The government will also continue to have a duty to conduct the fiscal-budgetary policy with prudence in the management of budgetary resources and obligations. The aim will be to achieve the medium- and long-term sustainability of the fiscal position and the predictability of the fiscal-budgetary policy. Measures will be implemented to ensure Romania’s compliance with the deadlines and conditionalities established by the NRRP, especially in the field of fiscal reform, in accordance with the recommendations of the European Commission.

Romania’s budget remains fragile – let us not forget the years of the pandemic and the energy crisis, which led to the temporary suspension of fiscal rules. The situation was further complicated by the start of the conflict on Romania’s borders. This fragility is reflected in lower incomes, tax evasion, and the ‘still permissive’ tax regime that leaves open ways to avoid the payment of taxes and fees.

In this overall context, we must also bring to attention the role that the National Committee for Macprudential Supervision had, and still has, in coordinating the tasks related to financial stability and the management of financial crises in Romania. This committee is an independent body with regards the operational fulfilment of these objectives.⁵² Further, the governors must consider that all the social policy measures included in the present government programme fall within the deficit and the objectives assumed by the NRRP. Achieving a resilient economy by correcting internal and external economic imbalances, supporting sustainable development (through human capital, investments, and capital stimulation), increasing Romanian companies’ competitiveness, and digital transformation must remain a priority for government actors, who must focus on the efficiency of state spending and the fight against poverty.

52 The Committee’s fundamental objective is to contribute to the safeguarding of financial stability, including by strengthening the capacity of the financial system to withstand shocks and reducing the accumulation of systemic risks. This ensures that the financial system makes a sustainable contribution to economic growth. The Committee includes representatives of the National Bank of Romania, the Financial Supervision Authority, the Ministry of Finance, and the Bank Deposit Guarantee Fund.

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SERBIA: PUBLIC FINANCE – TOWARD THE EFFICIENT MANAGEMENT OF THE COUNTRY’S REVENUES



DUŠAN V. POPOVIĆ

Abstract

Like other countries of South-East Europe, the Republic of Serbia aims to join the European Union (EU). Within the Stabilisation and Association Process, Serbia has undertaken steps to harmonise its national legal system with that of the EU, as well as actions that seek to establish a functional market economy. However, Serbia's present geopolitical position outside of the EU allows for a larger autonomy in conducting its national economic policy. This chapter examines the particularities of the elaboration and enforcement of fiscal policy, and more specifically public finance, from the perspective of an EU candidate country. The Serbian public finance system is not fully aligned with EU law; however, the reforms implemented thus far were considered sufficient for opening the EU-Serbia negotiation chapters (now, clusters) pertaining to the area of public finance. Under the general fiscal rules prescribed by the Budget System Act, the government sector debt, including the liabilities based on restitution, should not exceed 60% of gross domestic product (GDP), while the target medium-term fiscal deficit should represent 0.5% of the GDP. Under the principles of responsible fiscal management, the employee expenses in the government sector must be fixed at a sustainable level; thus, efforts are made to keep the proportion of these expenses in the GDP under 10%. Although the budgetary procedure is well designed, the 'regular' path for budget adoption was not always observed in the past, mainly due to economic perturbations caused by the COVID-19 pandemic.

Keywords: *public finance, Serbia, budget, European integrations, Fiscal Council*

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1. Introduction

Like other countries of South-Eastern Europe (hereinafter: the ‘SEE countries’), the Republic of Serbia aims to join the European Union (EU). In 1993, the European Council in Copenhagen defined the accession criteria (also known as the ‘Copenhagen criteria’), which represent the essential conditions all candidate countries must satisfy to become an EU Member State. Further to reaching adequate political stability and institutional capacity, each EU candidate country must establish a functioning market economy and the capacity to cope with competition and market forces. Following the pre-accession experience of Central and Eastern European countries that joined the EU in 2004 and 2007, the EU defined the Stabilisation and Association Process. This process is an enlargement policy based on the Stabilisation and Association Agreements (SAAs) each SEE country has concluded with the Union.

The SAAs are modelled on the Europe agreements that the EU signed with Central and Eastern European countries in the 1990s. These SAAs are international agreements concluded with the objective of preparing the candidate or potential candidate country for EU membership. Each SAA clearly defines the aims of the association; for example, the SAA concluded with the Republic of Serbia indicates the following aims: (i) supporting Serbia’s efforts to strengthen democracy and the rule of law; (ii) contributing to political, economic, and institutional stability in Serbia, as well as to the stabilisation of the region; (iii) providing an appropriate framework for political dialogue to allow for the development of close political relations between the parties; (iv) supporting Serbia’s efforts to develop its economic and international cooperation, including the approximation of its legislation to that of the European Community; (v) supporting Serbia’s efforts to complete the transition into a functioning market economy; (vi) promoting harmonious economic relations and gradually developing a free trade area between the European Community and Serbia; and (vii) fostering regional cooperation in all the fields covered by the SAA.¹ The necessity of a framework for political cooperation and regional dialogue is highlighted. This goes together with the obligation to commit to economic cooperation and development. The concept of four freedoms (i.e. the free movement of workers, capital, goods, and services) and the principle of free competition, both included in the EU’s internal market, are extended to these association agreements. The SAAs also provide for asymmetric trade liberalisation between the EU and each of the SEE countries. The approximation of laws consists of the adoption of the EU *acquis* in the respective countries’ legal systems. The SAAs set a timeframe for the approximation efforts undertaken by the corresponding SEE country. The SEE countries have all reached different stages in the European integration process. Serbia signed the SAA in 2008 and was granted EU candidate status in 2012.

1 Stabilisation and Association Agreement between the European Communities and their Member States of the one part, and the Republic of Serbia of the other part, Art. 1 para. 2.

With respect to economic and trade policy, the SAA concluded between the EU and the Republic of Serbia envisages that the two parties shall cooperate to (i) exchange information on macroeconomic performance and prospects and on strategies for development; (ii) jointly analyse economic issues of mutual interest, including the framing of economic policy and the instruments for implementing it; and (iii) promote wider cooperation with the aim of speeding up the inflow of know-how and access to new technologies. Further to this, Serbia is required to establish a functioning market economy and gradually approximate its policies to the stability-oriented policies of the European Economic and Monetary Union.² Serbia's present geopolitical position of Serbia outside of the European Union allows for greater autonomy in conducting its national economic policy and, to a certain extent, its public finance.

The efficient and transparent management of public finances increases the trust in state institutions and benefits citizens through better healthcare, social, and other public services, as well as a higher standard of living.³ Moreover, healthy public finances contribute to companies becoming more competitive in the market and economic growth. Improved public financial management is a necessary step on Serbia's path to joining the EU. The budget of the Republic of Serbia and some other countries in the region of former Yugoslavia accounts for a significant part of the national gross domestic product (GDP). As such, public financial management is essential for economic development, the availability of public services, and citizens' quality of life. Relations between the central government and local authorities, as well as decentralisation and transparency in the spending of public funds, are equally important areas of public finance. To improve the performance of its public finance sector, the Republic of Serbia joined the UN 2030 Agenda. The Sustainable Development Goals of the 2030 Agenda formally came into effect on 1 January 2016, following the adoption of a resolution at the UN summit in September 2015. Up until 2030, the signatories are expected to mobilise all resources to eradicate poverty, fight inequality, and devise a response to climate change. The Sustainable Development Goals, which build on the Millennium Development Goals and recognise that the fight against poverty goes hand in hand with economic growth and industrialisation, are geared toward several societal needs, including health, education, social protection, a healthy environment, and communities resilient to climate change.⁴ This means that all development plans and policy documents in the process of Republic of Serbia's EU integration also integrate the 2030 Agenda and use it to profile the Republic of Serbia as a future EU Member State.

In this chapter, the system of public finances in the Republic of Serbia is presented through an analysis of the budgetary procedure, budget constraints, and the

² SAA, Art. 89.

³ For alternative definitions, see: Kennedy, 2012, pp. 3–4; Tanzi, 2020, pp. 11–29; Rosen, 2008, p. 371.

⁴ For an in-depth analysis of Serbia's implementation of the 2030 Agenda objectives, see: Government of the Republic of Serbia, Public Policy Secretariat, 2022.

role and responsibilities of the Fiscal Council, as well as an overview of the main characteristics of the ongoing Public Finance Management Reform Programme.

2. Budgetary procedure

The Budget System Act (BSA)⁵ is the main legislative instrument regulating the planning, preparation, adoption, and execution of the budget of the Republic of Serbia and those of autonomous provinces (Vojvodina, and Kosovo and Metohija) and local self-governments. The BSA also regulates the preparation and adoption of the financial plans of organisations related to mandatory social insurance, which include (i) the Republic Fund for Pension and Disability Insurance, (ii) the Republic Fund for Health Insurance, (iii) the Military Social Security Fund, and (iv) the National Employment Service. Similarly to other jurisdictions, the Serbian BSA specifies what budgetary processes are prescribed in law, who is responsible, and when key budgetary steps should be taken.

The question of how budget processes are implemented is also regulated to a certain extent by the BSA, although by-laws are more appropriate for this purpose in many cases. The BSA prescribes that the budget system should achieve the following goals: (i) overall fiscal sustainability and control, which implies the implementation of policies without significant changes in the consolidated general government, with comprehensive control of total budget funds, through the establishment of expenditure and outflow ceilings that are guaranteed by the law, at both the overall and budget beneficiary levels; (ii) allocation efficiency, which implies a possibility of setting priorities within the budget, allocating funds in line with the government priorities within the budget, and transferring funds from old to new or less productive to more productive priorities; (iii) technical or operational efficiency, which implies the use of budget funds and the possibility of their application with the lowest possible costs; and (iv) allocation efficiency, which implies allocating budget funds in order to promote gender equality.⁶

The BSA recognises the following types of public revenues: (i) taxes; (ii) contributions for mandatory social insurance; (iii) non-tax revenues, namely, fees, charges, fines, and other non-tax revenues; (iv) self-contribution; and (v) grants, transfers, and financial assistance from the EU.⁷ The BSA also lays down a closed list of types of government proceeds: (i) proceeds from the sale of non-financial assets, (ii) proceeds from

5 Budget System Act, *Official Journal of the Republic of Serbia* 54/2009, 73/2010, 101/2010, 101/2011, 93/2012, 62/2013, 63/2013, 108/2013, 142/2014, 68/2015, 103/2015, 99/2016, 113/2017, 95/2018, 31/2019, 72/2019, 149/2020, 118/2021, 138/2022 and 118/2021, Art. 1.

6 BSA, Art. 4.

7 See also: Popović, 2022, pp. 3–15.

borrowing, and (iii) proceeds from the sale of financial assets.⁸ In addition to types of public revenues and proceeds, the BSA enumerates several types of government public expenditures and outflows. The public expenditures recognised by the BSA include (i) expenditures for employees, (ii) expenditures for goods and services, (iii) amortisation and usage of equipment, (iv) payment of interest and borrowing-related expenses, (v) subsidies, (vi) financial assistance and transfers, (vii) mandatory social insurance and social security, and (viii) other expenditures. The BSA enlists the following government outflows: (i) outflows for the acquisition of non-financial assets, (ii) outflows for principal repayment, and (iii) outflows for the acquisition of financial assets.⁹

The budget of the Republic of Serbia is adopted by the National Assembly. The government is responsible for the execution of this budget, which is prepared and adopted in accordance with the budget calendar prescribed by the BSA. Namely, on 15 February, the Minister of Finance provides instructions for proposing priority areas of financing for the budget beneficiaries. On 15 March, based on the instructions received from the Minister of Finance, the direct beneficiaries of the budget are required to provide proposals for determining the priority areas of financing for the budget year, as well as for the two following fiscal years, to the Ministry of Finance. By 15 May, the Minister of Finance must prepare the Draft Fiscal Strategy, which lays out the government's economic and fiscal policies. This strategy includes projections for the budget year and the two following fiscal years, specific decisions on priority areas for financing, and the medium-term priorities for public investment. By 1 June, the Fiscal Council must provide an opinion on the Draft Fiscal Strategy. Thereafter, by 5 June, the Minister of Finance is required to provide the government with a proposal of the Fiscal Strategy for adoption. The government is expected to adopt the Fiscal Strategy by 15 June and submit it to the Financial Committee of the National Assembly for consideration. On 5 July, the Minister of Finance shall provide instructions for the preparation of the draft budget. Then, on 15 October, the government is required to adopt the revised Fiscal Strategy, inclusive of the information on the financial and other effects of the new policies, taking into account the macroeconomic framework updated after 15 May. On 20 October, the government should provide the revised Fiscal Strategy to the Financial Committee of the National Assembly. Finally, on 1 November, the Minister of Finance provides the government with the Draft Act on the Budget, which the government adopts by 15 November, thereafter submitting the proposal to the National Assembly. On 20 December, the National Assembly is scheduled to pass the Budget Act of the Republic of Serbia.¹⁰

Once adopted, the BSA and the revised Fiscal Strategy are published in the Official Journal of the Republic of Serbia. The budget is adopted for the period of one fiscal year and is effective for the year for which it was adopted. The fiscal year is a 12-month period, commencing on 1 January and ending on 31 December of each

⁸ BSA, Art. 14.

⁹ BSA, Art. 27.

¹⁰ BSA, Art. 31.

calendar year. The budget may also be adopted for the period of three fiscal years. In the event that the National Assembly does not adopt the budget within the time limits set out in the budget calendar, interim financing shall be conducted for a maximum period of the first three months of the fiscal year.¹¹ The interim financing period may be extended for three additional months, thus lasting for a total period six months, in the event that the budget is not adopted before 15 March of the current budget year.

Further to regulating the central budget (the Budget of the Republic of Serbia), the BSA lays out specific rules on the planning, preparation, adoption, and execution of the budgets of autonomous provinces, cities, and municipalities. The regional and local budgets are adopted in accordance with a somewhat different budget calendar. By 1 August, the local government finance authority is required to provide instructions for the preparation of the draft local government budget. By 15 September, the direct beneficiaries of the local government budget must provide the draft financial plan to the local government finance authority for the budget year and two following fiscal years, which should include a performance report for the programme for the first six months of the current year. By 1 November, the local government finance authority is required to provide a draft decision on the budget to the competent executive authority of the local government. Thereafter, by 15 November, the competent executive authority of the local government should provide a proposed decision on the budget to the local government assembly. By 20 December, the local government assembly¹² is required to pass the decision on the local government budget. Finally, by 25 December, the local government finance authority is bound to deliver the decision on the local government budget to the Minister of Finance.¹³

3. Budget constraints

The BSA sets out several principles of responsible fiscal management that must be observed by both central and local governments and budget beneficiaries. The general fiscal principles are (i) the principle of accountability, (ii) the principle of fairness, (iii) the principle of responsibility, (iv) the principle of stability, and (v) the principle of transparency.¹⁴ The principle of accountability means that the central, regional, or local government is accountable to the assembly for the execution of its responsibilities in relation to the management of fiscal policy. The principle of fairness means that the management of fiscal policy is implemented in such a manner as to

11 BSA, Art. 46.

12 Assembly of an autonomous province, city assembly, or municipal assembly.

13 BSA, Art. 31. For a more detailed analysis of local budgetary procedure and principles see: Raičević et al., 2003, pp. 175–191.

14 BSA, Art. 27b.

take into account its impact on the well-being of present and future generations. The principle of responsibility comprises managing public assets and liabilities, natural resources, and fiscal risks in such a way as to reinforce fiscal sustainability. The principle of stability means that fiscal policy is implemented in a way that prevents sudden changes in trends of macroeconomic and fiscal indicators. Finally, the principle of transparency implies the clear identification and definition of the tasks and responsibilities of the various government authorities and/or local government bodies and officials in relation to the management of fiscal policy.¹⁵ Further to these general fiscal principles, the BSA sets out the specific principles according to which the government should determine and implement the objectives of the fiscal policy, as follows: (i) the sustainability of state debt; (ii) the regular servicing of debt; (iii) the predictability of tax rates and the tax base for the following year; (iv) the responsible management of fiscal risks; (v) the management of public assets, public liabilities, and natural resources in a manner that does not burden future generations; and (vi) the promotion of economic growth.¹⁶

Under the general fiscal rules prescribed by the BSA, the government sector debt, including liabilities based on restitution, should not exceed 60% of the country's GDP, whereas the target medium-term fiscal deficit should represent no more than 0.5% of GDP. If the government sector debt is higher than 60% of GDP, the fiscal position of the government sector must be balanced so that the fiscal deficit is 0% of GDP at maximum. If the government sector debt is between 55% and 60% of GDP, the fiscal deficit should be 0.5% of GDP at the maximum. If the government sector debt is between 45% and 55% of GDP, the fiscal deficit should be 1.5% of GDP at maximum. Further, if the government sector debt is below 45% of GDP, the fiscal deficit should not exceed the amount of 3% of GDP. If the fiscal deficit laid down by the general fiscal rule prescribed by the BSA is exceeded, the government shall, at the proposal of the Ministry of Finance, pass a decision on a programme of measures to adjust the excessive fiscal deficit in the medium-term. Upon obtaining a reasoned opinion of the Fiscal Council, the government must provide this programme to the National Assembly for informational purposes. If the government sector debt exceeds or is predicted to exceed 55% of GDP, the government must submit to the National Assembly, together with the budget for the following year in the Fiscal Strategy, as well as in the revised Fiscal Strategy, a programme to reduce government sector debt relative to GDP. The government must also submit a report on the implementation of the debt reduction programme and the updated programme for each subsequent year in which this debt remains above 55% of GDP. Finally, if the government sector debt exceeds or is predicted to exceed 60% of GDP, the National Assembly shall adopt the

15 In public finance theory, budget transparency may have a two-fold meaning. First, transparency may refer to the outputs of budgeting; here the ideal is that the tradeoffs inherent in a budget should be made clear and understandable to policy-makers and the public. Second, transparency may refer to the inputs of budgeting; here, the ideal is to ensure that the decision-making process is itself conducted in public. See: Garrett and Vermeule, 2006, pp. 2–3.

16 BSA, Art. 27b.

debt reduction programme once a year at minimum in the course of the preparation and adoption of the budget for the following fiscal year.¹⁷

The general government debt-to-GDP ratio fell from a peak of over 70% in 2015 to 53% in 2019. It then increased to 57.8% in 2020 as a result of the high crisis-induced deficit, before broadly stabilising at 57.1% in 2021 and 55.10% in 2022.

The BSA also prescribes special fiscal rules with the objective of ensuring that the target fiscal deficit and government sector debt-to-GDP ratio are achieved through restrictions on public expenditures. Under the principles of responsible fiscal management, employee expenses in the government sector must be fixed at a sustainable level, with efforts made to keep the share of these employee expenses in the GDP under 10%. Further to this, salaries and/or wages can only be raised in a year in which, based on the relevant planning documents of the competent authorities, the share of employee expenses in the government sector within the GDP is expected and/or assessed to be up to 10%, and only in such a manner that this expected share is kept under the stipulated percentage following the adjustment.¹⁸ Moreover, the BSA establishes rules on the fiscal deficit of local authorities, which may not exceed 10% of their revenues in a given year. The local government may submit a request for the approval of a fiscal deficit above the specified level to the Ministry of Finance only in cases in which such a deficit is the result of implementing public investments.¹⁹

In the event of natural disasters and external shocks that may endanger human health and national security and provoke a significant decline in economic activity, the government may temporarily deviate from the fiscal principles and rules. A decision regarding such a deviation must be submitted to the National Assembly for informational purposes. This decision must indicate the reasons for the deviation from the rules, the measures that the government intends to take to re-comply with the fiscal rules, and the timeframe for re-compliance with the rules. It must also present medium-term fiscal plans demonstrating the level of fiscal deficit and debt of the state and the public sector.²⁰

4. The Fiscal Council

In October 2010, significant amendments to the BSA resulted in the introduction of fiscal rules as a foundation of a responsible fiscal policy and the establishment of a Fiscal Council as an independent state body accountable to the National Assembly. The Fiscal Council was formed with the objective of improving the culture

17 BSA, Art. 27e.

18 BSA, Art. 27e.

19 BSA, Art. 27ž.

20 BSA, Art. 27z.

of fiscal responsibility in the Republic of Serbia through the provision of independent analyses of fiscal policy and encouraging professional debate on fiscal policy. The Fiscal Council's mission is to assess the credibility of the fiscal policy in terms of compliance with established fiscal rules and to provide publicity and ensure responsibility in the implementation of this policy. The Council reviews the macroeconomic and fiscal suppositions underpinning the development of government documents, provides an independent and credible assessment of the economic policy, assesses fiscal risks and the prospects for the government to fulfil its fiscal objectives in the future, and evaluates to what extent the government has respected fiscal rules in the past.

Three types of fiscal councils can be differentiated in legal and economic theory: 'soft' councils, 'hard' councils, and 'very soft' councils.²¹ The first type of council has only an advisory role and publishes its recommendations. The second type is empowered to adopt binding decisions on the budget. Finally, the third type is formed by experts from academia, and its decisions are available only internally to state institutions.²² The Fiscal Council of the Republic of Serbia largely corresponds to the first, 'soft' type of council. The International Monetary Fund has argued in favour of strengthening national fiscal councils and aligning their status in terms of institutional capacity, proficiency, experience, operational independence, and key functions such as mandates, tasks, and access to information.²³

The Fiscal Council of the Republic of Serbia consists of three members appointed by the National Assembly. One member is nominated by the President of the Republic, another by the Minister of Finance, and the third by the Governor of the National Bank of Serbia.²⁴ Members of the Fiscal Council must be citizens of the Republic of Serbia who do not perform another public function, have not been convicted, have at least five years of work experience, hold a postgraduate degree in the field of economics, and have published scientific papers on macroeconomics, fiscal policy, public finance, accounting, or other related scientific fields. In addition, a candidate for the presidency of the Fiscal Council must have at least five years of experience in performing managerial tasks. Members of the Fiscal Council must not be members of a political party nor be guided in their work by political beliefs.²⁵ Fiscal Council members are appointed for a term of six years; this term was chosen in order to avoid overlap with the four-year term for members of the National Assembly. The first three members of the Fiscal Council were appointed in March 2011, and the body became fully operational in April 2011.

Further to its general duty of assessing the credibility of the government's measures of economic policy, the Fiscal Council is empowered to perform the

21 See, for example: Calmfors and Wren-Lewis, 2011, pp. 11–12; Beetsma et al., 2018, pp. 3–4.

22 Anđelković, 2018, pp. 374–377.

23 Arnold et al., 2022, pp. 18–19.

24 BSA, Art. 92b.

25 BSA, Art. 92v.

following additional tasks: (i) prepare an opinion on the Draft Fiscal Strategy, (ii) prepare and submit an analysis of the revised Fiscal Strategy for the corresponding fiscal year and of the Draft Budget Act of the Republic of Serbia to the National Assembly, and (iii) prepare and submit estimates of fiscal impact of other laws and amendments that were submitted during the Assembly debate to the National Assembly.²⁶ The Fiscal Council may, at any time and on its own initiative, or upon request, provide advice to the government on issues related to fiscal policy and public finance management. For transparency reasons, and in order to raise awareness of responsible fiscal policy, all analyses, reports, recommendations, and advice prepared by the Fiscal Council are made publicly available within five working days from the date of their submission to the Minister of Finance, the government, or the National Assembly.

Although the BSA prescribes the Fiscal Council's participation in different stages of the budgetary procedure, there are no consequences for the government for not following the Council's recommendations. For example, if any of the Fiscal Council's recommendations are not included in the Fiscal Strategy, this must be stated, the reasons for this decision must be provided, and the delivered opinion of the Fiscal Council must be attached to the Fiscal Strategy in its entirety.²⁷ However, on several occasions, the Fiscal Council has complained that the government ignored its recommendations and did not provide any explanation for not taking them into consideration. For instance, in its opinion on the Draft Fiscal Strategy for 2022, dated June 2021, which included forecasts for 2023 and 2024, the Fiscal Council presented several recommendations aimed at improving the document's credibility (e.g. the recommendation to present the sectoral structure of subsidies, including those stemming from local government). According to the Fiscal Council, some of its recommendations were not included in the revised Fiscal Strategy and some were not adopted appropriately.²⁸

To properly discharge its duties and responsibilities, the Fiscal Council needs to obtain access to information; thus, the BSA empowers it to request that any government minister submit appropriate economic and fiscal forecasts and analyses. Furthermore, the Fiscal Council may require the Minister of Finance to prepare and submit fiscal projections based on alternative assumptions and scenarios. The Fiscal Council is also empowered to request information from any entity in the public sector, including public enterprises, if such information is essential to its work.²⁹ However, failure to comply with a request made by the Fiscal Council does not result in real sanctions as the BSA prescribes that the president of the Fiscal Council may only inform the National Assembly of any lack of cooperation by a public sector entity or governmental body.

26 BSA, Art. 92ž.

27 BSA, Art. 27g para. 3.

28 Republic of Serbia, Fiscal Council, 2021, pp. 2–3.

29 BSA, Art. 92i.

5. Public Finance Management Reform Programme

In November 2015, the government of the Republic of Serbia adopted the Public Financial Management Reform Programme 2016–2020³⁰ (hereinafter: the 'PFMRP 2016–2020'). The overall objective of the PFMRP 2016–2020 was to achieve a sustainable budget with a reduced debt-to-GDP ratio through stronger financial management and control and to improve the audit control process.³¹ The PFMRP 2016–2020 contained 19 different measures, including improving the credibility of macroeconomic forecasts, budget planning, and the coverage and reporting on budget execution; the further implementation of multi-year programme budgeting at all levels of government; improving the strategic and legislative framework for implementing internal financial control in the public sector; and enhancing regulations and procedures for public procurement. Multi-year programme budgeting was also introduced in 2015 for all budget users. The biggest improvement in the area of the financial control of public funds was achieved in May 2017 through the adoption of the Strategy of Public Internal Financial Control (PIFC) Development for the period 2017–2020.³² The implementation of the PIFC legislation and its underlying framework, as well as the development of sufficient administrative capacity at the central and local levels, in social security funds, and in state-owned companies, is one of the requirements for the temporary closure of the EU-Serbia negotiations on Chapter 32, which is dedicated to financial control. Under the new enlargement methodology, Chapter 32 is now part of Cluster 1 – Fundamentals, which illustrates the importance the EU attaches to developing financial control instruments.³³

In June 2021, the government of the Republic of Serbia adopted the Public Financial Management Reform Programme for the period 2021–2025³⁴ (hereinafter: the 'PFMRP 2021–2025'). The goal of the PFMRP 2021–2025 is to achieve a sustainable budget with stable public debt relative to GDP through better financial management and control, the internal audit process, and linking budget planning to government policies. Two of the key objectives of the PFMRP 2021–2025 are improving budget discipline and achieving the more transparent use of public funds. The roles involved in implementing the framework of internal control are divided between several entities. The Central Harmonisation Unit of the Ministry of Finance is tasked with designing, co-ordinating, and monitoring the frameworks of PIFC. The

30 Republic of Serbia, Ministry of Finance, 2015.

31 Apart from regular budget financing, the implementation of the programme was supported by the European Commission (IPA, TAIE), the GIZ project for public financial reform, the World Bank, the IMF, the OECD, and the UNDP.

32 Republic of Serbia, Ministry of Finance, 2016.

33 In March 2020, the EU revised its enlargement methodology for the Western Balkans. The main novelty in this enlargement methodology is the establishment of six negotiation clusters that cover several negotiation chapters.

34 *Public Financial Management Reform Programme 2021–2025* [Online]. Available at: https://www.mfin.gov.rs/upload/media/s47t6d_62612f05e7604.pdf (Accessed: 11 September 2023).

functioning of the established systems for management, risk monitoring, and the application of PIFC rules is subject to review by an independent, internal audit of the beneficiaries of public funds. The ex-post control of the compliance of financial transactions and operations of public-fund beneficiaries are entrusted to the Budget Inspection. Meanwhile, the roles of financial management, control, irregularity management, combating fraud, and auditing EU funds use are assigned to organisational units and institutions within the system of the indirect management of EU funds in the Republic of Serbia. One of the key weaknesses the PFM RP 2021–2025 seeks to rectify is the lack of technical administrative capacities in the organisational units and institutions pertaining to this system of the indirect management of EU funds.

Finally, under the PFM RP 2021–2025, the National Assembly will continue to develop its control function over public finances. Its Committee on Finance, State Budget, and Control of Public Spending is tasked with discussing State Audit Institution reports in the presence of representatives of the State Audit Institution and auditees, and, as and when required, representatives of other relevant central- and local-level bodies, organisations, and institutions. To strengthen the parliamentary oversight of public finances, the Committee will monitor the implementation of measures listed in the conclusion of the National Assembly on the occasion of the adoption of the State Audit Institution's Operating Report.³⁵ Further to the steps taken to enhance Parliament's oversight function with regard to the executive power performance, the Parliament Committee began organising public hearings for the presentation of the Draft Budget System Law and the Draft Act on Final Account of the Budget. The objective of these public hearings is to collect relevant information and expert opinions on the draft laws and clarify any of their proposed features. In accordance with the PFM RP 2021–2025, the first public hearing for the 2023 Draft Budget System Law and the Draft Act on 2021 Final Account of the Budget was held in December 2022.

6. Concluding remarks

The public finance system in the Republic of Serbia has undergone significant changes in recent years, aiming to achieve further alignment with EU rules. Although the Serbian system is not fully aligned with EU law, the reforms implemented thus far were estimated to be sufficient for the opening of EU-Serbia negotiation chapters pertaining to the area of public finance. Negotiations on Chapter 5 on public procurement were opened in December 2016; negotiations on Chapter 17, which is dedicated to economic and monetary policy, were opened in December 2018; negotiations on Chapter 29, which relates to the customs union, were opened in June 2017;

³⁵ Ibid., p. 87.

negotiations on Chapter 32 on financial control were opened in December 2015; and negotiations on Chapter 33, which covers financial and budgetary provisions, were opened in June 2018. Following the reform of the EU's enlargement methodology, the negotiations related to the public finance system are now part of Cluster 1, entitled 'Fundamentals'.

Under the general fiscal rules prescribed by the BSA, government sector debt, including the liabilities based on restitution, should not exceed 60% of GDP, and the target medium-term fiscal deficit should represent no more than 0.5% of GDP. According to the principles of responsible fiscal management, employee expenses in the government sector must be fixed at a sustainable level, with efforts made to keep the share of these expenses in the GDP at under 10%. Although the budgetary procedure is well designed, the 'regular' path for budget adoption was not always observed in the past, mainly due to economic perturbations caused by the COVID-19 pandemic. The two 2021 amending budgets were adopted via urgent procedures, whereas the 2022 budget was adopted in line with the normal legislative procedure, which included a series of parliamentary debates. The Fiscal Council was also consulted in the process. Moreover, budget transparency needs to be improved. No transparency roadmap, prebudget statement, or mid-year report has been produced or published. The Ministry of Finance does not publish the budget execution profile at the beginning of the year, which prevents any analysis of deviations from targets. Some additional policy and fiscal risk information could be included in the executive's budget proposal. The transparency of local budgets has been improved by the introduction of budget portals in 21 cities and municipalities in Serbia, which have enabled councillors in the local assemblies, as well as citizens, to monitor the preparation and spending of the budgets throughout the year and to actively participate in these processes. Finally, the link between the government programme and the sector strategies and operational plans of budget beneficiaries remains weak.

In Serbia's 2022 EU Progress Report, the European Commission insisted that Serbia should contain overall spending on wages as a percentage of GDP and take preparatory steps toward an appropriately designed public sector wage system reform.³⁶ The public wage increases exceeded nominal GDP growth in three consecutive years, leading to an increase in the wage bill from 9.0% of GDP in 2017 to 10.5% in 2020. The share decreased to 10.0% in 2021 owing to very high nominal GDP growth. The wage system reform has been postponed until 2025. The European Commission also emphasised that the annual ceiling for the overall general government fiscal deficit does not appear to be sufficiently transparent and operational. There are no adequate sanctions in the case of non-compliance, nor effective enforcement mechanisms.³⁷

³⁶ Commission Staff Working Document, Serbia 2022 Report, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM(2022) 528 final, p. 67.

³⁷ Ibid., pp. 70–71.

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SLOVAKIA: NEVERENDING STORY ABOUT FISCAL RESPONSIBILITY



MIROSLAV ŠTRKOLEC

Abstract

This chapter addresses the issue of budget management in Slovakia. The importance of this issue for the state is emphasised by the fact that the essential aspects constituting the foundations of public finances are directly regulated in the Constitution of the Slovak Republic. The Constitution regulates not only the basic rules for the creation and content of public budgets but also the powers of the supreme constitutional bodies in this field. An extremely important area of regulation is the prevention of excessive deficit and excessive state debt. For this purpose, significant constitutional changes took place in Slovakia, which led to the creation of a new constitutional body, the Council for Budget Responsibility. Similarly, responsible budget management is equally important at the local self-government level, where the legislation also establishes several brakes to prevent deficit budgeting and the indebtedness of self-government. In this chapter, we discuss these complex issues in detail and highlight the key aspects of Slovak legal regulation. At the end of the chapter, we deal with the current challenges for budget management in Slovakia, which are connected to the growing deficit and the associated need to find new sources of income for public budgets, as well as the reduction of public expenditures.

Keywords: *public finance in Slovakia, budgetary rules, budgetary responsibility, state debt, Supreme audit office, Council for Fiscal Responsibility*

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1. Constitutional rules of public finance

The fundamental law of the Slovak Republic is the Constitution of the Slovak Republic (hereinafter: the ‘Constitution’). The Constitution was adopted on 1 September 1992, that is, before the establishment of the Slovak Republic on 1 January 1993. It was promulgated in the Collection of Laws of the Slovak Republic under No. 460/1992 and has been amended 23 times. At the time of its adoption, the Constitution laid down, among other things, the basic elements of the new Slovak statehood (state sovereignty) and established a catalogue of fundamental rights and freedoms, dividing state power into three branches. Naturally, when it was adopted, the Constitution also included norms regulating the foundations of financial management and the control of public finances. In its previous form, the Constitution already declared the state budget to be adopted by law, the principle of the division of taxes and fees into state and local areas, the principle of the legality of imposing taxes and fees, the separation of the state budget from the budgets of local governments, and the independent budget audit by the Supreme Audit Office (SAO) of the Slovak Republic.

Of course, the Constitution has undergone a complex evolution in the more than thirty years since its entry into force, and many amendments have had a direct or indirect impact on public finances. In what follows, we precisely assess the current state of the Constitution through the prism of the constitutional regulation of these amendments. However, as shown below, the constitutional regulation of the sphere of financial law not only concerns issues of public finances and budgetary management but also includes the principle of the legality of imposing taxes and fees and the positions of the National Bank of Slovakia and the SAO.

1.1. Constitutional foundations of the budgetary management of the State

The constitutional foundations of public finances are found in Title Three of the Constitution, which stipulates in Art. 58 that the financial management of the Slovak Republic shall be maintained through the state budget, which shall be adopted by a law. Thus, it is the Constitution that directly provides for the legal form of adoption of the state budget, which can be considered one of the most important acts of state power. The literature on financial law in Slovakia perceives the state budget on several levels, namely (i) the set of monetary relations through which the national cash fund is created, distributed, and used in a non-repayable way; (ii) the basic financial programme of the State, which includes the majority of the State’s expected revenues and expenditures in a given year; and (iii) the national cash fund, that is, a monetary substrate in which its revenues are collected so that they can subsequently be used for budget expenditures.¹

¹ Babčák, Čakoci and Štrkolec, 2022, pp. 187–188.

According to the Constitution, only a law can determine the revenues of the state budget, the rules of budgetary management, and the relations between the state budget and the budgets of territorial units. The importance of the state budget as the basic financial and economic instrument of the national fiscal policy is also underlined in the Constitution by the fact that the state budget (as well as taxes and fees) cannot be the subject of a referendum (Art. 93). The above can be viewed as both a manifestation of the constitution-making body's mistrust of the will of the people expressed through this instrument of direct democracy and a constitutional safeguard against a possible referendum on, for example, the question of a significant increase in the expenditure of the state budget with a negative impact on the stability of public finances.²

The constitutional regulation of the state budget is followed by several laws adopted directly on the basis of constitutional authorisation. The most important sources of budget law include the Act on the Budgetary Rules of Public Administration,³ the Act on the Budgetary Rules of Local Government,⁴ and the State Budget Act.⁵

1.2. Constitutional foundations of the budgetary management of local government

The foundations of the regulation of local government in the Slovak Republic are found in Title Four of the Constitution, which defines municipalities and higher territorial units as local government units. The Constitution accepts local government as an important constitutional value that enjoys constitutional protection and considers the principle of local government as one of the fundamental principles upon which the Constitution is built.⁶ At the same time, the Constitution defines the basic parameters of the existence and functioning of municipalities and higher territorial units, including the independence of local government units as self-governing and administrative units, own territory and population, own assets and financial resources, the right to associate for securing matters of common interest, decisions on matters of local government by local referendum or by their own bodies, and the original power to issue ordinances of general application in matters of local government.

² Drgonec, 2019, p. 1252.

³ Act No. 523/2004.

⁴ Act No. 583/2004.

⁵ For the year 2023, Act No. 526/2022 on the state budget for 2023, which determines the specific amounts of state budget revenues and expenditures, as well as the state fiscal deficit. A particularly important part of the State Budget Act comprises the provisions delineating the amount of the state's liabilities for the repayment of the principal of the government debt and the limit for the state's public expenditures. However, for the first time, the limit for public expenditures was approved directly in the State Budget Act only for the current fiscal year 2023 as a result of a significant amendment to the Act on the Budgetary Rules of Public Administration, which entered into force on 1 April 2022.

⁶ Orosz and Svák, 2022, p. 18.

Art. 65 of the Constitution also regulates the principles of the financial management of local government. According to the Constitution, municipalities and higher territorial units are legal persons that manage their own property and financial means independently under the conditions laid down by a law. Municipalities and higher territorial units shall finance their needs primarily from their own revenues, as well as state subsidies. A law shall lay down which taxes and fees are to be a municipality's revenue and which are to be a higher territorial unit's revenue. State subsidies may be claimed only within the limits of a law. The constitutional concept of the budgetary management of local government, thus, enshrines two basic principles: the principle of the priority of financing from own revenues and the prohibition of imposing taxes and fees other than those provided for by a law. Thus, if a law does not establish a tax or fee at all or does not establish it as a revenue of local government, local government cannot impose such a tax or fee.⁷ Consequently, it follows that the state must create a legal environment that realistically enables municipalities and higher territorial units to conduct their own budgetary management, particularly by creating sources of revenue that are sufficient for the performance of their tasks and functions.⁸

The constitutional regulation of the budgets of local government is followed by several laws adopted on the basis of constitutional authorisation. The most important sources of budget law include the Act on the Budgetary Rules of Local Government, the Act on the Budgetary Allocation of Income Tax Revenues to Local Government,⁹ the Act on Local Taxes and Local Fee for Municipal Waste and Small Construction Waste,¹⁰ and the Act on the Local Development Fee.¹¹

1.3. Constitutional foundations of budgetary management control

One of the constitutional foundations of budget law is Art. 60, which establishes the SAO as an independent authority that audits the management of the budget and financial resources of the state, local government, and public institutions. Its scope of competences extends to all persons who manage and handle these resources.

The SAO was one of the constitutional bodies established by the Constitution when it was adopted by the Slovak National Council on 1 September 1992. The direct establishment of the SAO as an audit authority within the constitutional text was standard in comparison with the constitutions of other democratic states (which

⁷ Drgonec, 2019, p. 1120.

⁸ The current status quo has been criticised as sub-optimal. See: Kačaljak, 2023.

⁹ Act No. 564/2004, which stipulates that personal income tax is the revenue of municipalities (70%) and higher territorial units (30%).

¹⁰ Act No. 582/2004, which establishes a system of eight local taxes that are the revenues of the municipal budget but, in its current wording (as of 2015), does not provide for any local tax that could be imposed by higher territorial units.

¹¹ Act No. 447/2015, which provides for the possibility of municipalities imposing a development fee. See: Popovič, 2016.

were also used as a basis for the Constitution), with the SAO being established as a ‘new type’ of audit authority. The establishment and constitutional fixation of the SAO as an independent authority standing outside the system of other state bodies was a manifestation of the effort to create a *sui generis* audit institution to ensure effective control over the management of state finances.

The constitutional regulation of the SAO has undergone several developments; however, the current situation has been in force since 2006. In the above-mentioned development of the constitutional regulation, the constitution-making body has twice expanded the SAO’s competences in order to give it the broadest possible ‘scope’ in relation to the audit of public finances and public property. In the current constitutional situation, the scope of the SAO’s competences (without claiming to be exhaustive) includes state finances, local government finances, other public finances on a national scale, foreign (mainly European) finances, mixed finances, and private finances guaranteed by the Slovak Republic.¹²

From a theoretical perspective, the SAO’s independence can be perceived mainly in terms of institutional and personal independence. Institutional independence ensures that the scope of its competences is not influenced by anyone or anything. This independence serves to ensure freedom from constraints by another public authority in the SAO’s exercise of its powers as an independent audit authority.¹³ It is expressed in the fact that the SAO is independent of other public authorities and has autonomy in the procedure of selecting the audited entities, determining the subject of the audit, and its performance. The SAO is bound only by the Constitution and the law.

Personal independence is expressed in the SAO’s management and in filling its management positions. The SAO is headed by its President. The SAO’s President and Vice-Presidents are elected and removed by the National Council of the Slovak Republic (hereinafter: the ‘National Council’). The problem with personal independence being defined in this way is that the Constitution does not provide any prerequisites or conditions under which the National Council can remove the President and Vice-Presidents of the SAO. In this regard, the doctrine of constitutional law states that the Constitution does not create any guarantee of the personal independence of SAO officials.¹⁴ However, the above is partially remedied by legal regulation, as Act No. 39/1993 on the SAO sets out the prerequisites for the removal of SAO officials, including a final conviction for a criminal offence, incompatibility of functions, and failure to perform the duties stipulated under the SAO Act.

1.4. Constitutional guarantees for the preservation of the debt level

At the beginning of this section, we consider it necessary to clarify that the constitutional regulation of the fundamental issues of the functioning of the State

¹² Štrkolec, 2009, p. 359.

¹³ Drgonec, 2019, p. 1101.

¹⁴ Drgonec, 2019, p. 1102.

is defined not only in the Constitution but also in the constitutional laws. They have the same legal force, and their adoption requires a three-fifths majority of all members of the National Council (Art. 84 para. (4) of the Constitution). At the same time, the Constitutional Court does not rule on the conformity of a constitutional law with the Constitution (Art. 125 para. (4) of the Constitution); in fact, the constitutional text directly excludes the authority of the Constitutional Court to review the constitution-making activity of the National Council.¹⁵ In connection with the above, it is also typical for financial or, in a narrower sense, budgetary regulation that, in addition to the Constitution itself, constitutional laws regulate several issues. The doctrine of constitutional law calls this situation a polylegal constitutional order.¹⁶

The adoption of Constitutional Act No. 493/2011 on fiscal responsibility, which entered into force on 1 March 2012, was crucial for the constitutional guarantee of the level of public debt. This constitutional law was adopted to achieve the long-term sustainability of the Slovak economy, strengthen transparency and efficiency in the use of public finances, and promote Slovakia's long-term competitiveness, taking into account the requirements of economic and social justice and solidarity between present and future generations. The law deals with the establishment and scope of competences of the Council for Fiscal Responsibility, the rules of fiscal responsibility, and the rules of fiscal transparency. The Council for Fiscal Responsibility is an independent authority that monitors and evaluates the development of the Slovak economy and assesses the implementation of the rules of fiscal responsibility.

The most important provisions of the Constitutional Act on Fiscal Responsibility set an upper limit for public debt of 50% of gross domestic product (GDP), using Slovakia's level of debt as published by Eurostat as a reference value. The measures provided for in the Constitutional Act on Fiscal Responsibility are triggered when the debt level reaches 40%. Depending on the increase in the debt level, increasingly stringent measures are then triggered to pursue the debt reduction target, as follows.

The first level of the debt limit: If the amount of debt reaches 40% of GDP and is below 43% of GDP, the Ministry of Finance shall submit a written justification of the amount of debt to the National Council, including a proposal for debt reduction measures.

The second level of the debt limit: If the amount of debt reaches 43% of GDP and is below 45% of GDP, the government shall submit a proposal for debt reduction measures to the National Council, and the salaries of government members shall be reduced.

The third level of the debt limit: If the amount of debt reaches 45% of GDP and is below 47% of GDP, the Ministry of Finance shall block the state-budget expenditures to the amount of 3% of the total state budget expenditures approved by the State Budget Act for a given fiscal year; at the same time, no funds shall be released from

¹⁵ Orosz and Svák, 2022, p. 407.

¹⁶ Giba and Bujňák, 2020, p. 1107.

the Prime Minister's Reserve and the Government's Reserve, and the government may not submit to the National Council any proposal for the public administration budget entailing an increase in public administration expenditures compared to the previous year.

The fourth level of the debt limit: If the amount of debt reaches 47% of GDP and is below 50% of GDP, the government may not submit to the National Council any proposal for the public administration budget with a deficit, and municipalities and higher territorial units may only adopt a balanced or surplus budget for the following fiscal year.

The fifth level of the debt limit: If the amount of debt reaches 50% of GDP or more, the government shall ask the National Council for a vote of confidence.

For the sake of fairness, it should be added that, despite the period for which this constitutional law has been in force (more than 11 years), the transitional provisions of this constitutional law are still in effect, according to which these limits were 10% higher until the end of 2017 (i.e. the first level of the debt limit was above 50%, and the fifth level of the debt limit was above 60%); from 2018 to 2027, these limits are reduced by one percentage point each year.

However, this constitutional law also defines exceptions when these measures do not apply, usually referred to as 'escape clauses'. During a state of war, no measures apply until its end. In addition to this exception, other exceptions apply in the cases defined below, but only on the condition that the third level of the debt limit has been exceeded. If at least one of the following conditions is met, exceeding the third level of the debt limit will not lead to associated measures: (i) For the two years following the adoption of the Government Policy Statement or a vote of confidence in the government. This escape clause has been justified on the grounds that the measures described represent a significant interference with the government's otherwise free discretion to finance its priorities and implement the Government Policy Statement. It would, therefore, be undesirable and unfair if they were to be applied immediately after a new government took office, without giving the government room to implement the procedures to ensure debt reduction; (ii) For the following 3 years, if annual GDP growth is reduced by at least 12%; (iii) For the following 3 years, if expenditures for the recovery of the banking sector, expenditures to address natural disasters, and expenditures resulting from the implementation of international treaties exceed 3% of GDP in a given year.

Although Constitutional Act No. 493/2011 on fiscal responsibility is undoubtedly part of the constitutional order, over time, considerations have emerged on the need to directly regulate the long-term sustainability of budgetary management in the Constitution. These efforts culminated in the adoption of an amendment to the Constitution that entered into force on 1 January 2021 and explicitly states in Art. 55a that the Slovak Republic shall protect the long-term sustainability of its economy, which shall be based on transparency and efficiency in the use of public finances. In support of the objectives set out in this article, the constitutional law regulates the

rules of fiscal responsibility, the rules of fiscal transparency, and the scope of competences of the Council for Fiscal Responsibility.

Thus, the Constitution essentially incorporated into its text what had been part of the Constitutional Act on Fiscal Responsibility for years. In this context, the literature on constitutional law refers to the so-called fiscal constitution of Slovakia, which consists of Art. 55a of the Constitution, in conjunction with the Constitutional Act on Fiscal Responsibility.¹⁷ Although, given the polylegal nature of the constitutional order, the justification for this step was a matter of debate (as it essentially only declared a legal situation that had been in force for years), it was ultimately perceived as positive, mainly because: (i) it contributed to the clarity and consistency of the constitutional system; (ii) the Council for Fiscal Responsibility acquired the status of an authority directly established by the Constitution; (iii) fiscal responsibility rules and fiscal transparency rules became concepts of the Constitution itself, enshrining the constitutional mandate for their existence; and (iv) fiscal responsibility and fiscal transparency became constitutional values, and Art. 55a of the Constitution, in conjunction with the Constitutional Act on Fiscal Responsibility, can function as a reference norm in proceedings on the conformity of laws with the Constitution.¹⁸

2. The rules of guarantee for the preservation of fiscal deficit and government debt and the role of the central budgetary procedure and its stages

2.1. Institutional framework

The basic legal framework for the level of fiscal deficit and government debt in the Slovak Republic, as well as in other EU Member States, is the Treaty on the Functioning of the European Union (Art. 126 of the TFEU). The reference values are set by the Protocol on the Excessive Deficit Procedure annexed to the Treaties. The reference values in Art. 126 para. (2) of the TFEU are 3% for the ratio of the planned or actual government deficit to GDP at market prices and 60% for the ratio of government debt to GDP at market prices. The absence of an excessive government deficit is also a key criterion in terms of the convergence criteria for the adoption of the euro by Member States that have not yet adopted it (Art. 140 para. (1) of the TFEU).

¹⁷ Orosz and Svák, 2021, p. 758.

¹⁸ Orosz and Svák, 2021, pp. 756–757.

From the perspective of the Slovak Republic's membership in the European Union, the legal framework contained in the so-called 'Fiscal Compact', otherwise known as the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which was signed by the 25 EU Member States in Brussels on 2 March 2012, is also important. In the Slovak Republic, the Fiscal Compact was published in the Collection of Laws under No. 18/2013 by the Communication of the Ministry of Foreign and European Affairs.

According to Art. 7 para. (5) of the Constitution, this Treaty takes precedence over laws in the hierarchy of legislation, which is directly expressed in the text of the Constitution by means of a precedence clause that demonstrates its primacy over laws at the national level.¹⁹ By signing the Treaty, the signatory Member States agreed to strengthen the economic pillar of the Economic and Monetary Union by adopting a set of rules intended to foster budgetary discipline through a fiscal compact, to fortify the coordination of their economic policies, and to improve the governance of the euro area, thereby supporting the EU's objectives for sustainable growth, employment, competitiveness, and social cohesion.

The main aim of this Treaty was to strengthen the budgetary discipline of the euro area countries and the Union in the wake of the financial crisis, the origins of which date back to 2008–2009.²⁰ To implement this Treaty, Act No. 36/2013 on the Scope of Competences of the Authorities of the Slovak Republic in Ensuring Fiscal Responsibility in the European Union was adopted. This Act established the obligation of the Ministry of Finance, in accordance with the Fiscal Compact, to submit budgetary and economic partnership programmes to the Council of the European Union and the European Commission for endorsement and monitoring, to implement these programmes, and to report ex-ante on public debt issuance plans.

The key national safeguards against excessive deficits are contained in several legal Acts that provide both the institutional and legal framework for safeguards to avoid such deficits and ensure compliance with the limits on government debt or public debt. The institutional framework consists of several bodies responsible for the management of public finances, whose powers and competences in the area of public finances as a whole are defined by the Constitution and laws. The supreme budgetary control authority is the National Council, which adopts the state budget, verifies its implementation, and adopts the annual national accounts (Art. 86 point (g) of the Constitution). The executive authority responsible to the National Council for the management of the state budget is the government (Section 30(1) of the Act on the Budgetary Rules of Public Administration). In addition to these supreme state bodies, the Ministry of Finance is, of course, also active in this area as it is the central state authority for finance under the Competence Act (Act No. 575/2001) and is responsible for formulating and implementing policy in this area.

¹⁹ Orosz and Svák, 2021, p. 103.

²⁰ Babčák, Cakoci and Štrkolec, 2022, p. 157.

To increase transparency in the budgeting procedure of the public administration, advisory bodies to the Minister of Finance have also been established, namely, the Tax Revenue Forecasts Committee and the Macroeconomic Forecasts Committee. The Tax Revenue Forecasts Committee prepares tax and levy revenue forecasts at least twice a year, by 15 February and 30 June of the current fiscal year. The Macroeconomic Forecasts Committee prepares macroeconomic forecasts at least twice a year, also by 15 February and 30 June of the current fiscal year.

The Council for Fiscal Responsibility is another constitutional authority with important powers in the area of fiscal responsibility and transparency. It prepares and publishes reports on long-term sustainability; prepares and submits assessments of compliance with the rules of fiscal responsibility and transparency to the National Council; prepares and publishes, on its own initiative, opinions on legislative proposals submitted to the National Council, in particular with regard to their impact on the public administration budget and long-term sustainability; and carries out other activities related to monitoring and assessing the development of the Slovak Republic's economy and assessing compliance with the rules of fiscal responsibility.

2.2. Impact of central budgetary planning and its methods to maintain a balanced budget

Central budgetary planning is reflected, first and foremost, in the fact that, since 2005, all public budgets are, in principle, part of the public administration budget, which represents the medium-term economic instrument of the national fiscal policy. This budget is prepared annually for at least three coming fiscal (calendar) years. The public administration budget consists of the state budget and the aggregate of the budgets of other public administration entities (e.g. municipalities, higher territorial units, state funds, higher education institutions, the Social Insurance Agency, and health insurance companies), including revenues and expenditures related to the implementation of public health insurance, for a given fiscal year and the following two years.

The legal requirement to prepare a balanced public administration budget was not part of the Act on the Budgetary Rules of Public Administration at the time of its adoption (2004). Only its amendment, which entered into force in 2014, established that the public administration budget was required to be balanced or in surplus. The adoption of this amendment was a direct consequence of the above-mentioned international treaty, the Fiscal Compact. For the sake of fairness, however, it should be noted that both the Fiscal Compact (Art. 3 para. (1)) and the Act on the Budgetary Rules (Section 30a) provide for the possibility of temporary deviations from this requirement.

In the Slovak Republic, a rule was implemented with effect from 1 April 2022, according to which a mandatory part of the public administration budget is the public expenditure limit. The public administration budget is prepared and implemented in accordance with this limit. This public expenditure limit is the main budgetary

instrument to ensure long-term sustainability and is understood as the maximum amount of total accrued consolidated expenditures of public administration in the uniform methodology applicable to the EU. However, this limit does not apply *ex-lege* to all public expenditures, as it excludes, for example, local government expenditures or EU budget funds, including those from the Recovery and Resilience Facility.

The public expenditure limit takes two basic forms: a short-term and a medium-term limit. The short-term public expenditure limit is set for each fiscal year and is part of the State Budget Act for the current fiscal year 2023 (Act No. 526/2022). The medium-term public expenditure limit for the following four years is approved by the National Council by a resolution, which is generally binding and published in the Collection of Laws of the Slovak Republic.

2.3. Procedure of the adoption of the budget and its implementation

The Act on the Budgetary Rules of Public Administration defines the state budget as the basic part of the public administration budget, which ensures the financing of the main functions of the state in a given fiscal year. The state budget for each fiscal year includes revenues, expenditures, financial transactions with state financial assets, and other transactions affecting the state financial assets or state financial liabilities.

Traditionally, the Slovak financial law literature describes that the adoption of the state budget is the first of three stages of the budgetary procedure. As such, the budgetary procedure should be understood in a broader sense than just the adoption of the budget. The three stages of the budgetary procedure are as follows: (i) preparing, discussing, and adopting the draft budget; (ii) implementing the budget; (iii) preparing, discussing, and adopting the draft annual accounts.²¹

Such a definition of the stages of the budgetary procedure is in principle similar to that in the Czech Republic, although in the Czech literature we encounter the opinion that the control of budget implementation is also a separate stage.²² In the Slovak Republic, control is perceived as an integral part of all stages of the budgetary procedure²³, although it is naturally true that its application is most pronounced at the stage of budget implementation.

In this part of the monograph, we will take a closer look at the first two stages of the budgetary procedure: budget adoption and budget implementation. According to the Constitution, the state budget is adopted by the National Council through the State Budget Act in a special legislative procedure, which we refer to as the ‘budgetary procedure’. This procedure is characterised by several differences from the normal legislative procedure, in particular: (i) The exclusive right of the government to submit a draft State Budget Act to the National Council (the right of budgetary

21 Babčák, Čakoci and Štrkolec, 2022, p. 208.

22 Karfíková, Boháč and Kohajda, 2018, p. 139.

23 Babčák, Čakoci and Štrkolec, 2022, p. 209.

initiative). Thus, only the government has the right to submit this draft, while other entities with legislative initiative do not have such a right in relation to the state budget; (ii) The existence of statutory deadlines for the preparation and submission of the draft State Budget Act (by 15 October of the current year); (iii) The regular annual periodicity of the exercise of the right of budgetary initiative, which is connected with the limited period of validity and effect of the State Budget Act (one calendar year); (iv) A legal solution to the possible non-adoption of the State Budget Act, which is a temporary budget; (v) Prohibition of amending and repealing other laws through the State Budget Act; (vi) Setting the objectives to be achieved (amounts of revenues and expenditures) without specifying the procedures and means for achieving them.²⁴

Of course, before the draft state budget is submitted to the National Council, preparatory work is carried out, especially in the Ministry of Finance. This ministry coordinates the work on preparing the budget with other public administration entities (other ministries, constitutional bodies, central state bodies, other bodies and institutions). One of the Ministry of Finance's key responsibilities is to prepare the draft state budget in accordance with the stability programme, which is a requirement of the Stability and Growth Pact. This programme sets out a budgetary strategy to ensure excessive deficits are avoided and to achieve a position that ensures the long-term sustainability of public finances. The stability programme is usually published by the Ministry of Finance in April/May of a given year for a period of four years and constitutes the basis for work on the state budget.

The SAO also plays an important role in the procedure of preparing the draft state budget: the Ministry of Finance is obliged to submit the draft budget to the SAO, which prepares an opinion on it. Although the SAO's opinion is not binding for the National Council and its members, it is crucial for the preventive control of public finances and for averting the adoption of a budget with an excessive deficit.

The adoption of the state budget as part of the public administration budget is both a legal and a political matter. The state budget is not only an instrument for implementing national fiscal policy but also, ultimately, for policy in all key areas of the activities of the state and its bodies. It is through the revenues and expenditures in the state budget that the government, in implementing its policy statement, defines its policy priorities in defence, security, education, health, social affairs, justice, and other areas. The adoption of the budget is, therefore, usually a political rather than a legal issue, and the government majority naturally promotes its objectives in the state budget. Once adopted, the State Budget Act has the character of a purposive or teleological norm; in other words, it sets specific economic objectives on the revenue and expenditure side but does not define the instruments for achieving these objectives.

The second stage of the budgetary procedure is the implementation stage, which begins on 1 January of a given year. Budget implementation refers to the way in

24 Babčák, Čakoci and Štrkolec, 2022, pp. 211–214.

which the various entities implement the objectives of the adopted budget on both the revenue and expenditure sides. On the revenue side, these objectives comprise the achievement of the expected budget revenues, which is mainly ensured by the proper and efficient collection of taxes and fees, as well as by ensuring a smooth flow of other revenues to the state budget. On the expenditure side, the main concern is to stay within the expenditure limit. This is because the public expenditure limit approved by the National Council is binding for all public administration entities whose expenditures are part of the public administration budget. The Ministry of Finance has a legal obligation to communicate these limits to all public administration entities within 30 days of the approval of the expenditure limit.

In the second stage of the budgetary procedure, the Ministry of Finance's obligation to monitor all public administration entities' compliance with the public expenditure limit is particularly important. It does so at least once per calendar quarter; if it finds data indicating that the public expenditure limit has been exceeded, it asks the ministry or other entity concerned to justify these data and, at the same time, to take measures to comply with the limit.

2.4. Budgetary control

As mentioned above, budgetary control is mainly applied at the budget implementation stage. Budgetary control may be internal or external. Internal control is performed by each public administration entity, whereas external control is performed by entities that are legally mandated to do so. Control at the budget implementation stage is performed in accordance with several laws and by a number of bodies. As far as external control is concerned, several types can be distinguished, depending on the position of the control authority and the legal regulation of this control. In terms of the importance of the role of the control authority in the hierarchy of these bodies, we distinguish the so-called parliamentary control, performed on the basis of the Constitution by the National Council, which has the power to control the implementation of the state budget. This type of control essentially represents parliamentary control of the government, which may be considered illusory in a normal situation where the government has a parliamentary majority. Nevertheless, this control is crucial in terms of democratic legitimacy because it is performed by the highest representative authority in a parliamentary democracy.

Audits performed by the SAO in accordance with Art. 60 of the Constitution and Act No. 39/1993 on the SAO. Unlike the National Council, whose composition reflects the results of free political competition, the SAO is an authority with independent status and constitutional regulation. Although the SAO is often referred to as another power in the State, it does not have sanctioning powers, which limits the implementation of the conclusions of its audit activity to some extent. From the perspective of public control over the management of public finances, it is important that the SAO's audit reports are made public.

Government audits in accordance with Act No. 357/2015 on Financial Control and Audit, which are performed by the Government Audit Office. This office has nationwide competence in relation to public administration authorities, local government, and legal persons established by them, as well as other persons managing public finances.

Internal control is performed in accordance with Act No. 357/2015 as basic financial control, administrative financial checks, and on-the-spot financial checks. This law defines a general rule on the responsibility of the statutory body of each public administration authority for the performance of this control.

In basic financial control, a public administration authority is always required to verify the compliance of each financial transaction or its part with the budget of the public administration authority, laws, contracts, and decisions, as well as internal rules at the relevant management levels.

A public administration authority is obliged to perform an administrative financial check of each financial transaction or its part to verify compliance whenever the public administration authority provides or has provided public finances to another person.

An on-the-spot financial check is a procedure by which a public administration authority gathers evidence, undertakes checks, and establishes the facts it deems necessary and is entitled to perform in its own organisational units, in legal persons falling within its funding or founding competence, in legal persons through which public finances are allocated from its budget, and in other persons in receipt of public finances allocated from the public administration authority's budget.

3. Budgetary management of local governments

3.1. Brakes to avoid excessive indebtedness

The basic rules for the budgetary management of municipalities and higher territorial units are contained in the above-mentioned Act on the budgetary rules of local government. The rules for avoiding excessive indebtedness are contained in several provisions and can be divided into preventive and protective measures. These rules are applied at all stages of the budgetary procedure, which at the level of local government is similar to that of the state budget (see above). Some of them are implemented exclusively by the local government unit concerned, whereas others involve the intervention of the Ministry of Finance. This intervention is logical as local government budgets are part of the public administration budget.

Basic preventive measures are naturally linked to the stage of budget submission and adoption. The budget of a municipality or a higher territorial unit is the basic instrument of financial management, regulating the financing of the tasks and

functions of the municipality or higher territorial unit in a given fiscal year and expressing the autonomy of their management.²⁵ At the level of the local government, a multiannual budget is also prepared as a medium-term economic instrument of fiscal policy, which expresses the objectives of the territorial development and the needs of the population, including the programmes of the municipality or higher territorial unit, for at least three fiscal years. The internal structure of the budget of a municipality or higher territorial unit is directly defined by the law, which stipulates that it is made up of the current budget (current revenues and current expenditures), the capital budget (capital revenues and capital expenditures), and financial transactions.

The main brake to avoid excessive indebtedness among local governments is the obligation to prepare the budget of a municipality or a higher territorial unit as a balanced or surplus budget, which implies that the law excludes, in principle, the preparation of a deficit budget, where expenditures would exceed revenues. However, this legal rule allows exceptions to its application in the following cases. The current budget may be prepared as a deficit budget if the expenditures are to be covered by earmarked funds from the state budget, the EU budget, or unspent funds from previous years. Nevertheless, the amount of deficit may not exceed the sum of these unspent funds. The capital budget may be prepared as a deficit budget if the deficit can be covered by unspent funds from previous years, repayable financing (loans), or the surplus of the current budget in the fiscal year concerned. As can be seen, in principle, these exceptions allow deficit budgeting in a relatively restrictive way, but always with the requirement to cover the deficit by other means.

Other preventive measures to avoid excessive indebtedness include limits and restrictions on the use of repayable financing, that is, credits and loans. The main restriction is that these funds may only be used to finance capital expenditures (i.e. investments). Local governments are not allowed to finance their current expenditures with borrowed funds. The law sets two basic limits for credits or loans: (i) the total amount of debt of a municipality or higher territorial unit may not exceed 60% of the actual current revenues of the previous fiscal year, and (ii) the amount of instalments of credits and loans in a given fiscal year may not exceed 25% of the actual current revenues of the previous fiscal year.

Other measures are implemented with the intervention of the Ministry of Finance and are classified according to their severity and impact on the economy of a municipality or higher territorial unit. These measures include a monitoring regime, a recovery regime, and a receivership.

3.2. Relationship with the central budget

The budget of a municipality or higher territorial unit expresses the autonomy of its management. These budgets include not only the revenues and expenditures

²⁵ Tekeli, Hoffmann and Tomaš, 2021, p. 386.

of the local government unit but also its financial relationship to the state (shared taxes, subsidies for the delegated exercise of state administration, other subsidies). Before we examine the budgetary relationship of the state to local government units, let us go back to 2004, when so-called fiscal decentralisation took place in Slovakia. The purpose and ultimate objective of fiscal decentralisation was to create instruments for municipalities, towns, cities, and higher territorial units that would enable these local government units to raise, through legal instruments, sufficient funds for the performance of their statutory functions,²⁶ as well as societal tasks. In its original version, the Local Taxes Act (2004) provided for eight local taxes that could be imposed by municipalities on an optional basis (real estate tax, dog tax, public space use tax, accommodation tax, tax on vending machines, tax on non-winning gaming machines, tax on nuclear installations, and tax on the entry and stay of motor vehicles in the historical part of towns) and one local tax that could be imposed by higher territorial units (motor vehicle tax). This situation lasted for ten years, when the legislature adopted the Motor Vehicle Tax Act (2014), under which this tax again became a state tax. In the case of local taxes (with the exception of the tax on nuclear installations), the principle applies that the municipalities influence their own budget revenues by setting their rates, increases, reductions, or exemptions.²⁷ Thus, the municipalities themselves construct the elements of these taxes so that their primary fiscal purpose can be fulfilled, and they have considerably stronger powers to influence their revenues than previously.²⁸

The financial relationship between municipalities or higher territorial units and the state is manifested on several levels. The first is the shares in taxes administered by the state. Under the above-mentioned Act on the budgetary allocation of income tax revenues to local government, personal income tax (but not corporate income tax) is the revenue of municipalities (70%) and higher territorial units (30%).

The second level of the financial relationship between higher territorial units and the state includes subsidies, especially those for the delegated exercise of state administration. According to Art. 71 para. (1) of the Constitution, the exercise of certain powers of local state administration may be delegated to municipalities and higher territorial units by a law, and the costs of the delegated exercise of local state administration shall be covered by the State. In this way, the State has delegated many powers of state administration to municipalities and higher territorial units. This has been most significant in primary and secondary education, where the State has delegated the exercise of state administration to municipalities (primary schools) and higher territorial units (secondary schools). The delegated exercise of state administration is financed through subsidies, the amount of which is approved in the State Budget Act (by way of illustration, the total amount was EUR 1.890 billion in 2023).

26 Jesenko, Vernarský and Molitoris, 2015, p. 106.

27 Štrkolec, 2022, p. 188.

28 Románová, 2011, p. 67.

4. New trends in national fiscal policy – crisis management and digitalisation

It is customary to refer to the current period as a period of multi-crisis. After the financial crisis, which began to take full effect at the turn of 2008–2009 and culminated in several European and national solutions, particularly in the banking sector, the budgetary impact of several other crises has also begun to take full effect since 2020. We are, therefore, currently living in crisis, or post-crisis, times, with the criterion for differentiation being the specific crisis we have in mind. The crisis triggered by the COVID-19 pandemic, the effects of which slowly began to recede in 2022, was essentially immediately replaced by the crisis triggered by the war in Ukraine, which was accompanied by an energy crisis. Finally, all these crises were topped off by the inflation crisis, which saw a sharp rise in interest rates by national central banks and the European Central Bank.

In 2023, we published a study in which we analysed the impact of the pandemic and inflation on tax law and, indirectly, on budget law.²⁹ Comparing the years 2019–2022, we concluded that the following trends were significant in the area of the tax revenues of the state budget: (i) a general year-on-year decline in the share of tax revenues for the state budget in its total revenues over the period examined (80%–75%–73%); (ii) a significant drop in income tax revenue (2019–2021), followed by a significant increase in this revenue (2021–2022); (iii) stable or partially increasing value-added tax revenue; and (iv) substantially flat and stable excise duty revenue.

The decline in public budget revenues during the pandemic was naturally accompanied by an increase in expenditure as the role of the state during this period was also to compensate citizens and businesses for the negative impacts of the pandemic. This, of course, had an impact on the public deficit. Whereas according to the Statistical Office of the Slovak Republic, the general government deficit oscillated between 1.01% and 1.21% of GDP in 2018 and 2019, this deficit rose above 5% of GDP in 2020 and 2021 (5.35% in 2020 and 5.43% in 2021). Although 2022 appeared to be a consolidation year (deficit at 2.04% of GDP), the deficit for 2023 was expected to be above 6% of GDP.

The next external factor with an impact on budgetary regulation and law, especially in 2022–2023, is rising inflation, which increased to 15.4% in the Slovak Republic in February 2023 (in September 2023, the level of inflation was at 8.2%). With regard to the State's efforts to help the population with, among other things, the consequences of inflation, mention may be made in particular of an act amending the Income Tax Act, which increased the child tax bonus from EUR 22.17, or EUR 44.34 (for a child under 6 years of age) per month, to EUR 50 per month (for a child over 18 years of age) and EUR 140 per month (for a child under 18 years of age), with effect from 1 January 2023. Although there are some corrective mechanisms in this

²⁹ Štrkolec, 2023.

amendment related to the maximum amount of the tax bonus, the aim of its authors, according to the explanatory memorandum, was to improve the financial situation of families with children as the tax bonus reduces the tax paid; in other words, a higher tax bonus means a lower tax. Of course, this measure will have a significant negative impact on public administration budget revenues, which have been quantified at 543 million in 2023. Ultimately, however, local governments will suffer most from this measure as the higher tax bonus per child will reduce the personal income tax collected, which, as a shared tax, is a crucial source of revenues for municipalities and higher territorial units.

Regarding the issue of digitalisation, the question of its impact on potential future increases in public budget revenues is particularly relevant. It can be stated that, regardless of the degree of changes that the development of new technologies will bring in the future, technological developments will clearly have a major impact on the shape of tax systems and budgetary revenues. The possible range of these changes is wide and includes a spectrum of new tax institutions ranging from the introduction of certain new types of taxes that will organically complement the 'traditional' forms of taxation (income tax, general tax on consumption) to a complete 'rebuilding' of the tax system based on priority taxation by new forms of 'digital taxes'.³⁰ Research on these new challenges for tax law can be conceived in several areas: (i) the taxation of activities based on advanced digital technologies,³¹ (ii) the taxation of the sharing economy, and (iii) the taxation of virtual currencies.³²

Several partial conclusions can be drawn from the above. As the main source of revenues for public budgets in the Slovak Republic, taxes have thus far only slowly, and to a limited extent, burdened the activities carried out in the digital world. The digital tax has not yet been introduced: digital platforms are taxed, but the question is whether the current legislation allows for their effective taxation at all.³³ Finally, virtual currencies (or the income from their sale) are subject to taxation; however, the revenue from them is marginal.

5. Conclusions

We can generally state that the legal regulation of budgets in Slovakia is in line with EU requirements. This was achieved mainly through the constitutional regulation of budgetary responsibility, the implementation of the Fiscal Compact,

30 Štrkolec, 2021, p. 379.

31 Hrabčák and Stojáková, 2020.

32 Popovič and Sábo, 2021; Štrkolec, 2023, pp. 99–101.

33 Simić, 2022, pp. 134–139.

and the adoption of legally binding EU acts.³⁴ However, due to the growing trend of deficit and government debt, it will be crucial in the coming years that the European and national rules for preventing excessive deficit and government debt are actually respected. One of the tools to achieve this is the aforementioned limiting of public expenditures, to which Slovakia has committed itself in the Recovery and Resilience Plan. In any case, it is clear that fiscal policy faces serious challenges. These challenges also naturally stem from the crisis management of the COVID-19 pandemic and the energy and inflation crises, which have collectively resulted in an increase in the public deficit, as well as in the national debt.

The so-called caretaker government, which exercised its powers between May and October 2023, has presented a proposal for measures to consolidate both the public deficit and the national debt. Without them, the forecasts for the Slovak Republic foresee a deficit level of 6.5% to 7.0% of GDP in 2024–2026 and a rise in government debt to 66.5% over the same period, well above the reference values set by the Protocol on the Excessive Deficit Procedure annexed to the Treaties. Of course, it should be added that once the new government, which emerged from the parliamentary majority after the September 2023 elections, is appointed in October 2023, the choice and implementation of these measures will be up to that government.

Among the key measures on the revenue side of the public budgets was a proposal to increase the VAT rate by 2%, increase the tax rates on tobacco products and alcoholic beverages, introduce a tax on sweetened beverages, tax real estate according to its value, and reintroduce inheritance and gift taxes. On the expenditure side of the public budgets, the most decisive proposals were related to the reduction of employment in the public sphere, the abolition of free trains for students and pensioners, and the abolition of support for reduced energy prices for businesses.

The consolidation of public finances is limited by the requirements stemming from legal regulation at the European and national levels. However, the choice of instruments for this consolidation is a purely political issue, in which the interests and programme orientation of the current government majority are reflected. In the conditions of the Slovak Republic, we will have to wait some time until specific instruments are selected and implemented as the currently appointed government (at the time of writing, October 2023) has not yet presented its programme declaration and is yet to be given a vote of confidence by the National Council.

34 For example, Council Directive 2011/85/EU of 8 November 2011 on requirements for the budgetary frameworks of the Member States, OJ L 306, 23.11.2011, 41–47.

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CHAPTER 9

SLOVENIA: FISCAL SOVEREIGNTY IN THE FRAME OF EUROPEAN SEMESTER



RADO BOHINC

Abstract

This chapter explores the similarities and differences of *Slovenia's public finance system* in terms of its position as a Member State of the European Union (EU) and Economic and Monetary Union, thereby identifying the reasons for potentially differing viewpoints. The chapter focuses on sovereignty and the advantages and challenges of the EU as a supranational community in the field of economic policy, with special regard to aligning the objectives of the EU and those of its Member States. The *Introduction* outlines the European Semester and presents data on the state debt and budget deficit in Slovenia. The *first section* then presents the constitutional rules in public finance in the Republic of Slovenia and discusses the theory on the republic's budgetary independence and fiscal sovereignty at the various levels of public finance. This discussion includes consideration of the question of fiscal sovereignty in the EU versus its Member States. Next, the constitutional guarantees for the preservation of the deficit and debt level, including the fiscal rule in the Constitution of the Republic of Slovenia, are explored. The *second section* presents the rules guaranteeing the preservation of the fiscal deficit and state debt and the role of the central budgetary procedure and its stages. First, the EU legal framework on fiscal and macroeconomic surveillance, as well as the Slovenian national fiscal legal framework, the fiscal rule, and the impact of central budgetary planning on maintaining a balanced budget, are considered. The procedure of adopting and implementing the budget and reporting and control audit are also discussed in this section. In the *third section*, new trends in national fiscal policy, sustainability, and its implications for fiscal policy are examined, in addition to the fiscal policy challenges caused by technological

Rado Bohinc (2024) 'Slovenia: Fiscal Sovereignty in the Frame of European Semester'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 203–226. Miskolc–Budapest, Central European Academic Publishing.

https://doi.org/10.54237/profnet.2024.znecogov_9

development, digitalisation, and the energy crisis. This section also tackles the topic of crisis management methods related to COVID-19 and the energy crisis.

Keywords: *state debt, budget deficit, fiscal policy, fiscal rule, macroeconomic surveillance, municipal finance, excessive indebtedness, macroeconomic balances, economic governance, European Semester*

1. Introduction

In Slovenia, the regulation and determination of state debt are governed by the requirements set by the European Union (EU) in relation to the Stability and Growth Pact (SGP) and the European Semester (ES). The SGP is an EU framework that aims at ensuring fiscal discipline among Member States. To approximate the level of state debt to the EU criteria, Slovenia follows certain rules and mechanisms. As a member of the EU and the Economic and Monetary Union, Slovenia is also required to adhere to the criteria set by the EU in the SGP, which stipulates limits for budget deficits and public debt levels to ensure the stability and sustainability of Member States' finances.

One of the key indicators used to approximate the level of state debt to the EU is the debt-to-gross domestic product (GDP) ratio. Slovenia aims to keep its debt-to-GDP ratio below the reference values established by the EU, which are 60% of GDP for public debt and 3% for the budget deficit. To ensure compliance with the EU criteria and maintain fiscal stability, Slovenia actively participates in the ES process, regularly monitors its state debt levels, implements measures to reduce debt if necessary, and provides reports to the European Commission (EC).

2. Constitutional rules of public finance

2.1. Theoretical issues of fiscal deficit and state debt

2.1.1. An overview of academic standpoints

Academic standpoints, as well as the positions on what could be the appropriate level of fiscal deficit in Slovenia and how to ensure EU compliance, are diverse. This chapter discusses the question of whether the fiscal deficit in Slovenia is compliant with the level determined by EU rules and the mechanism that obliges the state to keep its deficit under the level prescribed by EU law. Different concepts

and academic views in the field of state debt are raised. In addition, the chapter explores the issue of how the state debt in Slovenia is determined and regulated, and explains the restricting rule that approximates the level of state debt to the EU criteria.

2.1.2. Theory on EU sovereignty issues

Economic sovereignty refers to a country's ability to exercise control over its economic policies, resources, and decision-making processes without external interference. Sovereignty is one of the contentious issues in the debate on EU economic governance. The EU has developed a complex system of economic governance that involves a mix of supranational, intergovernmental, and national-level decision-making. This has raised concerns among some EU Member States about the erosion of their sovereignty and their ability to control their own economic policies.

In general, scholars' positions on economic sovereignty vary depending on their backgrounds, ideologies, and research interests. Some viewpoints advocate for a strong emphasis on economic sovereignty, arguing that it is crucial for protecting national interests, preserving cultural identity, and pursuing independent economic policies. These perspectives highlight the importance of safeguarding key industries, promoting domestic production, and reducing reliance on foreign entities. On the other hand, some more nuanced views recognise the benefits of globalisation, international trade, and foreign investment. They argue that complete economic isolation or protectionism could limit opportunities for growth and innovation. These views also emphasise the importance of balancing economic sovereignty with engagement in the EU and the global economy, seeking mutually beneficial relationships, and participating in regional or international economic integration initiatives.

2.1.3. Fiscal sovereignty

The EU provisions on the ES obliging Member States to prepare a stability programme and a reform programme that include the coordination of the budget deficit and public debt are of key importance and represent a fundamental starting point for Slovenia. Certainly, more than any political direction, they influence the preparation and discussion of the budget and, thus, the country's fiscal policy. It is crucial for Member States that the European Council examines the programmes based on the assessment of the EC, in particular the progress made toward achieving medium-term budgetary objectives and adopting an opinion, as an integral part of the country-specific recommendations.

Governments are aware that Member States can be asked to adapt their stability programmes and that the Commission and EC monitor the implementation of these programmes. This is the real context when talking about fiscal sovereignty.

In Slovenia, the state authorities take both the opinions and recommendations accepted in the evaluation process very seriously; therefore, it is questionable to even discuss the non-binding nature of an opinion or recommendation, given that there are consequences that every country wants to avoid. Thus, *de facto*, these opinions and recommendations are mandatory guidelines for conduct in budget preparations and procedures.

The rules are strict and enforceable, and not simply recommendations that a Member State can follow: they thoroughly and directly interfere with a Member State's sovereignty in relation to its autonomy in the field of public finances and, consequently, taxes, monetary policy, and state aid. Another question is whether this is, in the long term, a harmful or beneficial intervention in the democracy and sovereignty of Member States. Sooner rather than later, long-term solid public finances and, thus, the economy and society become the political responsibility of the leaders of the Member State.

2.1.4. An appropriate fiscal rule for sustainable growth and stable public finances

The theory deals extensively with the question of the form in which the fiscal rule should be re-enforced. The prevailing criticism is that the Maastricht and SGP criteria were created in completely different macroeconomic circumstances. Damjan argues that since the beginning of the 1990s, the economic situation upon which the Maastricht public debt limit and the concept of the fiscal framework within the SGP are based has changed drastically.¹ He further states that in such a situation, insisting on a fiscal rule based on the context of the 1970s and the indicators of the 1990s would be completely misplaced, ineffective, and unsustainable. Referring to Ubide,² Damjan proposes four measures:³ abolishing the 60% debt-to-GDP target, making the NextGen Fund and Eurobonds permanent, introducing the principle of the golden rule for national budgets, and strengthening mandatory spending reviews by independent national fiscal councils. Damjan suggests that these four measures should be supplemented by a simple fiscal rule specific to each country that focuses on a single instrument – the trajectory of the primary budget balance.

2.1.5. Was the introduction of the constitutional fiscal rule necessary?

In 2013, provoked by the post-crisis EU debate on the fiscal discipline of Member States and in the light of the measures adopted at the EU level, Slovenia amended its constitutional rules on public spending and enforced the mandatory fiscal rule. According to the theory⁴ in Slovenia, this constitutional amendment was not necessary

1 Damijan, 2021; See also: Blanchard, Alvaro and Zettelmeyer, 2021.

2 Ubide, 2017.

3 Damijan, 2021.

4 Kamnar and Borak, 2013.

at all because the compliance of regulations with the international Acts to which Slovenia has acceded is already determined by Art. 8 and Art. 153 of the Constitution of the Republic of Slovenia.⁵ Art. 8 of the Constitution explicitly stipulates that laws and other regulations must be in accordance with the generally applicable principles of international law and international treaties that bind Slovenia. Ratified and published international treaties are applied directly. Meanwhile, Art. 153 explicitly states that laws must be in accordance with generally applicable principles of international law and with valid international treaties ratified by the National Assembly, as well as with other ratified international treaties. As the theory correctly notes, the National Assembly ratified the Treaty on Stability, Coordination and Governance in the Economic Monetary Union (TSCG).

The adoption of an amendment to Art. 148 was unnecessary as ratified international treaties are part of the Slovenian legal order. Experts have also commented on the use of terminology, namely, that different terms are used inconsistently for the same concept: in the first paragraph, receipts and expenditures, and in the second paragraph, revenues and expenditures.⁶

2.1.6. Small countries must be more fiscally cautious than large ones

Based on experience, the literature⁷ states that small countries, including Slovenia, must be more fiscally cautious than large ones. In 2013, Slovenia was on the verge of bankruptcy, even though public debt at that time was only 45% of GDP, significantly below the Maastricht criterion (80% of GDP) and today's level (86% of GDP). According to Mrak,⁸ it is unwise to take the Maastricht criteria as a reference. Mrak⁹ is very critical of the government, which is creating a large deficit this year (2024) with significant public spending and plans to continue to do so for the next two years. According to him, the public finance deficit is expected to decrease significantly under these circumstances, when economic growth has stabilised.

2.2. Constitutional guarantees for the preservation of the deficit and debt level

2.2.1. Fiscal rule in the Constitution of the Republic of Slovenia

Constitutional provisions are set out in Chapter VI of the Constitution of Slovenia and several laws and sub-laws that regulate public finances, state and municipality

⁵ Official Gazette of the RS, no. 33/91-I, 42/97 – UZS68, 66/00 – UZ80, 24/03 – UZ3a, 47, 68, 69/04 – UZ14, 69/04 – UZ43, 69/04 – UZ50, 68/06 – UZ121,140,143, 47/13 – UZ148, 47/13 – UZ90,97,99, 75/16 – UZ70a in 92/21 – UZ62a.

⁶ See: Constitution of Slovenia

⁷ Mrak, 2021; Mrak, 2022.

⁸ Mrak, 2021; Mrak, 2022.

⁹ Mrak, 2021; Mrak, 2022.

funding, taxes, and the budget. Art. 148 of the Constitution was introduced into the Slovenian legal order in its current form by the Constitutional law UZ148, which entered into force on 24 May 2013. The first sentence of the second paragraph of this article, which regulates the constitutional fiscal rule, stipulates that the medium-term balance of revenues and expenditures of state budgets without borrowing, or revenues, must exceed expenditures. The amended Art. 148 also provides an exception to this rule, namely, that this principle may be temporarily waived, but only in exceptional circumstances for the state.

Medium-term balancing means that the duty of such fiscal management and planning focuses on the state of public finances throughout the entire economic cycle and not only on the current budget year, and takes into account the current state of the national economy in the cycle in each year. The medium-term balance of the country's budgets without borrowing can be achieved in several ways defined by law. The amended Art. 148 of the Constitution mandates a rational and long-term sustainable public finance policy, as well as the prevention of excessive borrowing and the creation of high budget deficits and high levels of public debt, which could lead to the illiquidity and insolvency of the state.

2.2.2. Fiscal Rule Act

The Fiscal Rule Act (FRA),¹⁰ which was, according to the Constitution, adopted by the National Assembly with a two-thirds majority in 2015, determines *the method and time frame* of the implementation of the principle of balance, the criteria for determining exceptional circumstances, and what actions should be taken when they occur. The Constitution stipulates that the duty of medium-term balancing (second paragraph of the amended Art. 148 of the Constitution and the FRA) was to be used for the first time for the preparation of the state budget for 2015. The duty of gradual adjustment, which enabled the preparation of the state budget for 2015 in accordance with the amended Art. 148, appeared by promulgating the constitutional law.

According to Art. 3 of the FRA, revenues and expenditures of general government budgets are balanced (in the medium term without borrowing) if the structural balance of the general government sector in a given year is not lower than the minimum value set in the ratified international (EU) TSCG in the Economic and Monetary Union. The medium-term balance is ensured by limiting the projected volume of general government expenditure upwards to the level that ensures such compliance.

10 Official Gazette of the RS, no. 55/15, 177/20, compr. and 129/22

3. The rules of guarantee for the preservation of fiscal deficit and state debt and the role of the central budgetary procedure and its stages

3.1. Institutional framework

3.1.1. EU legal framework of fiscal and macroeconomic surveillance

In Slovenia, in addition to the Constitution, several national laws and government regulations govern fiscal deficit and state debt. These laws outline the fiscal principles, procedures, and borrowing limits in line with EU fiscal rules.

An important legal system feature of the ES is that the vast majority of rules from 1997 up to the present day have been created by EU regulations, rather than directives. EU regulations are binding legal Acts that have a direct effect on Member States' laws. Consequently, the development of fiscal legislation in Member States (except in rare cases) did not proceed with the adaptation to or harmonisation with European directives; instead, EU rules were implemented with immediate, direct effect. The question of sovereignty must, therefore, be resolved in the procedures for the adoption of EU regulations, which is a matter of primary law (Treaty on the European Union, TFEU). The most relevant pieces of the EU legislation in this field are: (i) Arts. 121, 126, and 148 of the TFEU, attached Protocol 12 and Regulation 1173/2011 (the deficit criterion: the public finance deficit is considered excessive if it is higher than the reference value of 3% of GDP at market prices; or the debt criterion: the debt is higher than 60% of GDP, and the annual target reduction of the debt by one-twentieth of the debt amount exceeding the 60% limit has not been achieved in the last three years); (ii) The six legislative Acts (the 'Six Pack') that reformed the SGP, especially Regulation 1175/2011;¹¹ (iii) The Fiscal Pact,¹² as an intergovernmental agreement that the budget expenditures of the signatory countries should not exceed 3% of GDP, and a slightly more narrowly defined structural deficit of 0.5% or 1% of GDP, depending on the state of indebtedness of the public finances in the signatory country; (iv) Several EU regulations that form the direct legal basis for the

11 Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 306, 23.11.2011, 12–24.

12 The TSCG, also known as the 'Fiscal Compact', is an intergovernmental Treaty signed by the EU Member States (except the Czech Republic and the United Kingdom) on 2 March 2021. The main provision of this Treaty is the requirement to have a balanced budget rule in domestic legal orders.

so-called budgetary surveillance (Pillar 1),¹³ macroeconomic surveillance (Pillar 2),¹⁴ and socioeconomic coordination (Pillar 3)¹⁵ of the ES process.

3.1.2. Legal framework of Slovenian public finance

Budgetary and other fiscal issues in Slovenia are based on the following financial laws and policy Acts: (i) The FRA determines the method and period of implementing the principle of medium-term balance of the revenues and expenditures of state budgets without borrowing (medium-term balance), the criteria for determining exceptional circumstances in which the medium-term balance may be deviated from, and the manner of dealing with their occurrence or termination; (ii) The Public Finance Act (PFA)¹⁶ governs the preparation and execution of the Slovenian budget, the management of state property, state borrowing and guarantees, the management of public debts (the terms and scope of state borrowing), the accounting and internal control of public finances, and budget inspection.

The PFA also lays down the rules applicable to the *Health Insurance Institute of Slovenia* and the *Pension and Disability Insurance Institute of Slovenia* (related to

13 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, 1–5 (the preventive arm of the Stability and Growth Pact); Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 306, 23.11.2011, 12–24; Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 209, 2.8.1997, 6–11; Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, OJ L 145, 10.6.2009, 1–9; Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, OJ L 140, 27.5.2013, 1–10; Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, OJ L 140, 27.5.2013, 11–23.

14 Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area, OJ L 306, 23.11.2011, 1–7; Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, OJ L 306, 23.11.2011, 8–11; Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 306, 23.11.2011, 33–40; Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L 306, 23.11.2011, 41–47.

15 Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, OJ L 306, 23.11.2011, 25–32; Art. 28 of the Charter of Fundamental Rights of the European Union, OJ C 326, 26.10.2012, 391–407.

16 Official Gazette of the RS, no. 11/11 – official consolidated text, 14/13 – corr., 101/13, 55/15 – FISP, 96/15 – ZIPRS1617, 13/18 and 195/20 – US; partially transposes into the legal order of the RS Council Directive 2011/85/EU.

the compulsory part of these types of insurance), public funds, public institutes and agencies when drawing up and submitting financial plans, managing cash, borrowing, guaranteeing, accounting, submitting annual reports and the internal control of public finances, and budgetary inspections.

In addition, the PFA regulates borrowing and the granting of guarantees by public institutes, public companies, and other legal entities in which the state or municipality has a decisive influence on management. Further, it regulates the medium-term planning of fiscal policy and measures to ensure fiscal discipline and establishes rules for the use of surpluses of institutional units in the general government sector. (i) The Budget Execution Act (BEA) determines the composition of the budget and the specifics of its implementation. The BEA also defines the use of cohesion policy funds, assigned revenues, and state revenues. In addition, the BEA governs the volume of borrowing and guarantees of the state and public sector at the state level. It also stipulates the assumption of obligations and other issues related to the implementation of the budget for the current year. (ii) The Accounting Act¹⁷ governs the keeping of business books and the preparation of annual reports for the budget, budget users, and legal entities under public law, as well as legal entities under private law that do not keep business books on the basis of the Companies Act. (iii) The Transparency of Financial Relations and Separate Registration of Various Activities Act¹⁸ governs the transparency of financial relations of state bodies and bodies of self-governing local communities with public undertakings and legal persons, sole proprietors, and private individuals who carry out activities in the general interest on the basis of an exclusive or special right or public authority. (iv) *The Financing Programme of the Slovenian central government budget for the fiscal year*¹⁹ is the basic operational document for financing the execution of the state budget and government debt management transactions. It defines the structure of instruments for financing the state budget and managing government debt.

For the purpose of our discussion, it is important to note that *Slovenian fiscal legislation strictly follows EU legislation*; in fact, there are mainly *regulations with direct effect* on this field. The EU fiscal regulation is very detailed, especially the parts that determine the limits of borrowing and the budget deficit and those related to the procedures for adopting the budget Acts of the Member States (the ES). In addition to regulations that have direct effects, there is, for example, the *Directive 2011/85/EU* on requirements related to the budget frameworks of Member States, which was transposed into the legal order of Slovenia by the FRA, PFA, and BEA. Directive 2011/85/EU lays down detailed rules necessary to ensure Member States' compliance with obligations under the TFEU with regard to avoiding excessive government deficits. Therefore, for example, if the FRA is an implementing Act of the amended Slovenian Constitution and at the same time, it implements an EU directive, it can be concluded

17 Official Gazette of the RS, no. 23/99, 30/02 – ZJF-C and 114/06 – ZUE.

18 Official Gazette of the RS, no. 33/11.

19 Based on Art. 84 of the PFA.

that the constitutional amendment resulted in the implementation of a European directive, which opens up additional aspects of sovereignty.

3.1.3. *Implementation of the constitutional fiscal rule*

The FRA is an *implementing Act for the constitutional fiscal rule*, that is, a method of implementing the principle from Art. 148/2 of the Constitution at the legislative level. This provision of the Constitution authorises the National Assembly to regulate issues related to the implementation of the constitutional fiscal rule in more detail (e.g. the method and time frame of implementing the principle of medium-term balance, the criteria for determining exceptional circumstances and what actions to take when they occur).

Following the Constitution, Art. 1 of the FRA *determines the method and time frame for implementing the principle of the medium-term balance* of the revenues and expenditures of the state budget without borrowing, the criteria for determining exceptional circumstances in which the medium-term balance may be deviated from, and the manner of dealing with their occurrence or termination.

In the *proposal for the initiation* of the procedure for amending Art. 148 of the Constitution with the draft of the Constitutional Act of 8 March 2012, the government highlighted excessive borrowing as a major problem in public finances. According to the proposal, the amendment of Art. 148 would establish a framework for ensuring the sustainability of public finances, noncyclical effects, and independent fiscal control over budgets before their adoption. For the stability of public finances, it is necessary for the budget to be balanced and for a legal basis to limit public borrowing to be adopted. The strengthening of public financial discipline and the placement of the fiscal rule in the Constitution was necessary *to prevent the further deterioration of Slovenia's position in the international financial markets*.

The purpose of Art. 148 of the Constitution was *to limit the state* (i.e. the government and, upon its proposal, the National Assembly) in making decisions on the amount of revenues and expenditures, borrowing, and the public financial deficit. Since this represented a question of limiting the decision-making rights of the National Assembly, the government decided to determine this limitation *by amending Art. 148 of the Constitution* and not, as was originally planned, only by adopting the relevant law (Decision of the Constitutional Court U-I-129/19-26). In the discussion, opinions were also highlighted (Proposal for the initiation of the procedure for amending Art. 148 of the Constitution), that it is all the more important for Slovenia *to maintain its fiscal sovereignty*, which over-indebted countries lose sooner rather than later, given that it is a small open economy in a monetary union without monetary sovereignty.

3.2. The impact of central budgetary planning and its methods to maintain a balanced budget

3.2.1. Medium-term fiscal strategy (Article 9 of the PFA)

On 9 December 2022, the Slovenian government adopted the *Medium-term Strategy for Public Debt Management* for the period 2023–2025 and authorised the Ministry of Finance to implement it. In addition to the target balance of the state sector and the upper limit of state sector expenditures for the current year and the following three years, which are specified in the framework for the preparation of state sector budgets from Art. 6 of the FRA, this strategy also includes: (i) *The spring forecast* and comparison of the spring forecast with the latest EC macroeconomic forecast; (ii) *Forecasts of the basic categories of taxes, contributions, non-tax revenues*, and other categories of state sector revenues for the current year and the next three years, based on the macroeconomic scenario without taking measures into account; (iii) *Forecasts of the basic economic categories* of state sector expenditures for the current year and the next three years, based on the macroeconomic scenario without taking measures into account; (iv) *Comparison of state sector revenues and expenditures* and the target balance of the state sector with the latest EC estimate; (v) *Qualitative and quantitative descriptions of the measures*. These are divided into the basic economic categories of the state sector revenues and expenditures with which the target balance of the state sector will be achieved, compared to the forecasts from points 2 and 3 above with unchanged policies; (vi) *Long-term assessments of the sustainability* of public finances; (vii) The upper limits of government sector debt and government sector guarantees for the current year and the following three years as a percentage of GDP; (viii) Sensitivity analysis under different assumptions of GDP growth and interest rates.

3.2.2. Financing Programme of the Slovenian central government budget

The Financing Programme for the execution of the budget for the 2023 fiscal year (*hereinafter: the ‘Financing Programme’*)²⁰ is an *annual operational document* for financing the execution of the state budget and government debt management transactions, based on the FRA and PFA. The Financing Programme follows Art. 81 of the PFA, which allows the government to finance not only the execution of the central government budget for the fiscal year but also additional financing for the purpose of pre-financing, which is limited by the level of debt principal repayments in the following two fiscal years.

According to the Financing Programme, the Slovenian central government budget debt was estimated to stand at EUR 41,283,208,212 (EUR 37,831 million in 2022) at the end of 2023, representing 66.6% of GDP (65.3% in 2022). Slovenia’s estimated GDP for 2023 was EUR 61,951 (EUR 57,921 in 2022). The Financing Programme is

20 Government Decision no. 41003-21/2022/4 of 22 December 2022.

expected to be composed of 0.7% floating-rate and 99.3% fixed-interest financing instruments. The priorities also include *structural or institutional changes*, which are financially evaluated in such a way that they are in line with the *limitations set by the FRA*. Those changes that promise verifiable and long-term positive effects that contribute to achieving the medium-term fiscal goal are considered *structural changes*.

3.2.3. *The terms and scope of state borrowing – Article 81 of the PFA*

Art. 81 of the *PFA* governs the *terms and scope of state borrowing*. In order to implement the state budget in the current fiscal year, *the state can borrow domestically and internationally, as follows*: (i) *up to the amount of the deficit* in the income and expenditure balance, the account of financial receivables and investments, and the repayment of debt principals due in the current fiscal year; (ii) *up to the amount necessary to repay the principals of the debts* of the state budget that fall due in the next two fiscal years.

During the period of *temporary financing*, the state can borrow *up to the amount required to repay the principals of the state debt* in the current fiscal year.

In order to carry out interventions on the secondary market of its own debt securities, the state *can borrow with the additional issuance of individual own debt securities* up to the extent specified for this purpose in the law governing the implementation of the budget for an individual year. The volume of borrowing for the implementation of interventions on the securities market is not included in the volume of borrowing nor in the amount of liquidity borrowing. Irrespective of the above rule, the state can take on additional liquidity debt but only up to a maximum of 15% of all expenditures in the last adopted budget.

The *law that regulates the execution of the budget for an individual year (the BEA)* determines the extent of state borrowing. It can increase up to the difference between: (i) spending rights for the repayment of debt principals, nominated in a foreign currency, which are planned in the adopted budget; (ii) the right of consumption, necessary for the realisation of repayments of the stated principals, caused by the increase in the exchange rates of foreign currencies during the realisation of the payment in relation to the exchange rate of these currencies at the time of budget planning.

The *PFA* also stipulates that the government must adopt a *medium-term public debt management strategy at least every three years*, in which it sets the medium-term goals to be pursued in the borrowing and debt management of the state budget. The strategy is then implemented by the ministry responsible for finance.

3.2.4. *The extent of state borrowing for each year*

The extent of state borrowing for each year is determined by Art. 51 of the 2023 and 2024 *Budget Execution Act*.²¹ For example, the law stipulates that in order to

21 Official Gazette of the RS, no. 150/2022.

cover the excess of expenditure over income in the income and expenditure balance, the excess of expenditure over revenues in the financial receivables and investments account, and the repayment of debts in the financing account, the state can borrow up to EUR 4,165,829,803 for the year 2023 and up to EUR 4,577,355,729 for the 2024 budget.

A borrowing instrument is also the *temporary sale of own debt securities*. State borrowing for the needs of managing its debts and debt assumption are not included in the scope of state borrowing. In addition, in accordance with Art. 81/3 of the PFA, the state may take on *additional debt for implementing interventions on the market* of its own debt securities. The maximum volume of additional borrowing for this purpose may not exceed EUR 2,800,000,000. The extent of state borrowing for each year is also determined in the annual budget; for example, *the amended budget for 2023*.²²

4. Procedure for the adoption of the budget and its implementation

4.1. Forecasts of macroeconomic aggregates and scenario preparation

The preparation and execution of the budget of the Republic of Slovenia, the management of the state, state borrowing and guarantees, the management of state debts, the accounting and internal control of public finances, and budget inspection are laid down by the PFA.

No later than seven days after the publication of statistical data on the growth of the GDP in the last quarter of the previous year, the *Institute of Macroeconomic Analysis and Development* (IMAD) forwards *the spring forecast of macroeconomic aggregates* for the current and at least the next four years to the ministry responsible for finance. A comparison between this forecast and the latest forecast of the EC, as well as an explanation of significant deviations, is then added (Art. 9b of the PFA). The IMAD also prepares a scenario that takes into account the financially evaluated effects of the measures from the *National Programme of Development Policies*. Then, no later than seven days after the publication of statistical data on the growth of GDP in the second quarter of the current year and the first annual assessment of economic growth in the previous year, the IMAD forwards *the autumn forecast of macroeconomic aggregates* for the current year to the ministry responsible for finance.

²² Official Gazette of the RS, no. 150/2022.

4.2. Preparation of forecasts of income or revenues and expenses (Article 9c of the PFA)

Based on the National Programme of Development Policies, the spring forecast, and the guidelines of the ministry responsible for finance, the proponents of financial plans (ministries and governmental offices) forward *the forecasts of revenues and expenditures* to the ministry responsible for finance. This is done for the *current year* and the *following three years* no later than 15 March of the current year. In addition, *public agencies and public funds (so-called ‘indirect users’)*, the founder of which is the state, *forward their revenue and expenditure forecasts* according to economic classification and forecasts of expenditures no later than 15 March of the current year to the ministry responsible for finance.

On the same basis, the *Pension and Disability Insurance Institute* and the *Health Insurance Institute* of Slovenia prepare tentative financial projections of revenues and expenditures for the current year and the following three years and forward the current year’s projections to the ministry responsible for finance by 15 March. Likewise, *all institutional units that belong to the state sector* (hospitals, universities, educational, cultural and research institutions, etc.) and others that are not direct users of the state or municipal budget prepare revenue and expenditure forecasts for the current year and the following three years and submit them to the ministry responsible for finance by 15 March of the current year.

4.3. Budget adoption procedure (Article 28 of the PFA)

The government must determine the *draft budget* and submit it to the National Assembly by *1 October* of the current year. If, during the preparation of the budget proposal or budget amendments, the assumptions of economic development, the direction of economic and public finance policy, or the scope and composition of the budget *change significantly*, the government adopts *amendments to the budget memorandum* together with the *proposal of the state budget* or budget amendments.

The National Assembly must adopt the budget within a time frame that allows the budget to *come into effect on 1 January* of the year for which the budget is adopted (Art. 29 of the PFA). Any changes to the budget must be adopted by the National Assembly before the beginning of the year for which they are to apply, in accordance with the procedure set out in the Rules of Procedure of the National Assembly.

4.4. Preparation, implementation, and monitoring of the budget proposal

The regulation on development planning documents and procedures for the preparation of the state budget proposal²³ regulates the *method of preparation, the implementation and monitoring* of development planning documents, the *formulation*

23 Official Gazette of the RS, no. 54/10 and 35/18.

of policies, the determination of *national development priorities*, and the preparation of the *budget memorandum*. This regulation also regulates the procedures and documents for the *preparation of the state budget, its amendments and rebalancing*, and other documents related to these Acts. Further, the regulation is also used to prepare the government's positions on development planning documents at the *level of the EU* and international organisations, as well as other obligations at the international level.

The development planning documents include the Development Strategy of Slovenia (Art. 6 of the PFA) and other documents *prepared by ministries and government departments* in accordance with regulations and with the adopted programme of work in the areas of individual policies. The Development Strategy of Slovenia is prepared by the government department responsible for development, the Ministry of Finance, and the IMAD (Art. 11 of the PFA).

On the proposal of the minister responsible for finance, the government adopts the *National Programme of Development Policies* by 30 November of the current year. This programme is a document that includes policies, sources of funds, and measures to achieve the target balance of the state sector in accordance with the FRA, and defines and financially evaluates the government's priorities for the next four years. To prepare the National Programme of Development Policies, *ministries submit the order of priorities* or the changes within their competence for the next four years to the ministry responsible for finance at the sub-programme level by no later than 15 October of the current year. The priorities are established in line with the goals defined in the country's overarching development document, the *Development Strategy of Slovenia*. In addition to their priorities, each ministry also forwards the associated proposed measures. The *2023 BEA* defines the *Recovery and Resilience Plan*. This document covers measures eligible for EU funding under the *Recovery and Resilience Mechanism*, which was set out in *Regulation 2021/241*.²⁴

5. Reporting and control audit

5.1. The report of the Fiscal Council

The Fiscal Council of the Republic of Slovenia is an independent state body that prepares assessments and recommendations regarding the compliance of the public finance policy with the fiscal rules, regulations governing public finances, and EU regulations that regulate economic governance in the Member States. Every two years, the Fiscal Council performs *an analysis of the forecasts* of macroeconomic aggregates from Art. 9b of the FRA for the previous four years and presents it in a

²⁴ Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, OJ L 57, 18.2.2021, 17–75.

report. In the event of identified deviations, the Fiscal Council *forwards the relevant findings to the government*, and the government must prepare *corrective measures* accordingly. The Fiscal Council publishes the report publicly on its website. According to Art. 7 of the FRA, the Fiscal Council's tasks include: (i) *Forwarding the assessment of the sustainability and compliance* of public finance policy with fiscal rules based on the draft Stability Programme to the government and the National Assembly within seven days of receiving the framework proposal and the draft Stability Programme; (ii) *Submitting the assessments on compliance with fiscal rules* based on the national budget proposal no later than 20 October of the current year, and on the state budget rebalance proposal within 15 days of receiving this proposal; (iii) *Forwarding the assessment* to the government and the National Assembly within 30 days of receiving the consolidated balance sheet of the state sector and the estimates of the Statistical Office of the Republic of Slovenia for the entire state sector by 30 June of the current year for the previous year; (iv) *Forwarding the assessment of the compliance of executed budgets of the state sector with fiscal rules* to the government and the National Assembly within 15 days of receiving the proposal for changes to the framework and the proposal for a programme of measures that will once again ensure adherence to the medium-term balance.

The government prepares a written position based on the Fiscal Council's assessment and forwards it to the National Assembly. The National Assembly can instruct the government to prepare amendments to the proposed Act or develop additional measures based on the Fiscal Council's assessment. If the assessment shows that the framework proposal is not in accordance with medium-term fiscal goals and the National Assembly does not accept the framework for this reason, the government must present an amended proposal of the national budget to the National Assembly by 15 September.

5.2. Repair mechanism

The correction mechanism from the FRA (Art. 11) is implemented in two cases: (i) If the government determines, based on the Fiscal Council's assessment, that the medium-term balance is not implemented; or (ii) If the government receives a recommendation or a call from the Council due to a deviation from the provisions of the SGP.

In these cases, the minister responsible for finance shall apply the *measures* set out in the PFA for the *medium-term balancing* of public finances. If the measures do not ensure the implementation of the medium-term balance or compliance with a recommendation or request by the Fiscal Council, the government must submit *proposals for amending the framework* and a *programme of measures* that will once again ensure compliance with the medium-term balance to the National Assembly within three months or after receiving this recommendation or request. The government forwards both proposals to the Fiscal Council.

The proposed programme of measures contains *measures to the extent that is proportional* to the established deviation from the medium-term balance or to a detected

divergence from the planned elimination of a deviation from the medium-term balance. The programme is compliant with the provisions of the SGP.

5.3. Fiscal discipline (Article 9e of the PFA)

In the cases referred to in the first paragraph of Art. 11 of the FRA (see above), the minister responsible for finance puts in place measures to ensure fiscal discipline, starting on the first day of the following month and for a maximum of 60 days. These measures endeavour to restore the medium-term balance of public finances, namely by: (i) Permitting the assumption of obligations only on with the prior consent of the minister responsible for finance; (ii) Recommending that the government adopt regulations that reduce the expenditures of the budgets of the state sector; (iii) Prohibiting the redistribution of consumption rights.

If a *proposal must be drafted to change the framework* in order to ensure adherence to the medium-term balance of public finances (Art. 3 of the FRA) in accordance with Art. 11/2 of the FRA, the measures remain in place until the adoption of the change to the framework.

5.4. Inspection control

The PFA regulates inspection controls in Art. 102. The *Ministry of Finance supervises* the implementation of the provisions that regulate operations with state budget funds. The tasks of inspection controls are performed by *budget inspectors* as employees with special powers in the ministry responsible for finance. The budget inspector independently performs the inspection control tasks assigned to them; issues minutes, decisions, and conclusions in the administrative procedure; and orders other measures for which they are authorised. The budget inspector also handles applications, complaints, communications, and other applications in matters within their jurisdiction and informs applicants of their actions at their request. The budget inspector is responsible to the supervisor for the correct and timely performance or omission of tasks; the provisions of the law regulating the general administrative procedure and the law regulating systematic inspections apply here.

Direct and indirect users and other recipients of funds from the state budget must allow budget inspectors to carry out inspections for funds obtained from the state budget; provide all the required data, documents, and reports that relate to inspections; and enable computer processing of these data.

5.5. Internal control of public finances

Internal controls of public finances include a system of financial management and controls, as well as *internal auditing for direct users* (ministries, government bodies, services) and *indirect budget users* (public institutions, public agencies, public funds), based on uniform foundations and the continuous verification of this system (Art.

99 of the PFA). The internal control of public finances must ensure that financial management and the system of controls work in accordance with the principles of *legality, transparency, efficiency, effectiveness, and economy*.

The *heads of the direct and indirect users are responsible* for establishing and operating an appropriate system of financial management and controls, as well as internal auditing. Internal auditing provides *independent verification of financial management* systems and controls, in addition to advice to management to improve their effectiveness. Internal auditing is carried out by *internal auditors*. The internal auditor performs audits in accordance with the code of professional ethics of internal auditors and with the standards of internal auditing issued by the minister responsible for finance based on the provisional opinion of the *Court of Audit*.

5.6. Audit of the final budget account

The final account of the state budget is an Act of the state that shows the anticipated and realised revenues and other revenues, as well as the state's expenses and other expenditures for the previous year. An integral part of the final account is the summary balance sheet of the state budget (Art. 96 of the PFA). The ministry responsible for finance prepares a proposal for the final account of the state budget and submits it to the Court of Audit by 31 March of the current year.

When issuing a draft audit report, the *Court of Audit may propose corrections* made by an auditor. The auditor's correction proposal must be based on applicable regulations and contain legal bases and a reference to the original authentic accounting documents, which enable the correction of any irregularities found by the Court of Audit in the proposal for the final account of the state budget. No later than in the objection to the proposal of the audit report, *the government decides which of the auditor's corrections* will be taken into account and in what way, and determines the final proposal of the final account of the state budget.

By 1 October of the current year at the latest, and at the proposal of the ministry responsible for finance, the government submits the proposal for the final account of the state budget, together with the final report of the Court of Audit and explanations for disregarding the auditor's individual correction proposals, to the National Assembly for adoption. If the National Assembly does not accept the proposal for the final account of the state budget, it instructs the government to prepare a new proposal and determine the corrections that must be taken into account based on the errors revealed in the Court of Audit's final report.

5.7. Budget balancing measures in 2022 and 2023

Budget balancing measures are regulated by the PFA and, specifically for 2022 and 2023, by the BEA. The rule is as follows: if expenditures increase or budget revenues decrease during the budget year due to the creation of new obligations for the budget or changed economic trends, the government may, on the proposal of the ministry

responsible for finance, *suspend the execution of individual budgets for a maximum of 45 days' expenditure* (temporary suspension of execution). With this measure, the government can stop the assumption of obligations, propose an extension of contractual payment deadlines and stop the redistribution of budget funds necessary for the assumption of obligations. The same can be done at the municipal level.

The government can also determine that direct users, except for the National Assembly, the National Council, the Constitutional Court, and the Ombudsman or the Court of Audit, must obtain the *prior consent of the ministry responsible for finance* in order to conclude a contract. The ministry responsible for finance prepares a proposal for the scope and measures of the temporary suspension of enforcement in cooperation with direct users. The suspension of enforcement measures must apply equally to all direct users. The government must inform the National Assembly about the decision.

If the budget cannot be balanced during the implementation of the measures, the government must propose a *rebalancing of the budget* no later than 15 days before the end of the period for the temporary suspension of the execution of the budget. With the rebalancing of the budget, which is adopted by the National Assembly at the proposal of the government, the revenues and expenditures of the budget are *rebalanced*.

During the period of the adoption of the budget rebalance, the government can, at the proposal of the minister responsible for finance, temporarily *suspend the execution of individual expenditures again*. Balancing measures according to the BEA are foreseen in the event that, based on the budget revenues paid during the current year, the government estimates that revenues will be less than 3% lower than planned or that expenditures will be less than 3% higher than planned in the adopted budgets. In this situation, in addition to the measures for balancing the budget (Art. 40 of the PFA), a measure for the *proportional reduction of spending rights* is applied, except for spending rights for the implementation of common European policies and dedicated budget revenues.

Measures to reduce consumption rights are set at the *same percentage for all direct users*, and the government determines which consumption rights are affected by the measure. The measures may refer to consumption rights from which one or more of the *following purposes are financed*: expenditure on goods and services, subsidies, transfers to non-profit organisations and institutions, other current domestic transfers that do not include funds for labour costs, current transfers abroad, or investment expenses and investment transfers. Consumption rights from the measure of the proportional reduction of consumption rights are redistributed to the general budget provision.

5.8. Creation and use of budget reserve funds

In the budget, according to Art. 48 of the PFA, funds are provided for the *budget reserve, which acts as a budget fund*. Funds from the budget reserve are used to finance expenses for eliminating the consequences of *natural disasters*, such as earthquakes, floods, landslides, avalanches, heavy snow, strong winds, hail, sleet, frost, drought,

other disasters caused by natural forces, *ecological disasters*, and mass outbreaks of contagious human, animal, or plant diseases.

A part of the total annual budget revenues to the amount determined by the budget, but *no more than 1.5% of the budget revenues*, is allocated to the budget reserve funds. This allocation is made temporarily every month but is made definitively after the final account of the budget for the previous year. The government decides on the use of funds of up to 2% from the planned budget reserve in individual cases at the proposal of the minister responsible for finance. The government informs the National Assembly about the use of funds in written *reports*. The National Assembly decides on any use of budget reserve funds of an amount that exceeds the specified amount by means of a special law.

6. New trends in national fiscal policy

6.1. Sustainability and its implications for fiscal policy

6.1.1. The challenges of fiscal policy

Reform orientations in fiscal policy in Slovenia have been created in the process of the ES. The submission and assessment of stability or convergence programmes are part of the ES, which is a broader process of coordinating economic policies in the EU and includes the preventive part of the SGP.

In the Stability Programme for Slovenia for 2023, due to large overruns in the previous year, the government planned to reduce the public finance deficit below the Maastricht threshold of 3% of GDP in 2024 and then further reduce it in the coming years. In 2023, the deficit of the government sector was expected to be 4.1% of GDP; in 2024, it is expected to decrease to 2.8% of GDP, and, in 2025 and 2026, sufficient fiscal effort will allow it to further decrease to 2.2% and 1.3% of GDP. In addition, public finance projections predict a gradual reduction of the country's consolidated debt to 63.5% in 2026.

According to the Commission, the specific nature of the macroeconomic shock caused by the Russian invasion of Ukraine, as well as its long-term consequences for the EU's energy security needs, *required the fiscal policy to be well thought out in 2023*.

6.1.2. Reform challenges

For 2023, the Commission proposed that Slovenia should *prioritise action in the following three areas*: (i) public finances; (ii) the implementation of agreed reforms and investments within the framework of the Recovery and Resilience Plan and cohesion policy; (iii) the field of energy. In the period after 2023, the Commission

indicates that Slovenia should implement a fiscal policy aimed at reaching a prudent medium-term fiscal position. It should also ensure the long-term *fiscal sustainability of the healthcare and long-term care systems*.

In the *National Reform Programme 2023*, the Slovenian government included reforms in the fields of pensions, healthcare and housing, public sector salaries, education, digitalisation, and taxes, among other things. *The Slovenian Recovery and Resilience Plan* already addresses many long-term challenges, especially those related to the ageing of the population (reform of the pension, health, and long-term care systems). In light of population ageing, the medium and long-term sustainability of public finances, especially the *healthcare and long-term care systems*, are an important challenge for the future.

6.1.3. *The green transition*

One of the main challenges faced by Slovenia's national fiscal policy in the future is to expand public investments for the *green transition*, including the use of the Recovery and Resilience Mechanism, RePowerEU, and other EU funds. A shift toward *greener and growth-friendly taxes* on additional sources of revenue for the *green transition* is needed (EU 2023 recommendation for Slovenia).

6.2. *Technological development, digitalisation, and energy*

According to the EU 2023 recommendation for Slovenia, the country's future fiscal policy should also expand public investments in the *digital transition* and *energy security*. The energy recommendation calls for the *diversification of fossil fuel imports* and the reduction of the general dependence on fossil fuels, in addition to the acceleration of the use of *renewable energy* sources, especially by further simplifying and accelerating the issuance of permits and strengthening the electricity *distribution network*. The recommendation proposes that Slovenia should strengthen the implementation of measures for energy efficiency *and the diversification of the energy supply*; in particular, by promoting the use of renewable energy sources, strengthening electricity distribution networks, building energy infrastructure, and rail transport.

6.3. *Crisis management methods, COVID-19, and the energy crisis*

6.3.1. *The COVID-19 crisis*

The economic and financial consequences of the COVID-19 pandemic in Slovenia have been significant. In 2020, general *government revenue* equalled EUR 20,195 million, that is, 4.6% or EUR 966 million less than in 2019, and the growth of general *government expenditure* amounted to 14.8%. Consequently, the general *government consolidated debt* at the end of 2020 stood at EUR 37.429 million, or 80.8% of GDP,

which was EUR 5.684 million higher than the previous year when it stood at EUR 31.744 million, or 65.6% of GDP.²⁵

In response to the consequences of the pandemic, *several legal Acts were laid down*. These measures relate to tax collection procedures that enable taxpayers to more easily fulfil their tax obligations. They also include measures in the field of budget execution and deadlines for the submission of asset balance sheets, annual accounts, and annual reports and those to mitigate the consequences for citizens and the economy (unemployment risks, wages and contributions, postponing the payment of borrowers' obligations).

6.3.2. Maintaining the general withdrawal clause in 2023

On this basis, the Commission considered that the conditions for maintaining the general *withdrawal clause from the SGP were also met in 2023* and that this clause would be *deactivated from 2024 onwards*. The Commission estimated that continuing to allow the general withdrawal clause in 2023 would provide the national fiscal policy with room to react when necessary. At the same time, it would ensure a transition from broader support for the economy during the pandemic toward an increasing focus on *temporary and target-limited measures*. According to the Commission, *fiscal prudence* is necessary to ensure medium-term fiscal sustainability. The general *withdrawal clause, therefore, does not constitute a waiver of the rules* of the SGP, but only allows for a *temporary deviation* from normal budgetary requirements if this does not threaten medium-term fiscal sustainability.

7. Conclusions

The EU provisions on the ES obliging Member States to prepare a Stability and Reform programme and the coordination of the budget preparation procedure are crucial for Slovenia as a Member State. The EU has developed a complex system of economic governance that involves a mix of supranational, intergovernmental, and national-level decision-making. This has raised concerns among some EU Member States about the erosion of their sovereignty and their ability to control their own economic policies. Scholars' positions on economic sovereignty vary depending on their backgrounds, ideologies, and research interests.

EU rules (mainly regulations) are strict and enforceable, and not just recommendations that a Member State can follow or not. EU fiscal rules thoroughly and directly interfere with the sovereignty and autonomy of Member States in the field of public finances. An important legal system feature of the ES is that EU regulations

²⁵ Bohinc, 2022.

(rather than directives) have created the vast majority of rules since 1997 and up to the present day. Regulations are binding legal Acts that have a direct effect on Member States' laws.

Provoked by the post-crisis EU debate on the fiscal discipline of Member States and in light of the measures adopted at the EU level, Slovenia amended its constitutional rules on public spending and enforced a mandatory fiscal rule in 2013. In line with the Constitution, the FRA determines the method and period for implementing the principle of the medium-term balance of state budget revenues and expenditures without borrowing, the criteria for determining exceptional circumstances in which the medium-term balance may be deviated from, and the manner of dealing with their occurrence or termination.

In Slovenia, in addition to the Constitution, several national laws and government regulations govern fiscal deficit and state debt. These laws outline fiscal principles, procedures, and borrowing limits that are in line with EU fiscal rules. Central budgetary planning encompasses several methods to maintain a balanced budget. For example, the Medium-term Strategy for Public Debt Management is a government document that targets the balance of the state sector and the upper limit of state sector expenditures and indebtedness. Another example is the Financing Programme for the execution of the budget, which is an annual operational document for financing the execution of the state budget and government debt management transactions.

The procedure of adopting and implementing the budget begins with several forecasts of macroeconomic aggregates and preparation scenarios and continues with the National Programme of Development Policies. The adoption, preparation, implementation, and monitoring of the budget proposal are set out in detail by national fiscal legislation. This legislation strictly conforms to EU rules, as do the process of reporting and control audit, the supervisory role of the Fiscal Council, the repair mechanisms, and the fiscal discipline, inspection, and internal control of public finances.

The budgetary management of local governments, the regulation of municipalities' finances, the process of the reparation of the municipal budget proposal, and the sources of the municipal budget are regulated partly by general financial legislation (PFA) and partly by specific municipal or local self-government legislation. Brakes to avoid excessive indebtedness and measures to balance the budget, including the temporary suspension of execution, are also regulated for the municipal level.

Future orientations in fiscal policy in Slovenia are more or less created in the process of the ES. The green transition, digitalisation, energy, technological development, and, of course, the inevitable social reforms (pension, long-term care, health), as well as the reform of the fiscal system, are all current challenges on the path to the sustainability of Slovenia's fiscal policy. Whether or not to maintain the general withdrawal clause, and by when, are questions that remain to be answered.

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PART II

STATE AID POLICY

EU LAW CHAPTER ON EU STATE AID RULES – THE BUMPY RIDE FROM ‘SUBSIDY CONTROL’ TO ‘SUBSIDY GOVERNANCE’



LÁSZLÓ SZEGEDI – BÁLINT TELEKI

Abstract

The EU integration process has shaped EU State aid law and policy. This evolutionary process has also been reshaped by the EU's expanding supranational competences, the ever-changing rules of procedure and methodology, and the different sets of actors involved in these policy cycles. This applies to the companies as beneficiaries of state aid, the Member States involved in providing such aid, and the EU actors, notably the Commission and the CJEU, in shaping state aid procedures and rules. The last decade has seen several challenges and opportunities for further development of this policy area. This chapter looks at the changes in the regulatory landscape in the light of the CJEU's case-law on standing rights, the coronavirus and the energy market crisis, the EU Green Deal initiative and the tax avoidance cases before the CJEU. In addition, we may also see some future trends concerning the territorial distortions between Member States due to the highly different levels of state aid, or the compensation of these distortions by funds at EU level financed by a certain percentage of the aid approved and granted, and finally the use of the newly enacted Foreign Subsidies Regulation as an external tool to protect the Single Market.

Keywords: *state aid distortions, standing rights, coronavirus and energy market crisis, taxation avoidance cases, Foreign Subsidies Regulation*

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1. History and policy characteristics of the EU state aid rules

1.1. The evolution of the EU state aid rules concerning a diverse set of policy areas

The evolution of the EU state aid rules runs parallel to the EU integration history. The EU state aid rules are a politically significant part of the EU competition law owing to the many related policy areas encompassed by them.

In the initial stages of the integration, the state aid policy was designed to create a common (later internal) market, which is increasingly viewed as the core component of the broader European unification project.¹ As remarked on by Buendía Sierra, one of the most cited experts on the EU state aid rules, these rules have a mother and a father. In this constellation, the father is (has been) the internal market (competition between Member States or just between states globally), whereas the mother is (has been) the competition between undertakings.²

To understand how state aid rules were formulated, the historical and, most notably, economic context of the integration needs to be examined.³ In the 1940s and the early 1950s, new mercantilism remained the dominant economic doctrine, and state aid to undertakings was one of the primary instruments used by governments to intervene in the economy.⁴ In the 1950s and the 1960s, restrictive practices meant treating subsidies as ‘bad’. With the less interventionist and less intensive regulatory approach of the state aid policy, the entire policy area became more sophisticated, with several regulatory products and many EU secondary legislations, especially soft norms.⁵ One of the main game-changers was the 1970s’ crisis cycles (collapse of the Bretton Woods monetary system and two consecutive oil shocks), as European governments started to deliberately use public subsidies to promote national undertakings that provided subsidies for national market competitors, as several Japanese and American companies began locating their plants in Europe with some Member States offering subsidies to attract them. During this period, it became necessary for the Commission to avoid a subsidy race (‘father side’), which would have had a negative impact from budgetary, competition, and internal market perspectives (‘mother side’).⁶

During this period, it was also demonstrated that state aid rules could substantially impact trade affairs within the common (later single) market on regional and global trade levels.⁷ Industrial policy was inevitably an integral part of the

1 Cini, 2016, p. 17.

2 Buendía Sierra, 2016a, p. 127.

3 Cini, 2016, p. 17.

4 Merola, 2016, p. 101.

5 Buendía Sierra, 2022, pp. 7–8; Cini, 2016, p. 17.

6 Merola, 2016, p. 103.

7 Verouden, 2016, p. 131.

evolution of state aid rules. By the mid-1960s, West Europeans were becoming concerned about the extent to which foreign direct investment came into the region, and a wave of US takeovers reflected the weakness of the European industry. Therefore, from this point until the 1970s, the Community began to contemplate taking positive actions in the broad field of industrial ‘policy’ for adopting more concrete and coherent policies; however, it produced limited results.⁸ In terms of the current challenges faced, a full-fledged EU industrial policy is yet to emerge. Moreover, China’s economic imperialism and the US’s increasing protectionism and geopolitical turmoil contributed to industrial and indirect state aid policy as well.⁹

Taxation as a policy area has a relatively short connection with state aid issues. Owing to the natural fluidity and flexibility of the concept of state aid, taxation-related subsidies and reductions granted by Member States became widespread. Parallely, the Commission started to adopt a much broader approach in dealing with tax avoidance practices by analysing these measures as state aid, which led to several cases before the Court of Justice of the European Union (CJEU).¹⁰ Several other CJEU cases dealt with the taxation sovereignty of the Member States when such national steps could potentially be labelled as state aid.

The coronavirus crisis, with its financial, economic, and health implications, demonstrated the broader impact of the EU state aid measures on further policy areas, such as on fostering gender equality as part of the compatibility assessment.¹¹ Moreover, the Commission’s green and digital transition agenda inevitably had a rebound effect on matters of state aid.¹² As some scholars have highlighted in the broader context of economic (especially energy-policy-related) issues, incorporating sustainability priorities into compatibility assessments could become even more relevant in the coming years.¹³

1.2. Actors of the EU state aid policy framework

State aid has become a politically significant part of the EU competition law owing to the parties concerned. As analysed above, subsidies or their prohibition always indicated Member States’ competencies, usually strategically relevant sectors of their national economies. However, Member States could have diverse attitudes, as state aid is generally prohibited under EU law, which is why state aid control was established in the EU (to avoid subsidy races between Member States trying to attract companies to their territories).¹⁴ Additionally, Member States

⁸ Di Carlo and Schmitz, 2023.

⁹ Di Carlo and Schmitz, 2023, pp. 23–25.

¹⁰ Piernas López, Hancher and Rubini, 2022, p. 4.

¹¹ Finckenberg-Broman and Broman, 2022; Piernas López, Hancher and Rubini, 2023, p. 4.

¹² Strihó, 2020, pp. 163–175.

¹³ Kingston, 2021; Kowalik-Bańczyk, 2023.

¹⁴ Buendía Sierra, 2016a, p. 122.

with fewer resources often do not realise that other (more affluent) Member States may use state aid as an antidote against its lower costs and other internal market economic effects,¹⁵ which has become even more visible under the current era of temporary state aid frameworks. Additionally, Member States are in a position of conflict, having access to most of the relevant information on the subsidy, yet not interested in disclosing them to the Commission, which is the primary centralised enforcer of such rules.¹⁶ A conflict of interest could also arise between Member States in the sense that one Member State may often not be interested in a decision by the Commission to declare state aid from another Member State as compatible with the internal market, as it may increase the advantage of undertakings from other Member States as potential competitors to the detriment of its own undertakings.

The position of *undertakings* can be categorised following a binary logic: all undertakings granted by a Member State, such as state aid, are considered beneficial, while almost all undertakings, such as state aid, granted to their competitors are not beneficial. Nevertheless, these undertakings are considered ‘third parties’ or ‘sources of information’ by the Commission, with relatively few ‘rights’, later partly extended by the European Court of Justice (ECJ)/CJEU. However, compared to the Commission and Member States, they still lack the same procedural rights.¹⁷

The main competencies of state aid control have been granted to the *Commission*, which can take sector-specific yet cross-sectoral decisions, along with Member States’ authorities functioning within the EU-level network. Therefore, Member States tend to view the Commission as an obstacle rather than a neutral arbiter.¹⁸ Moreover, as state aid policy has been converted to some kind of subsidy governance with a potential effect on various policy areas, the Commission’s role has been modified to that of a political actor in subsidy decisions as well as in drafting rules for these policy areas. Compatibility tests of aid measures concerning a single market are to be conducted exclusively by the Commission, which enjoys a wide margin of discretion, limited by external actors (Member States and ECJ/CJEU), or by the Commission itself, as laid down in detailed soft law guidance documents.¹⁹

Finally, the *ECJ (pre-Lisbon term)/CJEU (post-Lisbon term)* plays a pivotal role in shaping the notion of aid, controlling the legality of the Commission’s decisions and even extending third parties’ *locus standi* and further procedural rights.²⁰ As noted by Merola, the ECJ/CJEU always maintains a rigorous approach to preserving the role of state aid control, fully aware that aid policies implemented

15 Ibid.

16 Hofmann and Morini, 2011, pp. 354–355.

17 Bacon, 2009; Hofmann and Morini, 2011; Buendía Sierra, 2016a, p. 122.

18 Buendía Sierra, 2016a, p. 122.

19 Buendía Sierra, 2022, pp. 7–8.

20 Hofmann and Morini, 2011; Buendía Sierra, 2016a, p. 124.

by Member States or, even worse, individual aid to specific undertakings could result in an uneven playing field potentially hindering free competition that was the aim of the founding fathers.²¹ This is exactly why national courts played only a modest role in state aid matters, but held a more critical position in recovery issues.²² Additionally, this chapter will refer to the General Court (GC) (lower instance) and the Court (higher instance) if the two forums within the ECJ/CJEU differ in their conclusion of certain judicial cases or require further interpretation.

1.3. Regulation of the EU state aid

The primary legal basis of the EU state aid (Arts. 107–109 of the Treaty on the Functioning of the European Union (TFEU)) has remained practically unchanged since the beginning of integration.²³ Technically, Art. 107(1) can be considered a general prohibition: state aid is incompatible with the establishment of an internal market. This provision refers to five elements; any aid is considered incompatible with the internal market if it (i) is provided for an undertaking, (ii) is granted by a Member State or through State resources in any form whatsoever, (iii) is one that distorts or threatens to distort competition, (iv) favours certain undertakings or the production of certain goods (selectivity), and (v) affects trade between Member States. The first three define the notion of aid, which can be labelled as incompatible if the other two elements (selectivity-based distortion and effect on the trade between Member States) can be identified.²⁴ Additionally, a measure by a state/public authority constitutes state aid if it confers an economic advantage on an undertaking or a group of undertakings. The concept of ‘advantage’ used in the context of the EU state aid control is defined as follows: ‘An advantage, within the meaning of Art. 107 para. (1) of the TFEU, is any economic benefit which an undertaking could not have obtained under normal market conditions, that is to say in the absence of State intervention’.²⁵ Consequently, state aid classification and the analysis of advantages require a thorough examination of market positions between potential competitors.

However, state aid can be considered compatible if it aligns with one of the objectives indicated in Art. 107 paras. (2) and (3) of the TFEU.²⁶ In addition to the substantive legal requirements of Art. 107, Arts. 108–109 refer to the procedural issues of the EU state aid regime.

21 Merola, 2016, p. 102.

22 Buendía Sierra, 2016a, p. 125.

23 Papp, 2022a, p. 166.

24 Dán, 2022, p. 116.

25 Commission Notice on the notion of state aid as referred to in Art. 107 para. (1) of the Treaty on the Functioning of the European Union, 2016/C 262/01, OJ C 262, 19.7.2016, 1–50.

26 Righini, 2016, p. 137.

Primary law in this field has proven to be flexible enough to quickly translate new political guidelines into instruments for action.²⁷ Several pieces of EU's secondary legislation have been enacted during the EU integration, along with the ECJ/CJEU's extensive case law.²⁸ Presently, the secondary legislation's role has become more decisive compared to that of the TFEU, and most of the aids after the 2010s State Aid Modernisation (SAM) measures (explained below) are exempted based on group exemption regulations and, in parallel, ex-post monitoring of the Commission has been enhanced.²⁹

Member States have an obligation to provide prior notification of all new aid measures to the Commission, with some exceptions: (i) those falling under block exemptions, (ii) those under a *de minimis* threshold, and (iii) those under a scheme already authorised by the Commission, and (iv) when the aid constitutes compensation for the provision³⁰ of a service of general economic interest.³¹ Following the mandatory notification phase, the Commission starts a preliminary investigation to arrive at any of the three decisions mentioned: (i) no aid has been identified – measure might be implemented; (ii) aid is compatible with EU rules based on the compatibility test – measure might be implemented; and (iii) start in-depth investigation owing to serious doubts on the compatibility – measure might not be implemented.³² The Commission's in-depth investigation could also conclude as (i) positive if, as per the investigation, the measure concerned does not constitute an aid or can be considered as compatible with the internal market, (ii) further conditions are put forward in the decision for the aid measure to be implemented, and (iii) a negative final decision, if the aid measure is incompatible with the internal market, and, consequently, cannot be implemented.³³

In the recovery framework, the Commission might request the Member State to recover the aid measures implemented if a negative final decision has been taken. If the Member State does not comply with the decision within the prescribed time, the Commission may refer it to the ECJ in accordance with Art. 108 para. (2) of the TFEU without initiating an infringement procedure under Art. 258 of the TFEU.³⁴

²⁷ Merola, 2016, p. 108.

²⁸ Dán, 2022, pp. 114–115.

²⁹ Papp, 2022a, p. 168.

³⁰ European Commission, 2011.

³¹ European Commission, 2013, p. 1.

³² European Commission, 2013, p. 1.

³³ Art 4–9. Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Art. 108 of the Treaty on the Functioning of the European Union, OJ L 248, 24.9.2015, 9–29.

³⁴ European Commission, 2013, p. 2.

2. The EU state aid rules during the recent and current crisis management cycles

2.1. State aid rules before the coronavirus crisis

In terms of the ‘back to the future approach’, state aid rules and related regulations often evolve by following cyclical patterns in line with economic changes and further improvements. In the 2000s, the Commission began to mention increasingly about ‘competition between undertakings’ as the core mission of state aid control, paying only lip service to the other (‘competition between Member States’) dimension. Additionally, some techniques began to be imported from antitrust, which had just undergone modernisation.³⁵

Several changes related to the 2008-2012 crisis were similar to those of the 1970s following the economic trends and recession, which inevitably impacted state aid rules and national- and EU-level actors’ positions. This crisis period led to a sharp increase in state aid measures; that is, the allocated figure for state aid rose from less than 1% of the EU GDP in 2007 to around 13% in 2011.³⁶ A clear demand was observed to guarantee subsidies for financial institutions at that time, which led to the development of the common EU-level resolution framework. Additionally, there was a need to ensure a level playing field for European businesses and avoid a subsidy war among Member States by preventing them from adopting unilateral measures to react to the crisis; this forced the Commission to respond with a set of new coordinated policies and the enactment of new vital pieces of soft law³⁷ (‘Temporary Framework’).³⁸ In other words, the Commission realised and appreciated the relevance of the competition between Member States once again.

The Commission Communication of May 2012 on SAM was the starting point of further reform steps, with three main objectives: to (i) foster growth in a strengthened, dynamic, and competitive internal market; (ii) focus enforcement on cases with the most significant impact on the internal market; and (iii) bring streamlined rules and make faster decisions. Back then, there was a shift toward using the General Block Exemption Regulation³⁹ from the notifying measures, which suggested that the Commission moved beyond state aid control toward the direction of state aid policy⁴⁰.

³⁵ Buendía Sierra, 2016a, p. 125.

³⁶ European Commission Staff Working Document, Facts and Figures on State Aid in EU Member States, 2012 Update, SEC(2012) 443 final of 21 December 2012.

³⁷ Communication of the Commission – Temporary Union framework for State aid measures to support access to finance in the current financial and economic crisis, 2011/C 6/05, OJ C 6, 11.1.2011, 5–15.

³⁸ Merola, 2016, p. 107.

³⁹ Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Art. 107 and 108 of the Treaty, OJ L 187, 26.6.2014, 1–78.

⁴⁰ Van de Casteele, 2016, p. 117.

Furthermore, the SAM measures led to a change in the EU's approach toward 'competition between Member States'. The main difference was a substantial expansion of the categories of aid exempted from notification, for example, with the enactment of the Group Exemption Regulation. This move impacted the dichotomy of subsidy control vs. subsidy governance: notably, this may make some sense from the perspective of state aid policy (e.g. increasing research and development, and environmental investments), not so much from the aspect of state aid control. As Buendía Sierra noted, the latter was particularly true concerning the 'competition between Member States' as well. It was obvious that the level of resources that the different Member States could use for state aid varied considerably, more so after the crisis. Increasing the theoretical possibilities for all for granting aid without Commission control would imply that only certain Member States could use such options.⁴¹

Regarding the allocation of competencies, these policy steps resulted in keeping only the most relevant cases at the level of the Commission, combined with the further reform of the increased *ex-post* monitoring in 2017, that is, an enhanced transparency and control system. This can be viewed as a counterbalance, as 95% of the aids granted were exempted according to group exemption regulations after the SAM measures.⁴² For example, the Commission noted in 2017 that the number of state aid notifications halved in research, development, and innovation since 2014.⁴³ Interestingly, the European Court of Auditors (ECA) criticised in its 2011 report that the Commission did not assess the *ex-post* impact of its state aid control in a comprehensive manner.⁴⁴ Additionally, the *ex-post* monitoring results are to be made publicly available to enhance the 'circulation of best practices' among the Member States to be assessed by independent national authorities. This could be considered a step in the right direction, as it offers a 'follow-up tool' within the state aid mechanisms, reducing the overreliance on a formalised system.⁴⁵

2.2. State aid as the tool for the coronavirus- and energy crises-management

The coronavirus pandemic and later the energy crises-management led to a reconsideration of the EU state aid rules. This crisis-driven evolution also led to different policy steps due to the symmetric nature of the coronavirus crisis in terms of it impacting almost every economic sector instead of the finance-centred turbulence of the great financial crisis.⁴⁶ Compared to the austerity-centred crisis management of the 2008–2015 period, the COVID-19 pandemic led to emblematic EU-level solidarity measures⁴⁷ – especially with the creation of EU's NextGenerationEU recovery

41 Buendía Sierra, 2016a, p. 127.

42 European Commission, 2017.

43 European Commission, 2017; Papp, 2022a, p. 178.

44 European Court of Auditors, 2011, p. 59.

45 Papp, 2022a, p. 182.

46 Czecceli et al., 2020; Halmai, 2020, pp. 305–349.

47 Urbanovics and Teleki, 2021.

instrument with ca. EUR 800 billion temporary funds to support economic recovery from the coronavirus pandemic. The centrepiece of NextGenerationEU is the Recovery and Resilience Facility (RRF), in which the Commission raises funds by borrowing on the capital markets (issuing bonds on behalf of the EU). These are then available to Member States for implementing several reforms and investments, which include three main aims: (i) to realise green and digital transition of the EU; (ii) to address the challenges identified in country-specific recommendations under the European Semester framework of economic and social policy coordination; and (iii) to implement the RePowerEU plan as the Commission’s response to the socio-economic hardships and global energy market disruption caused by the post-coronavirus Russo-Ukrainian war.⁴⁸ The tendency of these reforms clearly indicate that the EU’s approach has become much more horizontal, with management incrementally binding together diverse policy areas, which also impacts the EU state aid policy.

In a narrower context, the Commission reacted quickly to the crisis by partially suspending and re-interpreting state aid rules.⁴⁹ Simultaneously, further changes to the framework have widened the scope for aid (State Aid Temporary Framework – SATF⁵⁰ – amended several times).⁵¹ SATF was adopted on 19 March 2020 to enable Member States to use the flexibility foreseen under state aid rules to support the economy during the coronavirus outbreak. However, it has not been extended beyond 30 June 2022, the expiry date for the SATF, with some exceptions. In particular, investment and solvency support measures could remain effective until 31 December 2023.

Owing to the limitations of the Editorial, this paper focuses on the overall evaluation of the related reform measures without further describing⁵² the SATF.

The temporary framework is based on Art. 107 para. (3) point b) of the TFEU. This allows Member States to adopt a wide range of aid measures, subject to prior notification and approval by the Commission. Furthermore, during the COVID-19 crisis, Member States could avail three other exemptions. First, the direct state aid exemptions under Art. 107 para. (2) point (b) of the TFEU to overcome the damages caused by exceptional occurrences. This exemption applies in the health, tourism, transport, retail, and culture sectors. In addition, Art. 107 para. (3) point (c) of the TFEU could be used for restructuring aid for companies in financial difficulties. Member States could also apply the so-called *de minimis* aid, where state aid up to EUR 200,000 per beneficiary is automatically allowed over three years.⁵³

48 European Commission, 2023a.

49 Gombos and Szűcs, 2021.

50 Communication from the Commission – Temporary Framework for State Aid measures to support the economy in the current COVID-19 outbreak 2020/C 91 I/01, OJ C 91I, 20.3.2020, 1–9.

51 Rosand, 2020; Papp, 2022b; Ruzicska, 2022.

52 Communication from the Commission – Temporary Crisis and Transition Framework for State Aid measures to support the economy following the aggression against Ukraine by Russia, 2023/C 101/03, OJ C 101, 17.3.2023, 3–46.

53 Bartucz, 2022.

These steps have had a positive impact as the Commission's decision-making process, which has speeded up leading to the rapid approval of aid measures in the initial stages of the crisis. Yet, the report requested by the European Parliament Committee on Economic and Monetary Affairs (EP ECON) also identified the monitoring system's deficiencies, partly revealed earlier in the ECA's 2011 report. As a result, the ECON report recommended that the evaluation process, transparency, and monitoring be prioritised by the European Commission. The report also identified the apparent threat of the unbalanced territorial impact of the subsidies due to fiscal imbalances between Member States.⁵⁴ In light of the overreliance on temporary frameworks, some authors have also questioned the credibility of the EU state aid rules in the longer term owing to (i) the moral hazard of readily justifiable (extendable lifelines) and the moral hazard associated with subsidy dependence; (ii) the fallacy of seemingly ordinary market transactions; (iii) the increasing reliance on *ad hoc* solutions and highly situation-specific interpretations potentially eroding the pre-existing *acquis*.⁵⁵

3. State aid rules in the CJEU's case law

3.1. Legal position of individual plaintiffs (competitors) in the CJEU's case law

In recent decades, the ECJ/CJEU has played a pivotal role in shaping the framework of the state aid rules following primary and secondary EU legislation, especially in the procedural rules and guarantees area. Several scholars have mentioned this role in general⁵⁶ and SAM reform steps in particular.⁵⁷ As Merola noted, until relatively recently, procedural rules were shaped by less worthy forces and objectives, such as a conservative approach by the administration or an unwillingness to accept any change regarding its consolidated internal practice.⁵⁸ The role of such procedural guarantees has become even more relevant in light of the previous decade's legislative reforms related to emphasising investigation only in significant cases, combined with *ex-post* monitoring by the competent authorities. Such a control and enforcement system could function more effectively if the national- and EU-level authorities could rely on additional information concerning subsidy cases, potentially from private parties (e.g. complainants and further market competitors). As for the evolution of these procedural guarantees, their origins are often rooted in

54 Van Hove, 2020, p. 8; Papp, 2022b, pp. 10–14.

55 Kociubiński, 2023.

56 Hofmann, Rowe and Türk, 2011; Hofmann and Morini, 2011; Chalmers, Gareth, and Monti, 2014.

57 Merola, 2016, pp. 108–109; Van de Castele, 2016, p. 118; Buendía Sierra, 2016a, p. 125.

58 Merola, 2016, pp. 108–109.

ECJ/CJEU’s case law. The Procedural Regulation further cemented this, which also serves as the sector-specific basis for the Charter of Fundamental Rights Art. 51, the right to good administration.⁵⁹

Individuals – competitors in this case – in the actions for annulment before the CJEU have only restricted standing rights. The well-elaborated case law of the Court called the Plaumann test of the 1960s required individuals, as non-privileged plaintiffs, to have a direct and individual concern as standing requirements. Several judgements in the case law elaborate on how direct and individual concerns shall be interpreted.⁶⁰ In the Lisbon Treaty too, these standing requirements have been reformulated. Lisbon’s primary law, namely Art. 263 para. (4) of the TFEU, as broadened standing rights to some extent in certain regulatory acts – yet, the standing rights of individuals are considered restrictive even today.⁶¹

In the case of competitors, the standing rights admissibility test (having direct and individual concerns) needs thorough case-by-case evaluation by the ECJ/CJEU. Individual concern refers to evaluation in context of the Plaumann case law: Persons other than those to whom a decision is addressed may claim to be individually concerned only if that decision affects them by reason of certain attributes that are peculiar to them or by reason of circumstances in which they are differentiated from all other persons and by virtue of these factors distinguishes them individually just as in the case of the person addressed’.⁶² In general, fulfilling these criteria depends on the part of the investigation procedure (preliminary or in-depth formal investigation procedure) in which the competitor is about to act and the competitor’s market status.

According to the ECJ/CJEU case law, the competitor may act only by instituting proceedings to safeguard procedural rights in the course of the preliminary investigation procedure. If this also means that the final decision of the Commission’s investigation finds that the aid is compatible with the common market, the individual could rely only on infringement of those procedural rights/guarantees since no in-depth formal investigation procedure has been initiated.⁶³ Therefore, the competitors’ standing right within the preliminary investigation procedure is primarily based on securing the procedural rights of the beneficiary’s competitor, whose rights have been initially acknowledged by the Court following an activist approach many times.

If the competitor initiates an action for annulment based on the compatibility test’s failure, the competitor’s standing right (individual and direct concern) must be

⁵⁹ Szegedi, 2019, pp. 248–254.

⁶⁰ Hofmann, Rowe and Türk, 2011, pp. 829–841.

⁶¹ Somssisch, 2021.

⁶² CJEU, 15 July 1964, C-25/62, *Plaumann v. Commission*, ECLI:EU:C:1963:17, part I. on the ‘Ground of the judgment’.

⁶³ CJEU, 19 May 1993, C-198/91, *Cook v. Commission*, ECLI:EU:C:1993:197, paras. 23–26; CJEU, 15 June 1993, C-225/91, *Matra v. Commission*, ECLI:EU:C:1993:239, paras. 17–20; CJEU, 24 February 2005, C-78/03 P, *Commission v. Aktionsgemeinschaft Recht und Eigentum (ARE)*, ECLI:EU:C:2005:761, paras. 35–37.

found to infringe on its procedural rights and its significantly affected position by the aid on the market. The game-changing judgement has been the ECJ's *Compagnie française delàzole* (COFAZ) ruling. According to the COFAZ, an applicant's position can be given individual consideration regarding the Commission's decision on aid compatibility only if the applicant's market position has been substantially affected by the aid to which the contested decision relates.⁶⁴ This binary logic of the case law was later reformulated by the ECJ, emphasising the market position element instead of the infringement on procedural rights.⁶⁵ Later, the ECJ also concluded that participation in the investigation procedure is necessary for finding that a decision is of individual concern to an undertaking (competitor).⁶⁶ Additionally, the case law became even more detailed on the applicant's admissibility test, relying much more on the level of market distortion instead of its substantially affected market position.⁶⁷ Several factors can influence the level of market distortion, such as a sudden increase in production capacity or a significant drop in sales (even closing down of market participants).⁶⁸ Even the most recent case law has upheld this line of examined criteria.⁶⁹ In certain cases (*Kronoply*), the Court acknowledged the individual concern of the applicants (competitors) even though the beneficiary and the applicants were not competitors on identical product markets but used the same raw materials in their production process or based on the adverse effects associated with the new entrance of the beneficiary.⁷⁰

In general, the standing rights in state aid cases have become more restrictive as the ECJ/CJEU's approach focuses on market position and market distortion analysis instead of on procedural fairness during the individual applicants' admissibility tests.⁷¹ Yet, the ECJ/CJEU has followed a much more extensive interpretation, especially in antitrust cases emphasising the protection of applicants' procedural rights in line with the role of the Commission/EU-level procedures potentially identifying

64 CJEU, 28 January 1986, C-169/84, *COFAZ and others v. Commission*, ECLI:EU:C:1986:42, para. 25.

65 Bacon, 2009, pp. 514–515; Hofmann, Rowe and Türk, 2011, p. 832; Hofmann and Morini, 2011, pp. 362–367.

66 CJEU, 22 November 2007, C-260/05 P, *Sniace v. Commission*, ECLI:EU:C:2007:700, para. 57.

67 C-78/03 P, paras. 35–37; CJEU, 22 December 2008, C-487/06 P, *British Aggregates v. Commission*, ECLI:EU:C:2008:757, paras. 47–56.

68 CJEU, 22 October 1996, T-266/94, *Foreningen af Jernskibs- og Maskinbyggerier i Danmark and others v. Commission*, ECLI:EU:T:1996:153, paras. 46–47; CJEU, 12 December, 2006, T-95/03, *Asociación de Empresarios de Estaciones de Servicio de la Comunidad Autónoma de Madrid és Federación Catalana de Estaciones de Servicio v. Commission*, ECLI:EU:T:2006:385, para 54.

69 The more recent case law cannot be seen as merely being restrictive. The GC noted in *Castelnou Energía* that it could not conclude that an undertaking did not have standing to bring proceedings, if this undertaking succeeded in avoiding or limiting such a decline; for example, by making savings or by expanding in other more profitable markets. These steps did not call into question the substantial effects of the aid on its position and were even taken as a result of those effects (CJEU, 3 December 2014, T-57/11, *Castelnou Energía vs. Commission*, ECLI:EU:T:2014:1021, para. 41).

70 CJEU, 24 May 2011, C-83/09 P, *Commission v. Kronoply*, ECLI:EU:C:2011:341, paras. 67–68.

71 Bacon, 2009, p. 516; Hofmann, Rowe and Türk, 2011, pp. 832–833.

third parties.⁷² These cases prove the pivotal role of the ECJ/CJEU in providing an interpretation of not just substantive but also procedural state aid rules sometimes even by rewriting the abovementioned ‘unwillingness of the administration to accept any changes when it comes to its consolidated internal practice’. Moreover, judicial practice has demonstrated that state aid cases incrementally involve further economic considerations (like analysing market positions and potential distortions), even if they deal with only formal issues like admissibility matters before the CJEU. These complex tasks could become even more substantial in the CJEU’s future workload, provided the evolution of this policy area shows a continuing shift from ‘subsidy control’ to ‘subsidy governance’ and covers a broader range of diverse policy implications.

3.2. CJEU’s case law in ‘the Taxation vs. state aid saga’

The ECJ/CJEU’s role has been decisive in procedural rights and guarantees concerning competence-based issues, especially regarding extension of EU competencies. Taxation-related cases created a turbulent era in the recent two decades between Member States fighting to keep their national sovereignty over taxation and the Commission acting as a centralised ‘state aid authority’ with much weaker competencies in taxation matters.⁷³ This issue has become highly relevant, particularly (i) in the fight against tax avoidance and aggressive tax planning and (ii) limiting Member States’ fiscal sovereignty when designing their tax systems.⁷⁴ Theoretically, this issue could become highly relevant as relief from economic burdens can also constitute an advantage, and therefore tax measures are relevant for the EU’s state aid regime.

As for tax avoidance and aggressive tax planning, the Commission started to apply state aid rules to an ever-growing number of national direct tax rules and regimes, especially after several publications revealed this practice of multinational enterprises (MNEs), known for using loopholes in the international tax rules. Lux-Leaks and EP committee inquiries made it obvious by as early as 2013/2014 that many MNEs shift their profits to no or low tax jurisdictions and exploit the differences between domestic tax systems to achieve double non-taxation.⁷⁵ The Commission also started investigating individual tax rulings, mainly transfer pricing rulings, issued by Member States to large MNEs suspected of granting ‘sweetheart deals’ to the latter.⁷⁶ In this manner, the Commission used this to tax MNEs – not exclusively Silicon Valley giants but further enterprises as well – which the US did not tax to boost their competitiveness.⁷⁷

72 CJEU, 25 October 1997, C-26/76, *Metro v. Commission*, ECLI:EU:C:1997:167, paras. 8–13; Foster, 2015, p. 230; Hofmann, Rowe and Türk, 2011, p. 831.

73 Rapp, 2021.

74 Stavitzky, 2022; Szudoczky, 2022.

75 Szudoczky, 2022, p. 25.

76 Stavitzky, 2022, p. 56; Szudoczky, 2022, p. 25.

77 Mason, 2020, p. 373; Szudoczky, 2022, p. 25.

Regarding methodology, the Commission's approach to labelling individual national rulings as state aid focused on selectivity [Art. 107 para. (1)] using a three-step analysis: (i) reference system determination: a general taxation framework to identify the selectivity as a result of special national rules (Commission's burden of proof); (ii) identification of the derogation that departs from the reference system's general rule, resulting in a more favourable treatment of certain undertakings as *prima facie* selectivity (Commission's burden of proof); and (iii) justification of the *prima facie* selectivity based on the reference system's intrinsic basic or guiding principle of further inherent mechanisms (Member State's burden of proof).⁷⁸

In tax avoidance and aggressive tax planning cases, the Commission combined the three-step analysis with the arm's length principle referring to the notion of aid to point out transfer pricing arrangements without a market-based outcome.⁷⁹ This resulted in the reduced tax liability of beneficiaries compared to other undertakings in comparable situations owing to the lack of taxation for incomes transferred through the arrangements.⁸⁰ What makes the related analysis more complicated is the hypothetical nature of the pricing agreements leading to a price range that can only be compared with ordinary market pricing and conditions. The Commission applied the Organisation for Economic Co-operation and Development's (OECD) transfer pricing guidelines⁸¹ involving five different methodologies; however, the MNEs were also permitted to use other guidelines.⁸²

The GC followed a rather strict but affirmative approach to examining the Commission's related decisions. The GC's rulings on Starbucks, Amazon, Apple, and Nike/Converse favoured neutrality among the abovementioned methodologies and expected the Commission to identify the MNEs' (and national actors') manifest errors.⁸³ In its Fiat judgement, a somewhat different outcome appeared, as the GC disapproved of the methodology applied by Luxembourg, calling it incompatible with ordinary market pricing/conditions, partly based on an existing advantage that resulted in an amount ten times greater than that to which the rate was applied under the tax ruling at issue.⁸⁴ This could be identified as a discrepancy between the applied methodology and the ordinary market pricing/conditions. Yet, scholars' criticism

78 Commission Notice on the notion of state aid as referred to in Art. 107(1) of the Treaty on the Functioning of the European Union, 2016/C 262/01, para. 138; Papp, 2021, p. 286; Szudoczky, 2022, p. 25.

79 Stavitzky, 2022, p. 58.

80 Szudoczky, 2022, p. 25.

81 OECD, 2022.

82 Stavitzky, 2022, pp. 58–59.

83 CJEU, 24 September 2019, T-760/15 and T-636/16, *Netherlands v. Commission*, ECLI:EU:T:2019:669; CEJU, 12 May 2021, T-816/17 and T-318/18, *Luxemburg and others v. Commission*, ECLI:EU:T:2021:252; CJEU, 15 July 2020, T-778/16 and T-892/16, *Ireland and others v. Commission*, ECLI:EU:T:2020:338; CJEU, 14 July 2021, T-648/19, *NIKE European Operations Netherlands Brand Converse Netherlands BV v. Commission*, ECLI:EU:T:2021:428.

84 CJEU, 24 September 2019, T-755/15 and T-759/15, *Luxemburg and Fiat Chrysler Finance Europe v. Commission*, ECLI:EU:T:2019:670, para. 283.

focused mainly on the external legal nature of OECD methodologies lacking EU harmonisation.⁸⁵ Even if the Court has the final word in these cases, apparently, state aid is not necessarily the right tool to remedy the systematic problems of the international tax system, considering the GC’s recent judgements.⁸⁶ However, these court cases led to modifying some national tax regulations and former national practices, even as the cooperation between national authorities intensified.⁸⁷ Additionally, the number of related EU legislative steps increased, especially on the globally harmonised minimum level of corporate taxation⁸⁸ or with the already enacted directive⁸⁹ on broader access to information in related matters.

Concerning the second issue, specific CJEU rulings can also be mentioned limiting Member States’ fiscal sovereignty in designing their tax systems. In this regard, the Gibraltar case had a decisive role in repealing corporate taxation by introducing a new payroll and business property occupation tax. This was calculated on the employees’ salary combined with the property located in Gibraltar as the tax base. In its analysis, the CJEU labelled this new tax materially selective, favouring off-shore companies *per definition* having neither employees nor properties – thereby excluding such companies as an inevitable consequence of the bases of assessment and not as a random result of the regime itself.⁹⁰ The manifestly discriminatory nature of such regulation has been decisive in this regard. Yet, Gibraltar remained the only judgement when the CJEU did not accept the reference framework of the Member State, providing a rare example of a successful justification during the three-step analysis.⁹¹ The underlying main question refers to the scope of national tax sovereignty and which national tax design issues could be considered consistent. In the case of turnover-based progressive taxes (of special sectoral taxes), this is even more complicated with the hybrid nature of profit-based turnover taxes (based on the ability of the taxpayer to pay) and turnover taxes (based on progressive tax rates).⁹² Regarding Hungarian sectoral taxes, the CJEU left it to the broad discretion of the Member States to define the reference system – as the Gibraltar ruling remained the exception rather than the rule.⁹³ Moreover, the turnover remained a natural and relevant indicator of the ability to pay, making progressive turnover taxation not incompatible with the single market Art. 107 para. (1) clause. Finally, the only option for the Commission to demonstrate the turnover-based progressive taxes’

85 Dourado, 2023, pp. 2–4.

86 Szudoczky, 2022, p. 26.

87 Stavitzky, 2022, pp. 55–81.

88 European Commission, 2022a.

89 Directive (EU) 2021/2101 of the European Parliament and of the Council of 24 November 2021 amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches, OJ L 429, 1.12.2021, 1–14.

90 CJEU, 15 November 2011, C-106/09 P and C-107/09 P, *Commission and Spain v. Government of Gibraltar and the UK*, ECLI:EU:C:2011:732, para. 106.

91 Papp, 2021, p. 290.

92 Szudoczky, 2022, p. 27.

93 CJEU, 3 March 2020, C-75/18, *Vodafone Magyarország*, ECLI:EU:C:2020:139, para. 50.

incompatibility was the manifestly discriminatory element – not yet genuinely concretised by the CJEU itself.⁹⁴

In general, the CJEU remained reluctant to expand (or overexpand) the Commission's competencies in taxation by labelling specific national tax regulations and practices as state aid. Just like in the case of the standing rights' expansion, the taxation saga demonstrated the potential outreach of the Commission's compatibility test to other policy areas.

3.3. Sustainability and green transition in the area of state aid?

The EU's Green Deal marks a new area in which green policies might become much more horizontal, potentially affecting the EU's other policy areas. Moreover, sectoral dialogue between different policy areas and related disciplines has become inevitable.⁹⁵ Additionally, the Commission's related state aid legal framework has also been amended (several times) in light of the Green Deal requirements.⁹⁶ Therefore, the question is whether the state aid case law of the CJEU will/should take a green turn, or even a U-turn is highly relevant.⁹⁷

Two major state aid cases can be mentioned in this context: energy policy issues rooted in economic policy and environmental law.⁹⁸ In these cases, the Commission's approval for providing state aid to construct and operate nuclear power plants (Great Britain's Hinkley Point C NPP – HPC and Hungary's new Paks2 reactor installations – Paks2) was challenged by Austria with somewhat parallel pleas. Both cases referred to the exemption provision of Art. 107 para. (3) of the TFEU, stating that state aid may be compatible with the internal market if it aims to develop an activity that constitutes a public interest objective and is appropriate, necessary, and not disproportionate.

The GC set a precedent on the competition aspects of nuclear investment and installations with both HPC and Paks2 judgements (the Court already decided HPC, while in the case of Paks2, the appeal was only submitted to the Court). First, new investments into nuclear facilities can constitute a public interest objective in conformity with Art. 107 para.(3) of the TFEU – even if they are not necessarily pursued by all Member States, and not in the sole interest of the beneficiary of the aid.⁹⁹

⁹⁴ Papp, 2021, p. 290; Szudoczky, 2022, p. 28.

⁹⁵ Meyer and Hoffmann, 2023; Csák and Nagy, 2020; Kutasi, 2022.

⁹⁶ Commission Regulation (EU) 2023/1315 of 23 June 2023 amending Regulation (EU) No 651/2014 declaring certain categories of aid compatible with the internal market in application of Art. 107 and 108 of the Treaty and Regulation (EU) 2022/2473 declaring certain categories of aid to undertakings active in the production, processing, and marketing of fishery and aquaculture products compatible with the internal market in application of Art. 107 and 108 of the Treaty, OJ L 167, 30.6.2023, 1–90.

⁹⁷ Terpan and Saurugger, 2020.

⁹⁸ Lovas, 2021a, pp. 25–59; Lovas, 2021b.

⁹⁹ CJEU, 12 July 2018, T-356/15, *Austria v. Commission, Hinkley Point*, ECLI:EU:T:2018:439, para. 86; CJEU, 30 November 2022, T-101/18, *Austria v. Commission, Paks2*, ECLI:EU:T:2022:728, paras. 98–99.

This implication also refers to the heated debate on the future use of nuclear power dividing many Member States (e.g. Germany and Austria dissenting from nuclear power, while France, Belgium, and most of the Central and Eastern European (CEE) region countries mainly favouring it). The judges did not rewrite these choices based on the state aid rules, unsurprisingly in light of the Member States’ free selection of their energy mixes, for which the Treaties formally guarantee freedom (Euratom).

Further recalling Member States’ free choice of energy mix, the GC (Court in HPC) also clarified that the Commission cannot require state financing to be allocated to alternative energy sources.¹⁰⁰ Member States have broad powers in the field of energy policy, including free choice of energy mix to achieve the EU’s preferred objectives, such as security of supply, diversification of energy sources, and decarbonisation. Changing of this rule would require an amendment of the Treaties (as it is included in the Lisbon Treaty). Nevertheless, it would be a challenging issue for the Member States in light of their divided opinion on the utilisation of nuclear energy, combined with the free choice of their energy mixes. In general, this political and scientific dispute is not a problem to be resolved judicially.¹⁰¹

The application of the compatibility test is even more complicated in Art. 107 para. (3) of the TFEU cases as the Court has overruled the GC’s approach in the HPC case. In this regard, the Court has clarified that state aid for an economic activity falling within the scope of the nuclear energy sector that is proven upon examination to contravene environmental rules cannot be declared compatible with the internal market. Nevertheless, mere principles (the protection of the environment, the precautionary principle, the ‘polluter pays’ principle, and the principle of sustainability) cannot be regarded as precluding in all circumstances when it comes to granting state aid for the construction or operation of a nuclear power plant. In general, the Court concluded that state aid for an economic activity shown upon examination to contravene rules of EU law on the environment cannot be declared compatible with the internal market.¹⁰² Kingstone referred to this argumentation saying that it might become a game-changer if further EU Green Deal-related legislation concretises the abovementioned principles of EU law – potentially already having resulted in incompatibility,¹⁰³ while Kowalik-Bańczyk also cited this argument of the Court as an illustrative exception of the state aid law area, noting how the competition law moved toward sustainability goals.¹⁰⁴

Yet, the GC’s Paks2 judgement upheld a somewhat restrictive approach regarding extra-economic consideration, concluding that ‘the breach of another rule of EU law would have had to be *indissociably linked* to the State aid measure’. Further, referring to the sector-specificity of EU policies, ‘the broader investigation would run counter

100 CJEU, 22 September 2020, C-594/18 P, *Austria vs. Commission*, ECLI:EU:C:2020:742, paras. 79–80; T-101/18, para. 97.

101 Kingston, 2021, p. 12.

102 C-594/18 P, paras. 45, 100.

103 Kingston, 2021, pp. 15–18.

104 Kowalik-Bańczyk, 2023, p. 11.

to, first, the procedural rules and guarantees specific to the procedures specially established for the control of the application of those provisions and, second, the principle of autonomy of administrative procedures and remedies'.¹⁰⁵ This analysis of the link in the Paks2 judgement dealt with the lack of a public procurement procedure. However, this matter is yet to be decided by the Court. In general, the the case law mandates the Commission to prohibit state aid measures which are *inextricably linked* to the infringement of environmental law – yet the right of the prohibition is still unclear in the mere case of indirect harm to the environment.¹⁰⁶

The HPC judgement also had a broader impact on the policy framework of the EU state aid rules besides green and sustainability considerations. As Buendía Sierra noted, the HPC could be seen as a timely reminder that the Commission must look both at the positive and at the negative effects of the aids, emphasising the adverse effects (environmental considerations raised by Austria).¹⁰⁷ Additionally, more recent state aid compatibility tests can identify this judgement's impact.¹⁰⁸

4. Conclusions – From 'subsidy control' to 'subsidy governance'?

Using the analogy of Buendía Sierra, the state aid law, as a tool of subsidy control, is moving toward an era of subsidy governance, involving extra-economic implications of the EU integration. Similar to what occurred at the beginning of the European integration, the multi-level nature of this area became highly relevant in crisis management situations, as described above. In the 1970s or during the significant financial and economic recession at the end of the 2000s – including the current era of the post-COVID situation and the ongoing energy and war-related crisis cycles – the dilemma became highlighted with the realisation that state aid cannot be considered a competition tool for mere subsidy control. It could be used on a broad range of further policy areas, including industry and trade, green and digital transition, not to mention taxation and corporate governance. These challenges must be addressed by the Union, national legislators, and enforcement actors, especially the CJEU. Considering the complexity of state aid involving highly specific evaluation of economic issues, it already incorporates the methodologies of further policy areas like corporate taxation, energy supply measurements, or analysis of competitors' market position.

105 T-101/18, para. 31.

106 Nicolaides, 2023.

107 Buendía Sierra, 2022, p. 11.

108 Nicolaides, 2021.

Nevertheless, this dilemma is explicitly multinational and multidimensional, expected to become even more relevant in the upcoming years, as the recent crisis management steps related to state aid control and governance can and must be evaluated in light of their unbalanced nature between Member States.

Referring to Buendía Sierra once more, the question posed is wrong: Who do you love more, your dad (‘father’s side’ of state aid as a subsidy race between Member States) or your mom (‘mother’s side’ of state aid as subsidy race with its negative impact on budgetary, competition, and internal market perspectives between undertakings)?¹⁰⁹ Buendía Sierra noted that a proper enforcement of state aid rules requires simultaneously considering both objectives when designing guidelines and adopting decisions. In this regard, ‘state aid is not only about competition between undertakings but also between Member States. Insisting on just one of both dimensions would be a mistake. Both form an essential ingredient of EU state aid’.¹¹⁰

The SAM reform with the Commission’s extended direct control only on the most substantial cases might also lead to de-prioritisation of less significant (small Member States’) markets (due to the presumably smaller size of beneficiaries and aid volumes), even if these markets require more awareness in terms of competition distortion.¹¹¹ This tendency and related threats have become even more relevant in light of the coronavirus crisis. As Ruzicska evaluated the SATF and the state aid in 2020 on the ‘father side’, Germany and France were ‘responsible’ for approximately 68% of the approved state aid, while smaller and financially weaker Member States deteriorated rapidly, for instance, as seen even when comparing Italy to France. A further deterioration of the level playing field is clearly evident in the EU. As a result, a company’s economic viability depends (among other things) on which state of the internal market it is based in (in the linkage of the mother’s and father’s sides). Further, the favoured companies could force – despite some measures to prevent the expansion of the beneficiary companies – some of the affected competitors out of business and thus exacerbate the differences.¹¹² The report requested by the EP’s ECON committee also identified the diverse capacity of the Member States to secure subsidies.¹¹³ In other words, ‘even if all Member States enjoy the same *de iure* freedom to use their economic arsenal, some may end up using bazookas while others shoot slingshots’.¹¹⁴ The overall trend shows that the territorial distribution of aid between Member States later became less unbalanced.¹¹⁵ This concern had been identified from other angles of competition law, like fusion control, even before the

109 Buendía Sierra, 2016a, p. 127.

110 Buendía Sierra, 2016a, p. 128.

111 Buendía Sierra, 2016b, p. 501; Papp, 2022a, p. 186.

112 Ruzicska, 2022, p. 2.

113 Van Hove, 2020, pp. 20–21.

114 Ruzicska, 2022, p. 3.

115 European Commission, Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Report on Competition Policy 2021, Brussels, 14.7.2022, COM(2022) 337 final, p. 44.

coronavirus crisis.¹¹⁶ In contrast, some smaller countries used derogations from EU market-based commitments.¹¹⁷

This dilemma of distortion could be addressed by setting up compensation funds financed by a certain percentage of the aid approved and granted. The EU's performance in creating EU-level funds to avoid further distortions between Member States as a crisis management tool remained unbalanced. The new Solvency Support Instrument has not been enacted as proposed by the Commission in May 2020, which would have built on the existing European Fund for Strategic Investments.¹¹⁸ The new RRF framework could be seen as a positive step along with some new fund programmes (CRII, CRII+, and REACT-EU).¹¹⁹

Taking a step further involves investigating the EU state aid rules outside of the single market, having even greater relevance in light of China's economic imperialism and the US's increasing protectionism.¹²⁰ To make this argument understandable, the EU must be present and present while formulating global laws on subsidies to avoid EU companies' disadvantage in the worldwide market. The unilateral interface mechanism requires equalising the terms of competition and investment when a subsidised entity is active in the EU internal market – while considering the further rules of global trade, which are primarily enshrined in World Trade Organisation (WTO) law.¹²¹ To provide a quick overview of the most recent policy steps in this area, the preferential trade agreements have been crucial in extending the territorial reach of the EU state aid law, which also proves the EU's regulatory power at the global level.¹²² As a further step, the new Foreign Subsidies Regulation can be mentioned. According to this unique piece of EU legislation, subsidies granted by non-EU governments currently go unchecked. In contrast, offerings granted by Member States are subject to scrutiny under the EU state aid rules by the Commission as the sole enforcer of this regime.¹²³ These new powers inevitably include further sophistication of the Commission's state aid compatibility test, which – using the analogy of extended subsidy governance – will presumably influence other state aid-related EU policies like industry or trade or digitalisation¹²⁴ and media. This territorial extension of state aid law also refers to the CJEU's primary function in state aid law enforcement, involving a broader scope of legal sources such as the WTO law.¹²⁵

The EU state aid law and policy-making have been shaped and reshaped by the EU integration process with its expanding supranational competencies, various sets

116 Bundeswettbewerbsbehörde, 2019.

117 Bartha and Horváth, 2023.

118 European Commission, 2020.

119 European Commission, 2022b.

120 Di Carlo and Schmitz, 2023, pp. 23–25.

121 Rubini, 2023a, p. 13.

122 Szirbik, 2023; Rubini, 2023a, pp. 14–16.

123 European Commission, 2023.

124 Nicoli and Iosifidis, 2023.

125 As most recent example, see: CJEU, 1 March 2023, T-480/20 and T-540/20, *Hengshi Egypt Fiberglass Fabrics and Jushi Egypt for Fiberglass Industry v. Commission*, ECLI:EU:T:2023:90; Rubini, 2023b.

of different actors, and everchanging rules of procedures and methodologies, and the last decade offered challenges as well as opportunities for a more profound evolution of this policy area. Addressing these challenges with a step-by-step formulation of proper subsidy governance by the EU legislator (and CJEU) in collaboration with national actors could be pivotal to ensuring the future competitiveness of internal markets’ undertakings as well as of its Member States.

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CROATIA: THE LONG AND WINDING ROAD TOWARDS COMPLIANCE WITH THE EU STATE AID LAW



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Abstract

This chapter examines the evolution of state aid and subsidy policies in Croatia against the backdrop of the European Union (EU) law. In doing so, it aims to contribute to the broader discussion on the convergence of state aid practices within the EU. It emphasises how the EU accession process impacted Croatia's subsidy landscape. Three distinct stages in Croatian subsidy policies are identified: pre-Stabilisation and Accession Agreement (SAA) era, the accession period marked by alignment with EU competition policy, and the post-accession stage where Croatia shares competence with the EU institutions. The chapter describes the challenges, legal reforms, and achievements of Croatia in aligning with the EU state aid law. On analysing Croatian policy and practice in the area of subsidies, it concludes that a remarkable degree of compliance with the EU law has been achieved. Conversely, there exists plenty of room for improvement from an economic perspective, given that Croatia still has an unfavourable state aid structure and a substantial total aid expenditure relative to its GDP.

Keywords: *subsidies, state aids, EU law, public finance law*

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1. Overview of Croatian subsidy policies

State aid and subsidies are deeply linked to the fundamentals of a country's economic system. Since subsidies provided by the public sector to private actors amount to a particular – and very visible – form of state interventionism, they should be largely absent from the economies based on *laissez-faire* and free-market principles. However, history teaches us that the transformations in individual countries often defy pure economic theories. In any case, in post-World War II period, countries of Western Europe embraced a 'mixed economy' model, combining free trade policies and the private market with a large degree of state interventionism.¹ This economic model continues to dominate the European Union (EU) Member States, under the guise of 'social market economy', even being explicitly introduced to the Lisbon Treaty.²

Croatia has been a latecomer in this regard, with its economy transitioning from a centrally planned socialist model to a market-based approach after the breakup of Yugoslavia in 1991. The legal underpinnings of the new economic model are enshrined in the Croatian Constitution.³ Notably, Art. 49 para. (1) of the Constitution states that free enterprise and free markets shall form the foundation of the economic system of the Republic of Croatia. However, Art. 49 para. (3) envisages the state playing a role in promoting the economic development and social welfare of its citizens, as well as ensuring the economic development of all regions. In practice, more than three decades of mixed economy in Croatia have been marked by a high level of state interventionism, regardless of the political party in power. Many studies have pointed out how the role of the state (public sector) in Croatian economy is relatively high compared to EU Member States, especially in relation to other post-Communist countries at similar levels of economic development (e.g. Hungary, Poland and Estonia).⁴

It must be noted that the accession procedure to the EU played a major role in shaping the Croatian economy as it stands today. In 2000, Croatian political elites – parties from both left and right of centre – arrived at a consensus that joining the EU is the paramount political goal that needs to be pursued by the country.⁵ Important legal steps in this regard were taken as follows: (i) stabilisation and Accession Agreement (hereinafter: SAA) was signed in May 2001; (ii) official application for the membership in the EU was submitted in February 2003; (iii) candidate status was granted in June 2004; (iv) negotiations began in October 2005; (v) screening process was completed in October 2006; (vi) the Treaty of accession to the EU was signed in December 2011; (vii) the Croatian people approved the accession treaty via a referendum held in January 2012.

1 See: Berend, 2016, pp. 190–191.

2 Art. 3 para. (3) of the Treaty on European Union (TEU). See: Claassen et al., 2019, pp. 4–5.

3 Constitution of the Republic of Croatia, Official Gazette No. 56/90, 135/97, 08/98, 113/00, 124/00, 28/01, 41/01, 55/01, 76/10, 85/10, 05/14.

4 See for example: Šimović and Deskar-Škrbić, 2021, pp. 44–51; Buturac, 2014, pp. 521–523.

5 See: Šeperić, 2011, p. 464.

After the Treaty of accession came into force on 01 July 2013, Croatia officially became the newest EU Member State.⁶

For the purposes of the present chapter, it is important to note that – as is the case with other ‘new EU Member States’ – during this arduous accession procedure, Croatia had to satisfy the so-called Copenhagen criteria.⁷ The economic criterion requires the candidate country to have a functioning market economy and producers that have the capability to cope with the competitive pressure and market forces within the EU. This entails more specific requirements with regard to antitrust and state aid.⁸ In fact, among the 35 chapters into which the EU *acquis* has been divided for the purposes of negotiations with Croatia, the most contentious was chapter 8, devoted to competition policy. While rather quick progress has been made in modernising the legislative and institutional framework related to state aid in Croatia (e.g. adoption of the State Aid Act and improved enforcement record of the Croatian Competition Agency), the more challenging task was to align existing aids in the steel and shipbuilding sector with the EU law.⁹ These issues were resolved by 2011, with the privatisation of five shipyards and the adoption of a restructuring plan for the steel sector companies.¹⁰

Against the preceding backdrop, three main stages can be identified in the development of Croatian subsidy policies: (i) the pre-SAA stage (1991–2001), in which the EU law played no role in shaping state policies toward subsidies; (ii) the accession stage (May 2001–June 2013), which was marked by a complete overhaul of the competition and state aid framework, in order to align it with the *acquis*; (iii) the membership stage (1 July 2013 onwards), in which Croatian authorities share competence in this area with the EU institutions, and granting of any new state aid must adhere to the rules enshrined in the primary and secondary EU legislation.¹¹

The period preceding the signing of the SAA (May 2001) was marked largely by a lack of clear policy objectives regarding subsidies. Remarkably, before the SAA, no legal framework existed to regulate this area.¹² One of the most prominent features of the subsidy practice has been a low degree of transparency, with limited publicly available data on the grantors (e.g. central government, municipalities, and state agencies), beneficiaries, as well as on the subsidy amounts.¹³ Sectoral aids – aids provided to companies operating in a specific sector of the economy – clearly dominated in this period, with the highest amounts directed to four sectors: transport,

6 See: *Chronology of important dates in the EU accession process* [Online]. Available at: <https://www.sabor.hr/en/European-affairs/croatias-path-eu/chronology/chronology-important-dates-eu-accession-process> (Accessed 20 June 2023).

7 On the Copenhagen criteria, see for example: Marktler, 2006.

8 See: Hancher, Ottervanger and Slot, 2016, p. 163.

9 Hancher, Ottervanger and Slot, 2016, pp. 164–165.

10 See: Šeperić, 2011, pp. 468–469.

11 For an overview of the EU state aid framework, see: Hancher, Ottervanger and Slot, 2016, pp. 49–122.

12 Bodiroga-Vukobrat and Pošćić, 2016, p. 488. Cf. Spevec, 2012.

13 Kesner-Škreb and Mikić, 2003, p. 108.

communications, tourism, and shipbuilding.¹⁴ In terms of the instrument type, direct subsidies from the public budgets played a central role. The high degree of state interventionism in this period may be best illustrated by the fact that direct subsidies alone provided from the central government budget in the year 2000 amounted to 2.4% of the Croatian GDP, while the EU average for all types of state aid in that year was 0.99% of a Member State's GDP.¹⁵ It must be noted that in this respect, the Croatian experience has not been dissimilar to that of other European transition countries, or Central and Eastern European countries (CEECs). As explained by Hölscher, Nulsch, and Stephan:

Prior to their accession to the EU, most CEECs pursued high levels of sectoral aid, as these countries first had to overcome the problems resulting from transition. Thus, disparities between East and West before accession can be explained in part by the restructuring of industries in order to reach commercial viability and to complete the process of privatization.¹⁶

Undoubtedly, Croatia finally becoming a Member State of the EU on 01 July 2013 was a watershed moment in terms of Croatian policy regarding subsidies. The new State Aid Act (*Zakon o državnim potporama*) was adopted to ensure alignment with the EU legislation.¹⁷ Notably, as per the State Aid Act, the priority goals of state aid policy have to be set by the government and publicised on a yearly basis in the form of the so-called guidelines for state aid policy (*smjernice politike državnih potpora*; hereinafter: Guidelines).¹⁸ As expressly stated in Art. 7 para. (2) of the State Aid Act, Croatian state aid policy is drafted on the lines of the EU state aid policy. Interestingly, this encroachment into the sovereignty of the national legislator has not been debated much in the Croatian academic community.¹⁹ In any case, even the first policy document, adopted for the period 2014–2016, emphasised the need to establish a coherent system for granting state aid and for achieving a higher degree of convergence with the EU in terms of the structure of aid, by reducing the share of sectoral aid favouring horizontal aids.²⁰

The latter still remains the main goal of Croatian state aid policy, as explained in the latest edition of the Guidelines, adopted for the period 2023–2025.²¹ More precisely, the main goal is to reduce the share of sectoral aids in the total aid expenditure,

14 Kesner-Škreb and Mikić, 2003, p. 127.

15 Kesner-Škreb and Mikić, 2003, p. 128.

16 Hölscher, Nulsch and Stephan, 2017, p. 786.

17 State Aid Act, Official Gazette No. 72/2013. This act has been repealed and replaced in 2014 by the new State Aid Act, Official Gazette No. 47/2014, 69/2017, that is currently in force.

18 See: Art. 7 of the State Aid Act. Compare also Bodiroga-Vukobrat and Pošćić, 2016, p. 490.

19 See: Butorac Malnar et al., 2021, pp. 510–511.

20 See: *Odluka o donošenju Smjernica politike državnih potpora za razdoblje 2014–2016*, Official Gazette No. 130/2013.

21 *Odluka o donošenju Smjernica politike državnih potpora za razdoblje 2023–2025*, Official Gazette No. 19/2023 (hereinafter: Guidelines 2023–2025).

thus achieving more convergence of aid structure with other EU Member States. To put things in perspective, in 2020, the share of sector-specific aids was 57.2% of all state aid measures provided to industries and services (excluding agriculture and fisheries).²² While this is significantly lower than that in the pre-accession period – for example, in 2011, the share of sectoral aid in the total state aid expenditure for industries and services was 73.9% – it is still much higher than the EU average of around 10%. Furthermore, according to the Guidelines, grantors of state aids in Croatia should ensure that the planned aid instruments are well-designed and have minimal impact on the market competition. More specifically, grantors are encouraged to spend more on (i) environmental protection, (ii) research, development, and innovation, (iii) training, (iv) employment, and (v) investment, focusing on regional aids.²³ One may note that such a policy is aligned with that pursued by the EU ever since 2005 and the presentation of European Commission's 'State Aid Action Plan (SAAP)', which focuses on 'better-targeted aid'.²⁴

Further, it is important to note that Croatia and other EU Member States converge more on the levels of the total state aid expenditure relative to GDP. In other words, in 2021, total state aid granted for non-COVID-19 objectives in Croatia amounted to 1.4% of the national GDP. While only three Member States (Denmark, Hungary, and Malta) spent more in relative terms, the share of Croatia in this aspect is much lower than that in the pre-accession period.²⁵ Again, this fits the experience of other CEEC countries in the years following the accession to the EU.²⁶

2. Croatian state aid law in times of crisis

2.1. COVID-19-related state aid measures

The outbreak of the COVID-19 pandemic in early 2020 and its persistence throughout 2021 and 2022 resulted in individual governments in Europe taking severe control and containment measures, leading to one of the biggest economic downturns in modern history. Among other tools aimed to alleviate this economic shock, the EU had to quickly adapt its approach toward state interventions in the internal market, including the state aid policy. In March 2020, the European Commission (hereinafter: EC) indicated that it would take all measures at its disposal to ease the socio-economic impact of the pandemic, with the adaptations of the EU

²² See: para. 2 of the Guidelines 2023–2025.

²³ See: para. 4.1 of the Guidelines 2023–2025.

²⁴ Hölscher, Nulsch and Stephan, 2017, p. 783.

²⁵ See: Madarević-Šujster, 2014, pp. 109–110.

²⁶ See: Hölscher, Nulsch and Stephan, 2017, pp. 783–786.

state aid framework at the centre of its efforts.²⁷ This is a consequence of the fact that the EU budget is extremely small compared to the total GDP of the Union, and the financial brunt of the COVID-19 measures had to be borne by Member States in their budgets.

Notably, solid legal bases exist in the primary EU law under which state aid measures granted in exceptional circumstances may be considered compatible with the internal market.²⁸ Most notably, under Art. 107 para. (3) point (b) of the Treaty on the Functioning of the European Union (TFEU), the EC may declare aid granted to remedy a serious disturbance in the economy of a Member State compatible with the internal market. On 19 March 2020, the EC issued a Communication on the Temporary Framework for state aid measures to support the economy during the ongoing COVID-19 outbreak.²⁹ The main aim of this soft law instrument was to establish the compatibility conditions that the EC could apply to the pandemic-related aid granted by Member States under Art. 107 para. (3) point (b) of the TFEU.³⁰ Accordingly, the Temporary Framework cleared the path for quicker and more flexible approval of state aid that could tackle problems relating to liquidity and access to finance faced by undertakings as a consequence of the COVID-19 outbreak.³¹ In fact, the following period saw probably the most intense wave of state aid notifications by Member States and corresponding decisions by the EC since the foundation of the EU.³² Nevertheless, for most of the envisaged instruments, the Temporary Framework was withdrawn on 30 June 2022.

Tourism and transport were among the most important sectors of the Croatian economy hit particularly hard by the pandemic. Accordingly, the period between March 2020 and June 2022 was marked by large state interventions in the economy, primarily aimed at ensuring liquidity for businesses and maintaining employment levels. More importantly, Croatia enacted a variety of state aid measures approved by the EC under the COVID-19 Temporary Framework.³³ The most significant ones are briefly described as follows: (i) A liquidity guarantee scheme for companies affected by the coronavirus outbreak, which was approved on 6 April 2020.³⁴ This measure took the form of state guarantees on loans and was accessible to all companies whose exports represent at least 20% of their yearly revenue. The scheme

27 See: Buendía and Dovalo, 2020, p. 3.

28 See: Correia, 2022, p. 9.

29 Communication from the Commission – Temporary Framework for state aid measures to support the economy in the current COVID-19 outbreak, OJ C 91I, 20.3.2020, 1–9, as amended by Commission Communications C(2020) 2215, OJ C 112I, 4.4.2020, 1–9; C(2020) 3156, OJ C 164, 13.5.2020, 3–15; C(2020) 4509, OJ C 218, 2.7.2020, 3–8; C(2020) 7127, OJ C 340I, 13.10.2020, 1–10; C(2021) 564, OJ C 34, 1.2.2021, 6–34; and C(2021) 8442, OJ C 473, 24.11.2021, 1–11.

30 On the legal nature of the Temporary Framework, see: Buendía and Dovalo, 2020, p. 4.

31 Buendía and Dovalo, 2020, p. 3.

32 Bouchagiar, 2021, p. 1.

33 A full account of the Croatian state aid measures enacted under the Temporary Framework is provided here: European Commission, 2024.

34 Commission Decision SA.56877 (2020/N).

was aimed at limiting the risk associated with issuing operating loans to companies most severely affected by the economic impact of the coronavirus outbreak, thus ensuring continuation of their activities. The guarantees supported lending to those companies, but they did not take the form of export aid contingent on export activities. The scheme was administered by the Croatian Bank for Reconstruction and Development (Hrvatska banka za obnovu i razvitak; HBOR), with the total budget of the scheme amounting to EUR 790 million; (ii) Two schemes to support pandemic-affected companies, in the form of zero-interest loans and loans with subsidised interest rates, which were approved on 9 April 2020.³⁵ The schemes were aimed at enhancing access to liquidity by companies most severely affected by the economic impact of the coronavirus outbreak, thus ensuring continuation of their activities. These schemes were also administered by the HBOR, with a total budget of EUR 1 billion; (iii) A scheme for loan guarantees and subsidised loans targeted at micro companies and small- and medium-sized enterprises (SMEs), which was approved on 12 May 2020.³⁶ The measure took the form of subsidised loans and state guarantees on loans, thus allowing targeted companies access to external financing. The scheme was administered by the Croatian Agency for SMEs, Innovations and Investments (HAMAG-BICRO), with a total budget of EUR 322 million; (iv) A scheme to support enterprises active in the maritime, transport, travel, infrastructure, and related sectors, which was approved on 30 June 2020.³⁷ The measure took the form of state guarantees on new loans from banks or other financial institutions, with the guarantee covering up to 90% of the loans. This scheme was administered by two state agencies – HBOR and HAMAG-BICRO – with a total budget of approximately EUR 80 million; (v) A scheme to support enterprises of all sizes active in the sports and tourism sectors and in the sectors directly related to them (e.g. hotels and restaurants), which was approved on 11 January 2021.³⁸ The measure took the form of guarantees on new working capital and investment loans and subsidised interest rates for new loans, aiming to help eligible companies access liquidity and continue with their economic activities; (vi) A scheme to support companies active in certain primary agricultural sectors (e.g. cattle, pig, poultry, and sheep producers), which was approved on 17 November 2021.³⁹ The aid was provided in the form of direct grants, addressing the liquidity needs of the beneficiaries. This scheme was administered by the Ministry of Agriculture of Croatia, with a total budget of EUR 22.7 million; (vii) A wage subsidy scheme (officially called as the ‘job preservation aid scheme’) to support employers and self-employed persons, which was approved on 9 December 2022.⁴⁰ The aid took the form of wage subsidies, aimed at reducing the wage costs of eligible employers and at supporting low-earning self-employed

35 Commission Decision SA.56957 (2020/N).

36 Commission Decision SA.57175.

37 Commission Decision SA.57711.

38 Commission Decision SA.60265.

39 Commission Decision SA.100417.

40 Commission Decision SA.103801.

individuals. Accordingly, the scheme's primary aim was to preserve the employment levels and to avoid layoffs, especially in sectors of the economy that were seriously affected by the pandemic.

Two further measures enacted by Croatian authorities and approved by the EC under Art. 107 para. (2) point (b) of the TFEU, which are deemed compatible with the internal market, refer to the aid granted to compensate damage caused by natural disasters or exceptional occurrences.⁴¹

First, an EUR 11.7 million grant to compensate the national airliner (Croatia Airlines) for the damage caused by the pandemic was approved by the EC on 1 December 2020.⁴² Bearing in mind the requirements for the approval of the measure under Art. 107 para. (2) point (b) of the TFEU, the Commission found in particular that the grant would compensate damage directly linked to the coronavirus outbreak. For the approval of the measure, Croatian authorities confirmed that an independent audit firm would verify that the aid does not exceed the amount of damage suffered between 19 March 2020 and 30 June 2020. Notably, this case was the only occurrence in which a Croatian state aid measure has been tested before the Court of Justice of the European Union (CJEU). Following one of several actions taken by Ryanair to annul EC's decisions regarding COVID-19-related aid provided to rival airline companies, the General Court decided on 9 November 2022 to dismiss Ryanair's action and to confirm the validity of the pertinent measure from the perspective of EU law.⁴³

Second, the measure approved on the basis of Art. 107 para. (2) point (b) of the TFEU concerned the state aid measure enacted by Croatia to compensate Zagreb International Airport for the damage suffered due to the pandemic. The measure took the form of a write-off of the concession fees amounting to a total of EUR 14.3 million. It was approved by the EC on 13 December 2022, finding that it compensates the damage suffered by the beneficiary and is proportionate.⁴⁴

In 2020, the total expenditure in Croatia for COVID-19 state aid measures amounted to EUR 220.3 million (16.3% of the total state aid expenditure); in 2021, it amounted to EUR 459.9 million (35.7% of the total state aid expenditure).⁴⁵ Both in 2020 and 2021, this was the lowest share of pandemic-related measures in the overall state aid expenditures among all EU Member States. Furthermore, if one considers the scale of the economic shock suffered amidst the pandemic (measured by the real loss of GDP), Croatia was among the Member States that spent the least on COVID-19 state aid measures (less than 25% of the GDP loss).⁴⁶ With regard to the

41 More on the role of Art. 107 para. (2) point (b) of the TFEU as the legal basis for pandemic-related measures see: Rosanò, 2020, pp. 626–629.

42 Commission Decision SA.55373.

43 See: CJEU, 9 November 2022, Case T-111/21, *Ryanair v. Commission*, ECLI:EU:T:2022:699. For an analysis of other related cases see: Correia, 2022, pp. 11–22.

44 Commission Decision SA.102197.

45 See: European Commission, 2023.

46 European Commission, 2023, pp. 43–44.

type of instrument used, Croatia was among the Member States that spent the least in direct grants. Contrarily, the government showed clear preference to channel aid through guarantees and loans.⁴⁷

2.2. State aid measures related to the war in Ukraine

As if one crisis were not enough, February 2022 witnessed the beginning of the Russian invasion of Ukraine, resulting in a brutal, still-ongoing war. Since this too caused major disruptions in the EU economy, the EC very soon adopted – similar to the above-mentioned COVID-19 framework – a Temporary Crisis Framework (hereinafter: TCF).⁴⁸ Its main goal was to specify the criteria for assessing compatibility of state aid measures (that Member States may take to remedy the economic effects following the Russian aggression against Ukraine) with the internal market and the ensuing sanctions imposed by the EU and international partners. While the TCF was amended on 20 July 2022 and on 28 October 2022, on 9 March 2023, the EC adopted a new Temporary Crisis and Transition Framework (hereinafter: TCTF).⁴⁹ The TCTF not only amends and prolongs the TCF partially, but also serves to foster support measures in sectors that are key for the transition to a net-zero economy in light of the European Green Deal.

A short overview of the Croatian state aid measures enacted under TCF and TCTF is provided as follows: (i) A EUR 1 million scheme to support maize seed producers was approved on 23 March 2022.⁵⁰ The measure was open to companies of all sizes active in the maize seed production sector affected by the price rise of electricity, animal feed, and fuel caused by the current geopolitical crisis and the related sanctions. Under this scheme, eligible beneficiaries were entitled to receive limited amounts of aid in the form of direct grants; (ii) A EUR 414 million scheme to support exporters was approved on 1 July 2022.⁵¹ The measure took the form of (i) guarantees covering part of new eligible loans granted by commercial banks and (ii) direct grants covering the loan guarantee premiums (not exceeding EUR 400,000 per beneficiary). It was open to companies whose revenues from export activities represented at least 10% of their total income over the previous year; (iii) a EUR 500 million scheme to support companies across all sectors, except credit and financial institutions, which was approved on 7 July 2022.⁵² Under this measure,

⁴⁷ European Commission, 2023, pp. 40–43.

⁴⁸ Communication from the Commission Temporary Crisis Framework for State Aid measures to support the economy following the aggression against Ukraine by Russia 2022/C 131 I/01, OJ C 131I, 24.3.2022, 1–17.

⁴⁹ Communication from the Commission Temporary Crisis and Transition Framework for State Aid measures to support the economy following the aggression against Ukraine by Russia 2023/C 101/03, C/2023/1711, OJ C 101, 17.3.2023, 3–46.

⁵⁰ Commission Decision SA.103217.

⁵¹ Commission Decision SA.103167.

⁵² Commission Decision SA.103003.

administered by the HBOR, limited amounts of aid or liquidity support took the form of (iiia) direct loans, (iiib) subsidised loans, or (iiic) interest rate subsidies; (iv) A EUR 437 million scheme to support companies across all sectors was approved on 23 March 2022 and amended on 20 July 2022.⁵³ The scheme was meant to remedy the liquidity shortage that Croatian companies were facing as a result of the serious disturbance of the economy caused by Russia's invasion of Ukraine. Under the scheme, aid took the form of (iva) direct grants covering guarantee premiums and (ivb) guarantees covering part of new loans; (v) A EUR 40 million scheme to support companies processing agricultural products was approved on 23 March 2022 (and amended on 20 July 2022 and on 28 October 2022).⁵⁴ The scheme took the form of (va) limited amounts of aid in the form of direct grants to compensate companies for the cost increase of energy sources other than natural gas and electricity and (vb) direct grants for the additional costs incurred due to severe increases in natural gas and electricity prices; (vi) A EUR 31 million scheme to support the livestock and crop production sectors was approved on 12 June 2023.⁵⁵ The scheme, which is still operational, consists of limited amounts of aid in the form of direct grants. Its purpose is to support the liquidity needs of livestock farmers and crop producers affected by the current geopolitical crisis.

2.3. RRF and state aids

Recovery and Resilience Facility (RRF) lies at the centre of the innovative fiscal architecture established by the EU in response to the pandemic-induced economic downturn.⁵⁶ More precisely, the RRF, finding its legal basis in Art. 175 para. (3) of the TFEU, is a temporary instrument through which most of the distribution envisaged by the Next Generation EU (NGEU) is channelled.⁵⁷ In short, the RRF – which entered into force on 19 February 2021 – finances reforms and investments in EU Member States on the basis of national recovery and resilience plans (hereinafter: RRP), lay down the reforms and investments that individual Member States must implement by the end of 2026, with clear milestones and targets.⁵⁸ Croatian RRP, consisting of 146 investments and 76 reforms, which are to be supported by a total amount of EUR 6.3 billion, has been approved by the Council on 20 July 2021.⁵⁹

⁵³ Commission Decision SA.103558.

⁵⁴ Commission Decision SA.10478.

⁵⁵ Commission Decision SA.107858.

⁵⁶ For an overview, see: Fromage, 2020.

⁵⁷ See: Leino-Sandberg and Ruffert, 2022, p. 443.

⁵⁸ See: Recital 30 of the Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, OJ L 57, 18.2.2021, 17–75 (hereinafter: the RRF Regulation).

⁵⁹ See: Council Implementing Decision of 28 July 2021 on the approval of the assessment of the recovery and resilience plan (RRP) for Croatia, ST 10687/21.

The RRF Regulation clarifies that all reforms and investments included in national RRFs must comply with the relevant EU state aid rules and follow all state aid procedures.⁶⁰ The Commission published a document containing practical guidance for the swift implementation of RRF-related state aid notifications,⁶¹ as well as a number of state aid guiding templates to assist Member States in the design of their RRFs.⁶² In this regard, the Croatian RRF makes it clear that a number of projects will be assessed in the light of the EU state aid rules and, subject to this preliminary assessment, they will be notified to the EC. So far, only three decisions, all positive, have been adopted: (i) A EUR 101.4 million Next Generation Network (NGN) Broadband plan, aiming to provide fast Internet access to places where it is currently not available, particularly rural areas, was approved on 10 December 2021.⁶³ The scheme funds new infrastructure, mainly through the European Regional Development Fund and partly through national funds. While the network remains in public ownership, a public undertaking (OjV) will offer long-term leasing agreements for the infrastructure to all interested operators; (ii) A EUR 783 million scheme to support the production of electricity from renewable energy sources was approved on 9 December 2021.⁶⁴ Under this scheme, aid will take the form of a premium higher than the electricity market price, and the beneficiaries will be selected through tenders, for a period of 12 years; (iii) A EUR 54 million scheme to support investments in logistics and distribution centres for fruits and vegetables was approved on 21 April 2022.⁶⁵ The aim of the scheme is to support producer organisations in the fruit and vegetables sector to invest in building and equipping logistics and distribution centres to improve the competitiveness of the sector. Under this scheme, support is in the form of direct grants.

3. Fiscal state aid

The power to tax is at the core of the concept of state sovereignty.⁶⁶ Indeed, taxation may be deemed an attribute of sovereignty without which no sovereignty can be called as such.⁶⁷ However, in the context of the EU, it is by now well established

60 Recital 8 of the RRF Regulation.

61 See: European Commission, 2021.

62 See: *Recovery and resilience facility (RRF) guiding templates* [Online]. Available at: https://competition-policy.ec.europa.eu/state-aid/legislation/rrf-guiding-templates_en (Accessed: 10 June 2023).

63 Commission Decision SA.41065.

64 Commission Decision SA.57089.

65 Commission Decision SA.101504.

66 See: Gadžo, 2018, pp. 42–45; Christians, 2009, pp. 104–106.

67 See: Separate Opinion by Judge M. Sfériadiès in PCIJ, 8 October 1937, *Lighthouses in Crete and Samos*, PCIJ Series A/B. No 71, p. 136.

that Member States may exercise their taxing powers only within the limitations posed by the EU law.⁶⁸ In the last decade or so, the EU state aid law was particularly effective in restraining the fiscal sovereignty of Member States, as evidenced by the volume of negative decisions of the Commission and cases appearing before the CJEU.⁶⁹ While a more detailed overview of the interaction between tax measures and the EU state aid law falls outside the ambit of this chapter, it should be emphasised that the broad definition of state aid under Art. 107 para. (1) of the TFEU necessarily calls for the scrutiny of a variety of national tax law provisions and their application in practice. This is particularly necessary in the case of so-called tax expenditures, that is, provisions by virtue of which a state fails to collect a part of tax revenue that it is normally entitled to collect.⁷⁰ In practice – as affirmed by the CJEU on multiple occasions – the crux of applying state aid rules to domestic tax measures is the criterion of selectivity.⁷¹ In this regard, the EC and the CJEU rely on a three-step derogation test to evaluate whether a tax scheme is selective.⁷² A further point of contention is regarding the role of tax rulings, that is, binding statements of the tax authority's interpretation and future application of tax laws to a taxpayer's arrangement.⁷³ These individual administrative acts may confer selective advantage to their addressees, thus violating the EU state aid law.⁷⁴

Regarding the Croatian tax system, interestingly, tax advantages have never been a prominent instrument of state aid. As already noted above, in the period preceding the signing of the SAA, direct grants dominated in the overall structure of state aid in Croatia. More recently, guarantees and loan subsidies have played a prominent role, along with direct grants.⁷⁵ In comparison to other Member States, Croatia relies much less on tax advantages as aid instruments: during 2019-2021, the respective shares of tax advantages in the total state aid expenditure were 8.6% (2019), 7.9% (2020), and 7.4% (2021).⁷⁶ Again, one should not underestimate the role of EU accession negotiations in this regard. It was during the accession period that the Croatian tax law framework was scrutinised from the perspective of the EU State aid *acquis*. Accordingly, the Croatian authorities committed to amend certain tax incentives that were identified as problematic by the EC, such as schemes related to

68 See: Terra and Wattel, 2012, p. 1.

69 See: Luja, 2016, p. 324.

70 Luja, 2003, pp. 8–10.

71 See: Luja, 2016, pp. 315–319.

72 See: Micheau, 2011, pp. 201–204.

73 See: Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union C(2016) 2946, OJ C 262, 19.7.2016, 1–50, paras. 169–174.

74 For an overview see: for example, Mason, 2017.

75 See: European Commission, 2023.

76 As stated in the yearly reports on state aids compiled by the Croatian Ministry of Finance. See: *Godišnja izvješća o državnim potporama* [Online]. Available at: <https://mfin.gov.hr/istaknute-teme/koncesije-i-drzavne-potpore/drzavne-potpore/godisnja-izvjesca-o-drzavnim-potporama/464> (Accessed: 02 June 2023).

the ‘free zones’ and disadvantaged regions.⁷⁷ Further developments in the EU state aid law were taken into consideration during the process of drafting tax incentive schemes currently found in the Croatian tax system.

One example is the ‘tonnage tax’ regime, introduced by virtue of the 2011 amendments to the Maritime Code (*Pomorski zakonik*).⁷⁸ This scheme aimed to stimulate the domestic shipping industry. Put simply, qualifying taxpayers (i.e. companies engaged in shipping business registered in Croatia or having their place of management therein) may, upon their own request, be exempt from the general corporate income tax system and instead pay a lump-sum tax determined by reference to the total tonnage of the vessels they have in operation. While a more in-depth analysis of this regime is beyond the scope of this chapter, it is important to note that its design was heavily influenced by the EU *acquis* on state aids to the shipping industry.⁷⁹ In 2021, the amount of aid granted via this preferential tax regime was estimated at just above EUR 1 million, with only three beneficiary companies.⁸⁰

Regarding the tax incentive for research and development (R&D) – which is, notably, one of the desired horizontal goals of the national state aid policy (see Section 1. above) – in 2018, Croatia introduced a special scheme by virtue of the Act on State Aid for Research and Development (*Zakon o državnoj potpori za istraživačko – razvojne projekte*). It is a horizontal scheme involving a tax allowance or a super deduction for enterprises engaged in R&D activities.⁸¹ It is available to all corporate and individual taxpayers, and the level of allowance depends on the type of research conducted, with SMEs getting more beneficial treatment in some cases. Monetary ceilings for maximum aid available are outlined. Most importantly, for the purposes of this chapter, this R&D tax incentive was designed in line with the provisions of the EU General Block Exemption Regulation (GBER).⁸² Interestingly, even the government acknowledges that the effects of this scheme have been underwhelming. In other words, from February 2019 to January 2021, only 55 requests have been granted for such aid. The procedure of approval has proven to be very slow and takes up to six months from the time of the taxpayer’s initial request.⁸³ Hence, a comprehensive reform of this scheme is planned within the framework of the Croatian RRP (see: Section 2.3. above). The expenditure for this scheme amounted to EUR 7.7 million in 2019, EUR 7.2 million in 2020, and EUR 2.5 million in 2021.⁸⁴

⁷⁷ See: European Commission, 2007.

⁷⁸ See: Ćorić, 2011.

⁷⁹ See in particular: Commission Communication C(2004) 43 – Community guidelines on state aid to maritime transport, OJ C 13, 17.1.2004, 3–12. Cf. Commission Decision SA.37912.

⁸⁰ See: Government of the Republic of Croatia, 2022, p. 58.

⁸¹ For an overview see: Arbutina et al., 2022, pp. 105–106.

⁸² See: notifications of state aid SA.51843 and SA.59979.

⁸³ See: Government of the Republic of Croatia, 2021.

⁸⁴ As stated in the yearly reports on state aids compiled by the Croatian Ministry of Finance. See: *Godišnja izvješća o državnim potporama* [Online]. Available at: <https://mf.gov.hr/istaknute-teme/koncesije-i-drzavne-potpore/drzavne-potpore/godisnja-izvjesca-o-drzavnim-potporama/464> (Accessed: 02 June 2023).

In terms of regional tax incentives, as of 1 January 2017, a preferential regime applies to corporate taxpayers engaged in business activities in the territory of the City of Vukovar, or in a municipality classified under the least-developed category according to the development index.⁸⁵ Corporate taxpayers may get either a full exemption from corporate income tax (in case of business activities in the City of Vukovar) or a 50% reduction of the statutory tax rate (in case of business activities in other qualifying municipalities), provided they have more than five employees (with a permanent contract), of which at least 50% are residents in the pertinent areas. It is important to note that this tax incentive has been introduced as a *de minimis* aid scheme.⁸⁶ Accordingly, the maximum amount of tax benefit available to a qualifying taxpayer is calculated in line with the provisions of the EU *De Minimis* Aid Regulation.⁸⁷

4. Concluding remarks and recommendations

In the theory of public finance law, subsidies are considered a key instrument in maintaining or promoting certain economic structures or activities deemed to be in the ‘public’ or ‘general’ interest.⁸⁸ Put simply, subsidies entail a distribution of public monies in the pursuit of specific policy objectives established by the government, for example, correction of market failures, environment protection, regional development, etc. In today’s ‘mixed economies’ of the EU, strong arguments remain for using subsidies as a particularly visible form of state intervention in the economy. The latest crises, related to the COVID-19 pandemic (2020–2023) and the war in Ukraine (February 2022–ongoing), have confirmed the importance of subsidies and their policy design.

In the context of the EU, however, important limitations to domestic legislators’ subsidy policy stem from the primary EU law, particularly from the general prohibition of ‘state aid’ under Art. 107 para. (1) of the TFEU. Within the complex EU system of competence distribution, state aid control lies exclusively with the Commission, thus significantly restraining national spending policies of individual Member States.⁸⁹ Of course, multiple political, economic, and legal objectives underlie such erosion of ‘national fiscal sovereignty’: while the primary aim relates to

85 See: Art. 28a of the Profits Tax Act, Official Gazette No. 177/04, 90/05, 57/06, 146/08, 80/10, 22/12, 148/13, 143/14, 50/16, 115/16, 106/18, 121/19, 32/20, 138/20, 114/22.

86 See: Cipek, 2022, pp. 97–101.

87 Commission Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid, OJ L 352, 24.12.2013, 1–8.

88 See: Lienhard, Mächler and Zielniewicz, 2017, p. 240; Hofman, 2016, p. 3.

89 See: Hofman, 2016, p. 5.

the creation of the internal market, one should not underestimate the role of the EU state aid rules in enforcing certain fiscal discipline standards on national governments and improving both the quality and effectiveness of public expenditures.⁹⁰ This is in line with the basic tenets of the ‘EU economic constitution’, ideologically rooted in the German ordoliberal doctrine.⁹¹

The evolution of Croatian subsidy policy and practices in the last three decades fits well within broader discussions on the pros and cons of the EU state aid law framework as it stands today. In the first decade as an independent country (1991–2000), Croatian transition from a centrally planned socialist economy to a market-based economy has been rather painful and with underwhelming economic results. In this period, the government did not shy away from implementing interventionist policies to smooth out the effects of economic and social transformations, including via large expenditure for direct, mostly sector specific, subsidies. However, the effectiveness of these subsidies has been questioned mainly owing to the lack of a coherent subsidy policy, as well as a pertinent legal framework. Important changes ensued after May 2001 and the signing of the SAA. During this ‘accession stage’, which lasted until 1 July 2013, the Croatian legal framework had to be aligned with the EU *acquis*, entailing, *inter alia*, a complete overhaul in the area of state aids and subsidies. The legal requirements to be met during the accession negotiations necessarily led to a change in Croatian policy-makers’ approach toward direct and indirect subsidies. This is confirmed by analysing the national state aid policy guidelines that have been enacted on a yearly basis by the government since 2013. Put simply, Croatian policy-makers are rather firm in their adherence to the general aims of the EU state aid policy. More specifically, the main goal of Croatian state aid policy has traditionally been to increase the share of horizontal aids in the total aid expenditure, at the expense of sectoral aids. The limitations of state fiscal sovereignty imposed at a supranational level have, at least in this regard, played a positive role.

From a purely legal standpoint, Croatian state aid practice in the post-accession period exhibited a remarkable degree of compliance with the EU law. Notably, till date, no negative decisions have been issued by the EC; nor have Croatian state aid measures been successfully challenged before the CJEU. From an economic perspective, however, there is much room for improvement. Croatia still lags behind other Member States in terms of a desirable structure of state aid – with an outsized share of expenditures for sectoral aids – while at the same time having a substantial total aid expenditure relative to its GDP.

90 See: Hofman, 2016, p. 6; Luja, 2016; Butorac Malnar et al., 2021, pp. 508–509.

91 See: Biebricher, 2018, p. 3.

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CZECH REPUBLIC: ROLE AND IMPORTANCE OF STATE AID AND SUBSIDIES



EVA TOMÁŠKOVÁ – MICHAL RADVAN

Abstract

State aid and subsidy policy in the Czech Republic, especially the manner in which the country's subsidy policy is aligned with regulations of the EU law, form the topic of discussion in this chapter. Direct aid and indirect aid are the two categories of aid covered under the subsidy policy, which has been a subject of much debate in Czech society. The first issue deals with the very essence of state subsidies, that is, whether the benefits of state incentives outweigh their disadvantages. The second is whether the rules are appropriately established for specific incentives and, for example, whether the incentive amount is adequate. The Office for the Protection of Competition and the Ministry of Agriculture and Fisheries monitors, coordinates, and controls state aid. Several entities exploited the advantages offered by state subsidies, although the provision of some subsidies was highly controversial. During the COVID-19 crisis, 18 COVID programmes were offered as the Czech Republic required substantial recovery of the economy and societal conditions. Further, during Russia's invasion of Ukraine, the energy crisis loomed, making it necessary to resolve this largely through green and digital transitions. A separate chapter is dedicated to fiscal state aid. State aid also provides an advantage through a reduction of the company's tax burden. These advantages can be used in varied ways, depending on the specific tax. However, despite several reservations (including a certain administrative complexity), these subsidies did contribute to developing the investment environment in the Czech Republic and offered opportunities for financing a wide range of products, such as project plans of towns and municipalities, small- and medium-sized enterprises, and non-profit organisations.

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1. General remarks on the subsidy policy of the Czech Republic

Aid can be (i) direct aid based on the national state budget or foreign aid, comprising mainly funds from the EU Structural Funds through individual operational programmes, other resources from the EU budget, and resources from international, governmental, and public organisations outside the EU or (ii) indirect aid, which can take several forms, such as tax incentives and reliefs, fast-track depreciation, reduction of social security contributions, exemption from customs duties, guarantee mechanisms, preferential loans, venture capital support, and preferential leases of national and regional infrastructure.¹

The legislation in the Czech Republic is based on the legislation of the European Union. The basic rules for controlling state aid are set out in the Treaty on the Functioning of the European Union (TFEU):²

[...] aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.³

The criteria for the above definition are described in detail in the Commission Notice on the concept of state aid in the TFEU.⁴ These are described as follows.

To understand the main characteristics of state aid, first, state aid refers to any advantage directly or indirectly granted, financed through state resources, by the state as such, or by an intermediate body with conferred powers. The term ‘enterprise’ refers to any entity that carries out an economic activity, regardless of its legal status or its financial backing. An advantage represents a situation that would not have occurred under normal market conditions. Distortion of competition is an assumption by the European Commission. Competition is distorted if the measure strengthens the position of the aid beneficiary *vis-à-vis* its competitors. Affecting trade between Member States is also an assumption by the European Commission. No threshold exists when a particular measure already affects trade

1 Czech Statistical Office, 2015.

2 Arts. 107–109 of the TFEU.

3 Art. 107 of the TFEU.

4 Art. 107 para. (1) of the TFEU.

between Member States. However, from the case law, it is clear that even a small amount or the small size of a beneficiary of public aid may affect the market between Member States.⁵ Different types of state aid may be considered compatible with the EU internal market.⁶

The legislation in the Czech Republic is set out in the Act on the Regulation of Certain Relations in the Field of State Aid⁷ and the Amendment to the Act on the Support of Research and Development.⁸ This Act defines state aid, the rights and obligations of providers and recipients of state aid, and other aspects related to state aid. It also regulates issues of interoperability of the Czech Republic with the European Commission, as well as other relations with the provision of state aid and small-scale aid (will be defined below). The law uses two terms distinguishing these definitions.⁹

The Office for the Protection of Competition (the Office, hereafter) is the authority responsible for the central coordination, advisory, consulting, and monitoring of state aid. The exemption is for agriculture and fisheries; in this case, the coordinating body is the Ministry of Agriculture. The Office plays an important role in the notification procedure as it cooperates with both the state aid providers and the Commission and sends notifications to the Commission electronically. The Office maintains a register of all granted aid in the Czech Republic and submits annual reports to the Commission on all existing aid schemes. In cases of violation of obligations, the Office is entitled to impose on the provider and the beneficiary of the state aid a fine of up to 1% of the amount of state aid provided.¹⁰

As mentioned above, the Office coordinates a number of activities that are processed by the Office. First, it cooperates with the provider before notifying the state aid to the Commission. Second, it cooperates with the Commission and with the provider in the course of the procedure before the Commission. Third, it submits annual reports to the Commission on state aid in the Czech Republic. Fourth, it exercises control over the implementation of final decisions on state aid as per the legislation in force before the new law comes into force. Fifth, it decides on matters of imposing a fine under this Act. Sixth, it informs the Commission about state aid. Seventh, it prepares opinions on the submissions of providers, both before and during the proceedings, before the Commission. Eighth, it issues opinions for providers of small-scale aid before the aid is granted (e.g. whether the aid is small scale and whether

5 *Definiční znaky veřejné podpory* [Online]. Available at: <https://www.uohs.cz/cs/verejna-podpora/definicni-znaky-verejne-podpory.html> (Accessed: 12 October 2023).

6 Art. 107 para. (3) of the TFEU.

7 Act no. 215/2004 Sb., on Regulation of Certain Relations in the Field of State Aid, as amended.

8 Act no. 130/2002 Sb., Amendment to the Act on the Support of Research and Development, as amended.

9 Neckář, 2017.

10 *The Competence of the Office for the Protection of Competition in the Area of State Aid* [Online]. Available at: <https://www.uohs.cz/en/state-aid/competence-in-the-area-of-state-aid.html> (Accessed: 25 August 2023).

it meets the conditions for granting it). Ninth, it represents the Czech Republic in negotiations related to state aid and the preparation of related EU legislation. Tenth, it is the administrator of the Central Register of small amounts of aid. A state aid provider may be anybody that determines to whom state aid will be granted. If state aid is determined by the Government of the Czech Republic, the provider is either the Ministry or another central administrative authority that submits the grant of state aid or drafts the rules of state aid.¹¹

The recipients of state aid may be a natural or legal person. However, an essential condition is that state aid has been decided in its favour.

Small-scale aid is granted under the EU legislation on *de minimis* aid. A provider may grant aid to a single entity in most areas for any purpose, provided the amount of such aid, together with other *de minimis* aid received by the entity over a period of three consecutive years, does not exceed EUR 200,000.¹² *De minimis* aid does not affect trade between Member States or distort competition.¹³ Data on small-scale aid provided to individual entities are recorded in the Register of Small-Scale Aid. This information system contains data about all small-scale aids and each granted subject. Before granting small-scale aid, the provider must verify in the Register whether the threshold for the recipients of small-scale aid would be met by providing small-scale aid. The provider registers the support in the Register of Small-Scale Subsidies within five working days at the latest.¹⁴

In 2020, the Act Regulation of State Aid Relations was amended, and in this context, a decree was issued. The decree issued the content and scope of data¹⁵ that the provider of small-scale aid is obliged to record in the Central Register of Small-Scale Aid and on the procedure for recording. Changes mainly comprise, in addition to the obligation of the provider of small-scale aid, recording in the Central Register of Small-Scale Aid (hereinafter referred to as the ‘Central Register’) new information on the type of measure, small-scale aid, from 1 September 2020 and replacement of the personal identification number with the date of birth when identifying a natural person.¹⁶

In the Czech Republic, the next legal regulation based on state aid is the Act on Certain Measures to Improve the Transparency of Financial Relations in the Field of State Aid.¹⁷ This Act regulates the selected rights and responsibilities of entities controlled by public entities and persons keeping their accounting separate. The aim of this Act is to ensure transparency of financial relations in the field of state aid.

11 Act on Regulation of Certain Relations in the Field of State Aid.

12 Regulation 1407/2013.

13 *Definiční znaky veřejné podpory* [Online]. Available at: <https://www.uohs.cz/cs/verejna-podpora/definicni-znaky-verejne-podpory.html> (Accessed: 12 October 2023).

14 Neckář, 2017.

15 Act no. 298/2020 Sb.

16 Decree no. 298/2020 Sb.

17 Act no. 319/2006 Sb., on Certain Measures to Improve the Transparency of Financial Relations in the Field of State Aid, as amended.

The Act summarises the procedures to be followed in the case of some measures for ensuring transparency in financial relations in state aid.

The state aid legislation is aimed at contributing to the functioning of the market environment within the European single market. Although legal regulation in the Czech Republic is governed by generally binding rules, it is also in accordance with the rules contained in the EU regulation. This is an essential condition for the realisation of a single internal market based on the four freedoms and for safeguarding competition. Each EU Member State has to guarantee the same implementation and supervision of state aid.¹⁸

State aid cases in the light of the CJEU's jurisprudence mainly pertain to the electricity market. A few decisions, however, are interesting. First, as per state aid relating to the support for electricity from high-efficiency co-generation,¹⁹ a total of 15 power-generating facilities with an installed capacity of more than 1 MW put into operation between 2016 and 2020 were eligible for operating aid. However, state aid to support electricity generation from small hydropower plants²⁰ could be provided only for a total of nine small hydropower plants with an installed capacity of more than 1 MW in the period from 2016 to 2020. For granting state aid, the date of submission of the application is decisive in procuring operating support for electricity generation.²¹ The European Commission introduced measures and conditions for non-overcompensation of aid. The commitment is that when providing investment support (as allowed by the current legislation of the Czech Republic), the so-called deduction formula will be applied to the support for generating electricity from renewable energy sources (or operating support for generating electricity from a combined production of electricity and heat). The amount of operating aid will be reduced by the amount of investment aid granted. Therefore, support can never be overcompensated in the context of the support setting.²² The matter of whether the application submission date should be the decisive factor for awarding state aid remains debatable.

Second, arbitrations exist in the field of renewable energy under the Energy Charter Treaty.²³ In this and a number of other cases, the Commission reiterated the argument that the EU state aid law precludes a finding that the legitimate expectations of the investor were infringed by amending or eliminating subsidies not approved by the Commission. In cases where provision of support commenced before the issuance of the European Commission's decision, for effective payment of support, the European Commission's decisions introduce commitments for a mechanism to check the adequacy of support in connection with the cumulation of several types

¹⁸ Neckář, 2017.

¹⁹ SA decision 45768.

²⁰ SA decision 43182.

²¹ *Informace k provozní podpoře elektřiny z vysokoúčinné kombinované výroby elektřiny a tepla a z malých vodních elektráren*, 2017.

²² Ministry of Industry and Trade, 2017.

²³ SA decision 40171.

of support for one power-generating facility. Since obligations to ensure non-compensation of aid are introduced in all decisions issued by the European Commission, making a distinction based on whether aid was provided before or after the European Commission's decision was issued can be considered a non-discriminatory approach. According to the European Commission, the criterion for assessing possible overcompensation for individual types of RES in the SA.40171 procedure is the value of the internal rate of return. In the case of the Czech Republic, the values of the internal rate of return were introduced in the European Commission's decision, and these values were directly incorporated into the commitment to the mechanism for reviewing the proportionality of aid.²⁴ At the same time, it was argued that any compensation toward this amount would in itself constitute state aid.²⁵ The Commission reached the same conclusion in the support scheme for the renewable energy sector also in Spain.

In the area of renewables, other cases can be cited too. The European Commission has taken a position on a number of arbitrations. In many investment arbitration cases, foreign investors have been awarded compensation for the withdrawal of subsidies or other benefits. If the European Commission considered that an original advantage was granted in contravention of the EU state aid law, it objected to the compensation. It argued that the EU law precludes a finding of legitimacy in such circumstances. Although not primarily an evaluation of state aid, the subject matter is arbitration proceedings related to state aid; the question is whether the current legal regulation of European legislation has led to the many arbitration proceedings. Potentially, any investment arbitral award could be subject to state aid control by the Commission, regardless of the type of conduct of the host state that was compensated. In view of these potentially far-reaching implications, the applicability of the EU state aid law to investment arbitral awards should be thoroughly examined.²⁶

2. State aid law (also) in times of crisis

2.1. *The national usage of RRF*

In response to the COVID-19 situation and the energy market disruption caused by Russia's invasion of Ukraine, the recovery and resilience plan of the Czech Republic is aligned to ensure a strong recovery of the economy and society. REPowerEU Plan is aimed at saving energy and diversifying energy suppliers to the EU. These

²⁴ Ministry of Industry and Trade, 2017.

²⁵ SA decision 40171.

²⁶ Fahner, 2022, pp. 672–686.

reforms and investments would help the Czech Republic become more sustainable and resilient in the context of green and digital transitions.

Key measures toward green transitions are as follows: (i) Investments in energy efficiency, which are of two types: (ia) large-scale renovation programmes to increase energy efficiency aimed at residential and public buildings and childcare and long-term care facilities, with a total budget of EUR 1.4 billion; and (iib) installation of renewable energy sources for businesses and households, with a total budget of EUR 480 million; (ii) Support for sustainable mobility, especially low-emission vehicles for business and the public sector, improvements in railway infrastructure, construction of electric charging stations, and promotion of cycling pathways. Investments in this area should increase by EUR 1.1 billion; (iii) Investments in the circular economy, a key measure, which include recycling infrastructure and supporting water savings in businesses. Expenditure for this area should increase by EUR 141 million.

Key measures toward digital transitions are as follows: (i) Investments and reforms supporting digital transition, especially digital skills, e-government, digital connectivity, and digital transformation of business; (ii) Investments in education related to digital transition, especially revamping digital curricula in education, digital equipment for schools, training for teachers, new university programmes aimed at digital fields, and upskilling and reskilling courses for citizens. The total budget is EUR 585 million; (iii) Digital transformation and cyber-security of public administration, healthcare, and the justice system. The total budget is EUR 585 million; (iv) Support for digital transformation of business, digital innovation hubs, and very high-capacity networks, as well as 5G networks. The total budget is EUR 650 million.

Key measures for economic and social resilience are as follows: (i) To improve the business environment by enhancing access to finance for business, improving and hastening construction licencing procedures, strengthening anti-corruption measures, and boosting cooperation between public and private research. The total budget is EUR 222 million; (ii) To ensure equal access to education by improving access to affordable early childhood care, supporting disadvantaged schools, and enabling tutoring for children at risk of failure. The total budget for these reforms and investments is EUR 393 million; (iii) To invest in increasing the resilience of healthcare services by building new hospitals and long-term care facilities, acquiring new medical equipment, strengthening cancer screening programmes, and promoting e-Health schemes.

Green and digital transitions are based on investments (91 projects) and reforms (33 reforms). Reforms are meant to find solutions to ensure sustained and sustainable growth. Investments are aimed at changing the economy in response to climate change, maximising the benefits of digitalisation, and improving the quality of public administration. The proposed plan also aims to strengthen social cohesion,

improve access to healthcare, tackle inequalities in education, and invest in pre-schools. All measures are to be implemented by August 2026.²⁷

2.2. Commission's state aid temporary framework and national subsidy policies

The European Union has activated support programmes aimed at mitigating the consequences and constraints caused by the fight against the COVID-19 pandemic and its negative effects on various areas of economic and social life. Within the European Union, state aid is under the control of the European Commission. In the Czech Republic, the Office for the Protection of Competition negotiates the conditions and approves support programmes. So far, 18 COVID-19 support programmes have been approved.²⁸

The following is a list of measures implemented in the Czech Republic: (i) Rent reductions – for companies finding it difficult to pay their rent or lease. These direct grants amounted to 50% of the original rent or lease due for April, May, and June 2020, with the lessee and the lessor agreeing, before the application for aid, on a 30% reduction of the original monthly rent or lease for the respective period and on the lessee having paid 50% of the original rent for the same period. In case the lessee is renting premises owned by the Czech State, the direct grants amounted to 80% of the original rent;²⁹ (ii) Operating costs of SMEs – operating costs, such as costs of extraordinary hygiene measures or personnel-related costs, restrictions on movement of goods, and additional transport costs, which ultimately lead to a negative cash flow of SMEs;³⁰ (iii) Payment of social contributions – for self-employed persons in the form of payment advantages regarding pension and state employment policy contributions, waiver of penalties related to late filing of annual statements and late payments of pension and state employment policy contributions or deferral of monthly pre-payments of pension and state employment policy contributions;³¹ (iv) Public health insurance reliefs for self-employed – for self-employed persons covered by the Czech system of public health insurance in the form of payment advantages related to monthly health insurance contributions and penalty payment;³² (v) Aid to the cultural sector – for the organisation or provision of musical, musically dramatic, and theatrical projects with the primary goal of offering cultural services and entertainment for the public. This aid includes grants for individual artists, organisers of film and music festivals, technical companies providing cultural services for the public, and for private galleries and museums as well;³³ (vi) Unemployment aid – the measure aims to provide support, especially to projects relating to employee training,

²⁷ European Commission, 2023.

²⁸ Marešová and Švanda, 2020.

²⁹ SA decision 57464.

³⁰ SA decision 57475.

³¹ SA decision 57149.

³² SA decision 57358.

³³ SA decision 58213.

childcare facilities, rent for childcare facilities and upskilling of caregivers, and wage subventions for jobs created for disadvantaged people;³⁴ (vii) Accommodation facility support – aid for micro-enterprises, SMEs, and large enterprises providing accommodation services in the Czech Republic;³⁵ (viii) Support for health spas – support for services provided by facilities with special permission to run spas, conduct medical procedures, and offer curative rehabilitation treatments;³⁶ (ix) Aid to mitigate the effects of SARS-CoV-19 on agriculture and food production – enterprises of all sizes that are food producers or agricultural undertakings in the Czech Republic;³⁷ (x) Aid for professional sports clubs – for undertakings participating in select professional sports leagues in the Czech Republic, for example, clubs for football, ice hockey, basketball, volleyball, and handball;³⁸ (xi) Support for operators of ski resorts – for companies actively operating ski resorts in the Czech Republic.³⁹ (xii) Support to tour operators – large tour operators selling package tours in the Czech Republic;⁴⁰ (xiii) Aid for the extraordinary direct costs faced by Czech terrestrial television network operators – for three digital terrestrial television network operators.⁴¹

During the pandemic, other state aids were also issued, but these were presented to the public as the most important. In the wake of the COVID-19 pandemic, state aid began to address financing of various types of aid to Ukraine during the crisis caused by the Russian aggression, the sanctions imposed on Russia. In this context, it became necessary to start addressing the energy crisis as well.

The Commission's state aid temporary framework is a special state aid legislation that allows Member States to take advantage of the flexibility of state aid rules and support the economy that was affected by Russia's invasion of Ukraine. This involved supporting severely affected businesses and sectors while maintaining a level playing field in the single market. The provider must notify the support provided under the Temporary Crisis and Transformation Framework to the European Commission through the Office for the Protection of Competition, which is much simpler than the standard notification procedure. Support can be granted only after a positive decision is issued by the European Commission.⁴²

34 SA decision 58167.

35 SA decision 58398.

36 SA decision 58018.

37 SA decision 59336.

38 SA decision 59353.

39 SA decision 61808.

40 SA decision 60280.

41 SA decision 60062.

42 Office for the Protection of Competition, 2022.

3. Fiscal state aid in tax law

State aid in the area of taxation was never a subject of research in the Czech Republic. The TFEU and other important European documents⁴³ concerning state aid are strictly followed in the Czech Republic. Fiscal state aid is generally regulated by the Investment Incentives Act,⁴⁴ Act on Regulation of Certain Relations in the Field of State Aid, Act on Certain Measures to Improve Transparency of Financial Relations in the Field of State Aid, and other related regulations, including the Income Taxes Act⁴⁵ and Tax Code.⁴⁶ A sub-statutory regulation dealing with state aid in taxation is found in the guidelines of the Tax Administration⁴⁷ and Customs Administration.⁴⁸

According to the Commission Notice, principle general measures do not constitute state aid. Principle general measures are tax measures open to all economic agents on an equal access basis that cannot be reduced in scope through discretionary powers or other factors that restrict their practical use. The most typical principle general measures are tax measures of a purely technical nature (e.g. tax rates, depreciation rules, and rules on loss carry-overs; provisions to prevent double taxation or tax avoidance) and measures pursuing general economic policy objectives for reducing the tax burden related to certain production costs (research and development, environment, training, employment). The state aid in taxation is usually in the form of an advantage, such as a reduction in the company's tax burden proposed in various ways, including a reduction in the tax base (special deductions, special or accelerated depreciation arrangements, or the entering of reserves on the balance sheet), a total or partial reduction in the amount of tax (such as an exemption or a tax credit), deferment, cancellation, or even a special rescheduling of tax debt.⁴⁹ In this context, state aid can be further divided into aid that arises in the tax law drafting (substantive tax law) and aid in the application of the tax law (procedural tax law).

In the substantive tax law, the Investment Incentives Act defines the investment incentive as state aid, that is, in the form of an income tax relief and an exemption from property tax in favoured industrial zones. The income tax relief can be applied by a taxpayer (legal person or natural person running a business) who has been promised an investment incentive on meeting general and special conditions.

43 For example, Commission Notice on the application of the state aid rules to measures relating to direct business taxation, 98/C 384/03, OJ C 384, 10.12.1998, 3–9; Commission Notice on the notion of state aid as referred to in Art. 107(1) of the Treaty on the Functioning of the European Union, 2016/C 262/01, OJ C 262, 19.7.2016, 1–50.

44 Act no. 72/2000 Sb., Investment Incentives Act, as amended.

45 Act no. 586/1992 Sb., Income Taxes Act, as amended.

46 Act no. 280/2009 Sb., Tax Code, as amended.

47 Guideline no. GFR-D-58 on waiving of tax accessories.

48 Methodological Information of the General Directorate of Customs no. 6/2022.

49 Arts. 8–16 of the Commission Notice on the application of the state aid rules to measures relating to direct business taxation, 98/C 384/03.

The general conditions are established in the Investment Incentives Act:⁵⁰ the implementation of the investment project in the territory of the Czech Republic; the environmental friendliness of the activities, construction, or equipment; and the commencement of work related to the implementation of the investment project after the date of submission of the application to obtain an investment incentive. Other general conditions are specified in the government's decree: the acquisition of tangible and intangible fixed assets at least to the value specified by the government; the creation of new jobs at least as per the number specified by the government, or investment in an activity that adds value to the activity carried out using skilled labour or advanced technology, as determined by the government. All other general conditions follow the 3-year limit set by the commitment decision. Special conditions are set in the Income Taxes Act.⁵¹ Except for the condition that the taxpayer must be the first owner of a movable property acquired as part of an investment project in the Czech Republic, all other special conditions are to avoid further tax optimisations in the following tax periods. Tax relief may be applied for ten consecutive tax periods. The first tax period for which tax credit may be applied is the tax period in which the taxpayer has fulfilled the conditions, but it must not be later than the tax period in which three years have elapsed since the decision on the promise of investment incentives was issued. Tax relief, taken together with other forms of investment incentive, must not exceed the maximum amount of state aid set by the decision to grant the investment incentive.

The exemption from property tax in favoured industrial zones can be granted fully or partially (as a percentage) by the municipality in the generally binding ordinance. The Immovable Property Tax Act⁵² states that in an ordinance, the municipality shall define the property of the favoured industrial zone by its parcel number, indicating the cadastral area in which it lies. The exemption is temporary, for a maximum period of five years. Both land and buildings in a government-approved favoured industrial zone are exempted under the Investment Incentives Act acquired for implementing an investment project. For this, a decision on the promise of an investment incentive in the form of exemption from property tax is issued. The exemption from property tax in a favoured industrial zone may not exceed the level of state aid under the Investment Incentives Act in the tax period in relation to the eligible costs actually incurred to date; simultaneously, it may not exceed the maximum amount of aid set by the decision on the promise of an investment incentive under the Investment Incentives Act in the aggregate with other forms of investment incentive.⁵³ Due to the extremely low immovable property tax in the Czech Republic, the exemption is not used in any of the almost 6.300 municipalities in the country.

50 Art. 2 of the Investment Incentives Act.

51 Arts. 35a, 35b and 38r of the Income Taxes Act.

52 Act no. 338/1992 Sb., Immovable Property Tax Act, as amended.

53 Art. 4 para. (1x), Art. 9 para. (1w), Art. 12d of the Immovable Property Tax Act.

General rules concerning state aid are included in the Act on Regulation of Certain Relations in the Field of State Aid. As per the Act, state aid is as defined in Art. 107 of the TFEU. This implies that apart from the two above-mentioned investment incentives, possibilities exist for more state aids in tax regulation. Some tools do not constitute state aid as they follow the conditions set in the Commission Notice on the application of state aid rules to measures relate to direct business taxation: they apply the rules without distinction to all firms and the production of all goods, and they are tools of the Member State to decide on the economic policy that they consider most appropriate and spread the tax burden across the different factors of production. In this group, the Commission mentions tax measures of a purely technical nature (e.g. the tax rates,⁵⁴ depreciation rules,⁵⁵ and rules on loss carry-overs;⁵⁶ provisions to prevent double taxation or tax avoidance) and measures pursuing general economic policy objectives through a reduction of the tax burden related to certain production costs (research and development,⁵⁷ environment,⁵⁸ and training and employment⁵⁹). Concerning the last exemption dealing with employment, a specific rule in the Czech Republic for income taxes is that a taxpayer has the right to deduct a tax relief of CZK 18,000 for each employee with a disability, or CZK 60,000 for each employee with a severe disability.⁶⁰ However, if it is an activity in which a non-disabled person and the disabled person have the same work performance, this could be considered an unlawful state aid. However, such a case has not yet been dealt with in the Czech Republic. Another example of potential state aid can be found in the provision that regulates VAT-exempt supplies without the right to deduction, specifically radio and television broadcasting conducted by statutory operators (Czech Television and Czech Radio).⁶¹ Thus, granting exemptions is subject to a certain amount of selectivity providing a certain advantage over private entities that broadcast under licence or registration.

State aid can be granted not only by the Parliament through acts but also by the local self-government units through their by-laws. The rights of municipalities to adopt generally binding ordinances affect property tax and local charges. Concerning the immovable property tax, exemption from property tax in favoured industrial zones has already been described earlier. Some agricultural land (arable

54 Arts. 16 and 21 of the Income Taxes Act; rates in other tax acts.

55 Arts. 26–32 of the Income Taxes Act.

56 Tax allowance for the loss: Art. 34 of the Income Taxes Act.

57 Tax allowance for research and development: Arts. 34a–34e of the Income Taxes Act.

58 For example, cost of operating one's own environmental protection equipment: Art. 24 para. (2g) of the Income Taxes Act, road tax relief for combined transportation: Art. 12 of the Act no. 16/1993 Sb., Road Tax Act, as amended.

59 For example, tax allowance for payments for examinations verifying the results of further education: Art. 15 para. (8); tax allowance for vocational education consisting of a deduction to support the acquisition of property for vocational education and a deduction to support expenses incurred per pupil or student in vocational education: Arts. 34f–34h of the Income Taxes Act.

60 Art. 35 of the Income Taxes Act.

61 Art. 54 para. (1b) and Art. 53 of the Act no. 235/2004 Sb., VAT Act, as amended.

land, hop fields, vineyards, orchards, and permanent grassland) can be exempted as subsidy for the agricultural industry. Although the exemption applies to all the above-mentioned types of agricultural land, it can be considered as state aid when other municipalities do not grant such exemptions. The additional exemption at the disposal of the municipality is in dealing with the consequences of an extraordinary, especially natural, disaster. The exemption may be full or partial, extending for a maximum period of 5 years. A municipality may exempt not only property affected by the event but also all immovable property throughout the municipality. Such a solution could be considered state aid; however, according to EU law, it is allowed only if it occurs due to environmental reasons.

The other group of local by-laws about immovable property deals with multiplying coefficients. The basic coefficient called location rent is set in the Immovable Property Tax Act as a multiplier applied to the standard tax rate for immovable property used for permanent living and for the development land. It follows the number of inhabitants in the municipality on seven levels. Municipalities have the right to increase or reduce the basic coefficient for the whole municipality or its individual parts. In the case of development land used for business purposes, a decrease in the location rent can be considered state aid regardless of whether it is applied to a part of the territory of the municipality or the entire territory. From a fiscal point of view, the most important right of municipalities is the opportunity to increase the immovable property tax by the local coefficient. This coefficient increases the tax liability for every immovable property (except agricultural land) in the whole municipality or in its individual parts by a factor of 1.1–5.0. However, if the coefficient is applied only in the individual part or parts of the municipality, the rest of the property where tax has not been increased can be considered to receive state aid. In this respect, the findings of the Constitutional Court must be mentioned. When investigating the ordinance of the municipality of Řepov, the Court stated that even individual property can be seen as an individual part of the municipality.⁶² Thus, when the municipality of Řepov increased the property tax for individual properties, it granted state aid to all other properties without adding the local coefficient.

Czech municipalities can adopt local by-laws to establish local charges. In other words, the municipality has the right to decide the local charges to be collected. The generally binding ordinance may not exceed the conditions defined by the Local Charges Act.⁶³ Czech municipalities can levy a dog charge, a tourist charge, a charge for using public places, a charge on entrance, a charge on communal waste, a charge for permission to enter selected places by motor vehicle, and a charge on evaluation of building land. Charges can be collected in the whole territory of the municipality or in select parts. The rates can differ between municipalities and even in different parts of the same municipality, as the statutory maximal rate is the only condition to be followed. The municipality can also grant exemptions other than statutory ones

62 Constitutional Court, Pl. ÚS 24/23, 18.7.2023.

63 Act no. 565/1990 Sb., Local Charges Act, as amended.

and tax credits. All these conditions may result in state aid. For illustrative purposes, only some cases are listed below: (i) One municipality may collect charge, while the other may not. For example, a tourist charge levied can increase the final price for a guest, which becomes a favourable condition for hotels in the neighbouring municipality where the charge is not collected; (ii) One part of a municipality could charge a lower rate than another part. For example, a tourist charge or charge collected for using public places; (iii) One municipality or a part of a municipality could grant an exemption. For example, charge for using public places is may be exempted for land owned by the municipality. If a touring circus is pitched on land owned by the municipality, it is cheaper for the circus, and in such a case, state aid is granted to the municipality itself.

In procedural tax law (during the application of the tax law), state aid can be identified in several ways. Most of these are mentioned in the Tax Code. At the request of the tax subject or ex officio, the tax administrator may authorise the postponement of tax payment or permit staggering tax payment.⁶⁴ Several conditions are already set in the Tax Code, with scope for adding others. A taxpayer has to pay the interest on the overdue amount, which is half the interest on late payment. Lower interest can be considered state aid. The taxpayer can also ask for a waiver of the interest. If the request is granted, it can be classified as state aid as well.

The Tax Code⁶⁵ further lists several tools connected with waivers. Generally, tax or accessories to tax can be waived in whole or in part, both at the request of the taxpayer or ex officio. Further, the Act on Certain Measures to Improve Transparency of Financial Relations in the Field of State Aid⁶⁶ considers tax (and tax accessories) waiver as public funds provided, that is, state aid. A taxpayer can request for the waiver of: (i) Tax if the tax act gives the public authority the power to do so (in this case, also ex officio). Such a waiver can be applied for local charges in the event of extraordinary circumstances, particularly natural disasters. A decision implies that the charge is waived for all taxpayers affected for the same reason.⁶⁷ According to the EU law, such a waiver is an allowed state aid; (ii) Charge for the municipal waste management system or its accessories if this can be justified, considering the circumstances of the case;⁶⁸ (iii) Penalties (20% of the amount of additionally assessed tax) up to 75% of the penalty if the tax has been paid; (iv) Fine for late tax return if the tax return was filed; (v) Late payment interest if the tax has been paid; (vi) Postponement of interest if the tax has been paid (in this case, also ex officio); (vii) Penalty for failure to report exempt income when failure to report exempt income is due to a reason that can be justified considering the circumstances of the case;⁶⁹ (viii)

64 Arts. 156–157a of the Tax Code

65 Arts. 259–260 of the Tax Code.

66 Art. 3 para. (2f) of the Act on Certain Measures to Improve Transparency of Financial Relations in the Field of State Aid.

67 Art 16b of the Local Charges Act.

68 Art 16a of the Local Charges Act.

69 Art. 38w para. (6) of the Income Taxes Act.

Fine for failure to file an audit report if the failure to file was for a justifiable reason considering the circumstances of the case.⁷⁰

The Minister of Finance can decide on mass waiver of tax or accessories to tax stemming from irregularities in the application of the tax laws or in exceptional circumstances, particularly natural disasters.⁷¹ Mass waiver was applied several times in the Czech Republic, especially during floods, the COVID-19 pandemic, and the Russian aggression on Ukraine.

A specific waiver is the tax grace summer. Natural persons who pay their tax debts incurred up to 30 September 2022 till the end of November 2023 can get rid of related arrears in tax accessories (interest, penalties, or fines). Additionally, debtors, both natural and legal persons, can be legally extinguished of minor tax arrears and tax accessories if they do not exceed CZK 1,000 in total with one tax office.⁷² The second instrument may be classified as state aid.

4. Conclusions and recommendations

The question of use of state aid and subsidies is highly debatable. While state aid can help develop the market, it can also hinder the development of the market. Further, individual Member States do not always try to use state aid and subsidies in accordance with the objectives and principles established by the European Union. An example of this can be the latest conclusion of the Supreme Audit Office, which was published in 2023. The Supreme Audit Office audited how the Ministry of Agriculture and the State Agricultural Intervention Fund handled state and European Union funds intended to support the processing of agricultural products during the years 2018 and 2021. Auditors found that although support should have been directed primarily toward micro-, small-, and medium-sized enterprises as per the strategy of the Ministry of Agriculture and the European subsidy programme, the Ministry had not prepared any national subsidy programme for them in those years. On the contrary, it had announced a programme to increase competitiveness intended only for large manufacturing companies. In this period, the Ministry of Agriculture paid CZK 1.7 billion to large enterprises. In the case of European subsidies, the Ministry of Agriculture established such conditions for drawing on aid that small- and medium-sized enterprises were interested in only one out of four investment operations. Every year, support from the Czech Republic and the EU was drawn mainly by large companies with profits of tens to hundreds of millions. The Ministry of Agriculture did not monitor and evaluate the economy, effectiveness, or benefits of spending

⁷⁰ Art. 101k of the VAT Act.

⁷¹ Art. 260 of the Tax Code.

⁷² Act no. 182/2023 Sb., on Extraordinary Waivers and Extinction of Certain Tax Debts.

national subsidies. When providing European funds, the Ministry of Agriculture did not verify whether the supported projects brought the required innovations or whether they merely replaced machines, equipment, and technologies. The Ministry of Agriculture thus enabled large enterprises to obtain another source of investment support.⁷³

Next, the Supreme Audit Office audited how the Ministry of Regional Development, the Ministry of Labour and Social Affairs, and the Centre for Regional Development distributed money to support social enterprises between 2015 and 2021. Funds amounting to almost CZK 2 billion were drawn from two operational programmes. According to the SAO's conclusions, the drawdown was accompanied by deficiencies. 'Support was also given to ineffective and inefficient projects. The subsidies often helped their recipients rather than socially endangered people', said Hana Kadečková, spokesperson for the SAO.⁷⁴

An interesting case in the media related to European subsidies is the case involving the ex-prime minister of the Czech Republic, Andrej Babiš, and other persons. The case concerns the legitimacy of a subsidy amounting to CZK 50 million for the construction of buildings by Čapí hnízdo, a company that received the subsidy in 2008. Until the end of 2007, this company was part of the Agrofert holding, owned by Andrej Babiš. The subsidy was intended only for small- and medium-sized enterprises. In the end, Imoba, the successor to Čapí hnízdo, returned the subsidy to the Regional Operational Programme, Central Bohemia, in 2018 after it was excluded from European funding.⁷⁵ Such cases of obtaining subsidies highlights the negative view of subsidies and subsidy policy.

In October 2023, the Government of the Czech Republic approved a recovery package to help reduce public finance deficit in the years to come. In addition to a number of often controversial measures, this package also includes a reduction in the deductible for European subsidies. The Minister of Finance of the Czech Republic said that it is the state's mistake if it subsidises profitable companies.⁷⁶ However, subsequent competitiveness of Czech companies continues to be questionable. If other countries pay subsidies at the current level, which in many cases are significantly higher than the subsidies paid to Czech companies, then it is not possible to talk about same and equal conditions for doing business in the European Union.

73 *Podpora zpracování zemědělských produktů: stát dotoval především velké firmy s až stamilionovými zisky*, 2023.

74 *Miliarda na sociální podniky: nejasná pravidla, selhání kontroly a někdy prospěch spíše pro příjemce než sociálně ohrožené skupiny osob*, 2022.

75 *Babiš podle obžaloby využil svůj vliv k zajištění dotací pro Čapí hnízdo, o propojení s Agrofertem věděl*, 2022.

76 *Perkenierová*, 2023.

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CHAPTER 13

HUNGARY: DOOMED TO VICTORY



GÁBOR KECSŐ

Abstract

This chapter focuses on the Hungarian state aid law and policy and its recent challenges. It also covers the historical view, economic aspects, and basic statistics while providing an overview of the domestic applicable law, fully considering the fact that the other chapters are devoted to the EU law on state aid policy and taxation matters. State aid may produce contradictory effects. On the one hand, it can restore market efficiency, while on the other, it can adversely intervene in the market mechanisms. Furthermore, political goals can be channelled through governmental subsidies. Without geographical and sectoral analyses of the economy, the question of the state aid's *raison d'être* cannot be answered. In Hungary, domestic state aid law is merged with the EU law; hence, a sovereign state aid policy cannot be pursued. This process started even before the country's accession to the EU. Aid measures under the general block exemption comprised the largest part of the spending between 2011 and 2021. Notified aid was the other important element in this period. In the last couple of years, the ratio changed; notified aid overtook general block exemption in terms of estimated value. Many large investments were financed through state aid between 2014 and 2022 in Hungary. Hungarian state aid institutions have thus proven their practical efficiency. The country was successful in addressing the impact of COVID-19 and the Russo-Ukrainian War through the provision of state aid. National tax sovereignty was not subordinated to the state aid law of the EU in the judgements related to Hungary in the CJEU. Some room for manoeuvre is preserved in its tax policy, especially in applying progressive tax rates on turnover, even if the multinational companies bear a higher burden of taxes than their domestic competitors. When the crises blow over, Hungary is keen on maintaining effective prohibition of state aid in the EU and making the most successful use of exceptions to the

Gábor Kecő (2024) 'Hungary: Doomed to Victory'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 291–315. Miskolc–Budapest, Central European Academic Publishing.

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main rule. The country's near future is determined by how it will use the Recovery and Resilience Facility.

Keywords: *state aid in Hungary, the Hungarian regional aid map, treatment of the COVID-19 era with state aid, state aid under the Russo-Ukrainian war period*

1. Overview of the Hungarian subsidy policy and law¹

1.1. *The Hungarian economy and economic policy*

Through the lens of classical economists, state aid is a tool for correcting market failure.² Its main function is to restore market efficiency. Beyond this, it is now widely accepted that political motivations underlie the granting of state aid. Considering the diverse society and economy within the EU, regional, distributive, employment, and industrial political purposes must be mentioned. Nevertheless, state aid clearly intervenes in the market mechanism and can cause significant distortions of competition. In other words, state aid can lead to economic costs.³ Consequently, it can be argued that state aid can work for and against market efficiency. Without geographical and sectoral analyses of the economy, this cannot be explained.

To understand the background of the Hungarian subsidy policy and law and draw conclusions, the economy of Hungary has to be examined at least at the level of basic indicators and key issues at two decisive points in the modern history of Hungary: when the country joined the EU (2004), and when the COVID-19 pandemic was followed by the war in the neighbouring country of Ukraine (2022).

1.1.1. *Accession to the EU (in 2004)*

In 2004, Hungary's GDP per capita was USD 16,269. The Organisation for Economic and Co-operation Development (OECD) average amounted to USD 28,469 in

1 As there is a separate chapter on the EU state aid law in this book, this section deals with Hungarian rules and practices and does not intend to interpret or comment on the EU law (rules, definitions etc.) regarding state aid. However, exceptions were required to make the chapter understandable. One remarkable exception is the regional state aid map for Hungary, which is laid down in a decision of the Commission (see section 1.4. of this chapter). This map is so profoundly defining that it cannot be skipped from this country-specific chapter. Furthermore, although the author aimed to focus on recent years, a brief historical overview could not be ignored either.

2 Haucap and Schwalbe, 2011, p. 5.

3 Haucap and Schwalbe, 2011, p. 13.

the same year, while the EU average was USD 25,926.⁴ The Hungarian tax-to-GDP ratio was 36.91% in 2004, higher than the OECD average (32.15%).⁵ In Hungary, the tax wedge (51.743% of labour cost) was well above the OECD average (35.685% of labour cost) in 2004.⁶ General government debt of Hungary was 65% and the OECD members' debt-to-GDP ratio for 2004 was 67.53%.⁷ Two branches of the economy were decisive in 2004. Industry and manufacturing added 26% and 22.1%, respectively, to the Hungarian gross value. The only other branch that reached the ratio of 10% was 'wholesale and retail trade; repair of motor vehicles and motorcycles' (10.2%).⁸ Hungary was placed at the 33rd position in the Growth Competitiveness Index.⁹ The Hungarian Central Bank did not issue its own competitiveness index in 2004.

The OECD Economic Surveys on Hungary in 2004 reveal that Hungary's strong growth comes primarily from deepening and widening its export-based industries. In maintaining the level of international competitiveness to achieve this, the authorities face long-standing issues of a weak transport infrastructure and a high tax wedge on labour. More recently, other challenges have emerged, particularly, high growth in wages. In mobilising untapped labour resources, grey-economy activities complicate the assessment of the true size of the active population. Further, opportunities in the grey sector are an additional factor in the economic incentives of those without official employment, alongside those generated by the tax-benefit system. Inactivity is relatively high among all age groups as per official figures, even among men in their prime.¹⁰

OECD emphasised the importance of joining the EU. According to the survey cited above, access to structural funds through EU membership would help in faster development of the transport network and other infrastructure; in 2004, the total value of structural and cohesion funds as well as pre-accession instruments was Hungarian Forint (HUF) 500,550 billion, or about 0.7% of the GDP. As was mentioned in 2004, membership would affect and, arguably, has already affected Hungary's competitiveness.¹¹

1.1.2. Almost 20 years later

In 2022, Hungary's GDP per capita was USD 41,907. The OECD average amounted to USD 53,966, and the EU average was USD 54,237.¹² The Hungarian tax-to-GDP

4 OECD, 2023a.

5 OECD, 2023b.

6 OECD, 2023c.

7 OECD, 2023d.

8 Hungarian Central Statistical Office, 2023. Note: The Hungarian Central Statistical Office treats the 'wholesale and retail trade; repair of motor vehicles and motorcycles' sectors as one branch of the economy.

9 IESE, p. 4.

10 OECD, 2004, p. 41.

11 OECD, 2004, p. 31.

12 OECD, 2023a.

ratio was 34%, which was almost equal to the OECD average (34.11%).¹³ In 2022, the tax wedge in Hungary (41.5% of labour cost) exceeded the OECD average (34.586% of labour cost) by 7%.¹⁴ The general government debt of Hungary was equal to the OECD average (89%).¹⁵ Industry added 22.5%, and manufacturing added 20% to the Hungarian gross value in 2021.¹⁶ Two other branches of the economy that touched 10% were ‘wholesale and retail trade; repair of motor vehicles and motorcycles’ (10.7%) and real estate activities (10.5%).¹⁷

In 2022, Hungary ranked 39th in the World Competitiveness Ranking,¹⁸ improving by three places compared to 2021. The Hungarian Central Bank has been publishing a competitiveness report pertaining to its own competitiveness index since 2017. According to its 2022 report, Hungary was the 17th EU member state, attaining 47.9 points out of 100. This is higher by 1.4 points to the average score of the other three Visegrad countries (Czech Republic, Poland, Slovakia); however, the average of all EU member states was 51.3. The first on the list was Sweden, scoring 66.9.¹⁹

According to the critical country report on Hungary published by the European Commission, since 2017, Hungary is catching up fast with the average income level in the EU. Hungary’s GDP per person rose from around 69% of the EU average in 2017 to 74.7% in 2022. The labour market improved significantly, with the employment rate (80.2%) rising well above the EU average and the unemployment rate (3.6%) remaining well below it in 2022. The main poverty indicators also improved. Investment and economic growth were boosted by fiscal and monetary policy stimulus. The budget deficit has been consistently above the EU average since 2017, and monetary conditions were supportive until mid-2021. The structure of investments did not favour productivity growth. Growth in labour productivity was similar to the regional average, despite a higher aggregate investment rate. This is because the structure of investment has changed since 2017 from a productivity enhancing machinery and intellectual assets to construction. Expansionary economic and fiscal policies contributed to the deterioration of external balance and rising inflation and house prices. Russia’s war of aggression against Ukraine magnified the macroeconomic challenges. Sharply rising energy prices widened the current account deficit to 8.2% of the GDP in 2022. Government debt is still above pre-COVID-19 levels, and its relatively short average maturity leads to a rapidly rising burden of interest payments. Higher commodity prices, currency depreciation, and indirect tax increases raised inflation to 25.9% in the first quarter of 2023, the highest in the EU. However, Hungary has also benefitted from a significant amount of EU cohesion

13 OECD, 2023b.

14 OECD, 2023c.

15 OECD, 2023d.

16 Note that 2022 data have not been published yet.

17 Hungarian Central Statistical Office, 2023.

18 IMD, 2022.

19 Hungarian Central Bank, 2022, p. 19.

funds, complemented by the Recovery and Resilience Facility (hereinafter referred to as RRF).²⁰ Since joining the EU in 2004, Hungary has received the equivalent of around 2% of its GDP annually from EU funds in net terms. In the coming years, EUR 21.7 billion of cohesion policy funds in the 2021-27 financial cycle and EUR 5.8 billion in grants under the RRF have been allocated to Hungary.²¹

1.2. A concise summary of the evolution of Hungarian state aid law

1.2.1. European Agreement 1991 and Accession Partnership 1998

State aid in the EU and in Hungary is considered an integral part of the competition law.²² The underlying reason for this is that governmental subsidy can distort competition between undertakings. Accepting this approach, which makes sense, discussing state aid in socialist regimes is futile. On this ground, a short description of the evolution of Hungarian state aid law must begin from 1989-90 when the country saw a transition from socialism to capitalism.

Revival of the Hungarian state aid law was designed to happen in accordance with the EU law. The Agreement of 16 December 1991, establishing an association between the European Community and its Member States and the Republic of Hungary (hereinafter referred to as European Agreement), was aimed at guaranteeing the accord. The European Agreement was adopted by the Hungarian Parliament in 1994.²³ Art. 62 para. 1 of the European Agreement states that three practices are incompatible with the functioning of the European Agreement, insofar as they may affect trade between the Community and Hungary.²⁴

Art. 62 para. 2 of the European Agreement provides a ‘benchmark rule’ for EU state aid law application saying that any practice contrary to these points shall be assessed on the basis of criteria arising from the application of the rules of Arts. 85, 86, and 92 of the Treaty establishing the European Economic Community.²⁵ It must be noted that Decision 30/1998 (VI. 25.) of the Constitutional Court of Hungary established a constitutional requirement that the Hungarian executive authorities shall not directly apply the criteria referred to in Art. 62 para. 2 of the European

20 See: *The Hungarian Recovery and Resilience Plan* [Online]. Available at: https://commission.europa.eu/business-economy-euro/economic-recovery/recovery-and-resilience-facility/country-pages/hungarys-recovery-and-resilience-plan_en (Accessed: 2 October 2023).

21 European Commission, 2023b, pp. 2–4.

22 Papp, 2016, pp. 1031–1032; Staviczky, 2018, pp. 22–23.

23 Act I of 1994.

24 These are as listed: (i) all agreements between undertakings, decisions by associations of undertakings and concerted practices between undertakings that have as their object or effect the prevention, restriction, or distortion of competition; (ii) abuse by one or more undertakings of a dominant position in the territories of the Community or of Hungary as a whole or in a substantial part thereof; (iii) any public aid that distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods.

25 Basically, these ex-articles are identical to the present text of Arts. 107–109 and 112 of the TFEU.

Agreement. According to the decision, the mechanism of direct applicability of the referred articles (85, 86, 92) would have been contrary to the Hungarian Constitution as the Hungarian legal order has a dualist approach in relation to international and domestic law. The European Agreement per se does not contain the text of the referred articles. Without adoption or promulgation, their contents shall not constitute as applicable law in accordance with the rule of law. On the one hand, these articles do not belong to the Hungarian legal system. On the other, the EU legal system does not extend to the territory of Hungary. A simple cross-reference is not enough constitutionally to avoid or replace the lawful integration of the whole state aid law of the EU into the Hungarian law.

Hungary officially became a candidate state to the EU when the Accession Partnership Treaty was signed in 1998.²⁶ This meant that with regard to state aid, further efforts were necessary to ensure full transparency, particularly through the establishment and updating of a comprehensive state aid inventory in accordance with EU practice. Moreover, the legal framework for granting of state aid must be aligned with the Commission's state aid legislation. All existing aid measures had to be reviewed and measures incompatible with the Europe Agreement were to be modified or abolished. The necessary powers and procedures had to be established for the state aid monitoring authority to implement the monitoring of new aid on a systematic basis. Regarding sectors traditionally subject to monopolies, the policy of liberalising and opening up to competition was to continue.²⁷

A legislation was passed responding to the decision of the Constitutional Court. An amendment to Act XXXVIII of 1992 on public household enacted the following rule into Hungarian law: any aid granted by the governmental budget in any form, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods or the provision of certain services, shall insofar as it affects trade between Member States and Hungary, is forbidden.²⁸ This came into force on the 1st of January 2002. At the same time, Government Decree 163/2001. (IX. 14.) listed aids that are exempted. These were similar to exemptions laid down in the existing EU law. For example, aid for research and development projects, environmental protection, investment in small- and medium-sized enterprises, and training were exempted. Certain sectors – such as the automotive industry – came under permissive regulation according to this decree.

These facts lead to the conclusion that the political objective even in the early 90s has been for Hungarian law to follow EU law in connection with state aid. The Hungarian Constitutional Court, however, did not allow EU law to formally govern state aid before EU accession. Accession partnership confirmed at the political level

²⁶ Hungary: Accession Partnership 98/C 202/04.

²⁷ Hungary: Accession Partnership 98/C 202/04. Annex Point 3.1.

²⁸ Art. 15 of Act XXXVIII of 1992 on the public household. Effective from the 1st of January 2002 until Hungary joined the EU.

that EU law will permeate Hungarian law regarding state aid. In 2002, the legislator enacted a rule that was identical in terms of its function to the EU state aid law.

1.2.2. Accession Treaty 2003

Undeniably, the most significant milestone from the aspect of the state aid law was Hungary's accession to the European Union.²⁹ This paved the way for EU law to prevail directly over the domestic law not only from a political but also from a legal point of view. Since the focus of this chapter is on the effective legal regulation of recent years, it is sufficient to note that certain aid schemes were considered as existing aid and individual aid effective in Hungary before the date of accession and still applicable after that date shall be regarded upon accession as existing aid: (i) aid measures effective before 10 December 1994; (ii) aid measures listed in the appendix of the Accession Treaty;³⁰ (iii) aid measures prior to the date of accession assessed by the state aid monitoring authority of Hungary and found to be compatible with the *acquis*, and to which the Commission did not raise an objection on the compatibility of the measure with the common market.³¹

Accession gave direct way to EU law in the field of state aid, and the respective domestic law was required to conform to EU law. The next section covers the Hungarian legal regime, which is not voluminous, because EU law regulates this in detail and leaves little room to national law.

1.3. The applicable Hungarian law and the State Aid Monitoring Office

The applicable legal background for implementing state aid control in Hungary is Government Decree 37/2011. (III. 22.) on procedures relating to state aid measures under EU competition law and the regional aid map (hereinafter referred to as Government Decree). This contains procedural rules relating to prior notification obligation of state aid measures, sets out cumulation provisions of aid from different sources, serves as a legal basis for the Hungarian regional aid map, and establishes rules relating to transparency of state aid measures and on the required content of aid measures. The scope of the Government Decree covers the legal procedure to be followed by the minister responsible for the management of sources from the EU, if the procedure is in connection with state aid. The minister of regional development

29 Treaty concerning the accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia, and the Slovak Republic to the European Union. Adopted in Hungary via Act XXX of 2004. A referendum on joining the EU was held in Hungary on 12 April 2003. The proposal was approved. Hungary subsequently joined the EU on 1 May 2004.

30 With respect to Hungary, 21 existing aid measures were listed in the Appendix to Annex IV of the Accession Treaty 2003.

31 Accession Treaty 2003 Annex IV Point 3.

according to the present structure of the Hungarian government³² does not have his own ministry. A few governmental institutions provide him support for back-office work. This is now the State Aid Monitoring Office (hereinafter referred to as SAMO) in relation to the tasks under the scope of the Government Decree.

The procedural rules of the Government Decree oblige all aid grantors to notify their planned aid measures to SAMO, which is responsible for assessing the compatibility of each proposal against the relevant EU rules and regulations. SAMO also provides guidance and assistance to the aid-granting bodies when they draft a specific aid measure to ensure compatibility with the EU law.

The procedure followed by SAMO depends on the characteristics of the planned aid measure. If during the preliminary assessment, SAMO finds a measure that could be incompatible with EU state aid rules, it can recommend modifications. It can also ask for additional information from aid grantors. In case a state aid measure requires approval from the European Commission, SAMO represents Hungary and serves as an intermediary between aid grantors and the Commission. It keeps the aid grantor informed of any additional questions and the decision of the Commission concerning the notified aid measure. Additionally, SAMO is responsible for sub-scheme (calls for applications) control.

Apart from state aid control and representing Hungary in proceedings before the Commission, the other duties of SAMO involve compiling the annual report on aid and fulfilling Hungary's obligation in the field of State Aid Transparency. SAMO also coordinates the Hungarian position regarding appropriate measures proposed by the Commission for the amendment of existing aid schemes and plays a key role in formulating the official national position on state aid related legislation. SAMO also keeps aid grantors informed about the recovery or suspension of any aid scheme or individual aid assessed by the Commission.³³

1.4. The Hungarian regional aid map for the period 2022-2027

The European Commission has approved Hungary's map for granting regional aid from 1 January 2022 to 31 December 2027.³⁴ The Hungarian regional aid map is among the first maps approved by the Commission within the framework of the revised Regional Aid Guidelines (hereinafter referred to as RAG). Hungary's regional aid map defines the Hungarian regions eligible for regional investment aid. The map also establishes the maximum aid intensities in the eligible regions. Aid intensity is the maximum amount of state aid that can be granted per beneficiary, expressed as a percentage of eligible investment costs. Under the revised RAG, regions covering

³² Act II of 2022, Government Decree 182/2022. (V. 24.).

³³ See this description of SAMO: *Welcome to the website of the State Aid Monitoring Office* [Online]. Available at: <https://tvi.kormany.hu/home> (Accessed: 2 October 2023).

³⁴ Commission decision of 16 September 2021 in case SA.63934 (2021/N) Regional aid map for Hungary (1 January 2022–31 December 2027).

82.09% of the population of Hungary is eligible for regional investment aid. These regions are all among the most disadvantaged ones in the EU, with a GDP per capita below 75% of the EU average. Therefore, they are all eligible for aid under Art. 107 para. (3) point (a) TFEU (so-called ‘a’ areas), with maximum aid intensities for large enterprises as follows: a maximum aid intensity of 50% is allowed for large enterprises in the regions of HU12 Pest, HU23 Southern Transdanubia, HU31 Northern Hungary, HU32 Northern Great Plain, and HU33 Southern Great Plain. A maximum aid intensity of 30% is permitted for large enterprises in the regions of HU21 Central Transdanubia and HU22 Western Transdanubia. In the latter two areas, the maximum aid intensities can be increased by 10 percentage points for investments made by medium-sized enterprises and by 20 percentage points for investments made by small enterprises, for their initial investments, with eligible costs up to EUR 50 million.³⁵

In 2023, the Hungarian authorities notified an amendment to the regional aid map for Hungary to increase the aid intensities for the territories identified for support from the Just Transition Fund.³⁶ In their notification, the Hungarian authorities proposed increasing the aid intensity for three counties (Baranya, Borsod-Abaúj-Zemplén, Heves)³⁷ as areas eligible for aid under Art. 107 para. 3 point (a) of the TFEU. These counties are located in the NUTS 2 regions of HU23 Southern Transdanubia and HU31 Northern Hungary. The Commission decided to approve the proposal, and consequently, the maximum aid intensity increased to 60% in these Hungarian counties.³⁸

The Hungarian regional aid map for the period 2014-2021 was less favourable for Hungary. During these years, counties Pest and Budapest, which are located in the heart of County Pest were not divided into two regions from the aspect of allocation of state aid. As the capital is the most developed area in Hungary in terms of GDP

³⁵ European Commission, 2022.

³⁶ The Commission provides support to Member States having identified the territories expected to be the most negatively impacted by the transition towards climate-neutrality. The Just Transition Fund supports the economic diversification and reconversion of the territories concerned. This means up- and reskilling of workers, investments in small- and medium-sized enterprises, creation of new firms research and innovation, environmental rehabilitation, clean energy, job-search assistance, and transformation of existing carbon-intensive installations. This fund is governed by two regulations. Regulation (EU) 2021/1056 of the European Parliament and of the Council of 24 June 2021 establishing the Just Transition Fund, OJ L 231, 30.6.2021, 1–20; Regulation (EU) 2021/1060 of the European Parliament and of the Council of 24 June 2021 laying down common provisions on the European Regional Development Fund, the European Social Fund Plus, the Cohesion Fund, the Just Transition Fund and the European Maritime, Fisheries and Aquaculture Fund and financial rules for those and for the Asylum, Migration and Integration Fund, the Internal Security Fund and the Instrument for Financial Support for Border Management and Visa Policy, OJ L 231, 30.6.2021, 159–706.

³⁷ These are NUTS3 units in the nomenclature of territorial units for statistics (hereinafter referred to as NUTS).

³⁸ State aid SA.107119 (2023/N) – Hungary Amendment to the Regional aid map for Hungary (1 January 2022–31 December 2027) – increased aid intensities for territories identified for support from the JTF.

per capita, its GDP significantly raised the average GDP per capita in the territory of the united county of Pest and Budapest. This led to the maximum aid intensity becoming zero in most of the territory of County Pest and in the whole of Budapest. The separation made the whole territory of County Pest eligible for state aid with 50% intensity, while the aid intensity in Budapest remains zero.³⁹ This change was of paramount importance in the state aid law in Hungary.

2. State aid in times of crisis

2.1. General and recent trends and stats in Hungary

Table 1 provides an overview of state aid spending in Hungary between 2011 and 2021. The total spending was EUR 28.5 billion stemming from four alternative types of procedures.

Table 1: State aid expenditure in current prices during 2011-2021 in Hungary⁴⁰

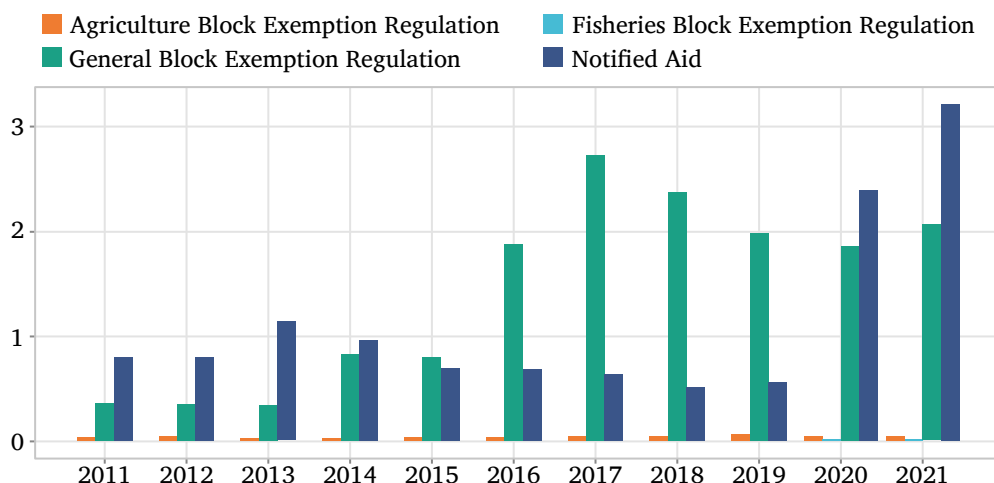
Type of Procedure	Expenditure (Billion EUR)	Share of Total
Agriculture Block Exemption Regulation	0.5	1.8%
Fisheries Block Exemption Regulation	less than 0.1	less than 0.1%
General Block Exemption Regulation	15.6	54.7%
Notified Aid	12.4	43.5%
Total	28.5	100.0%

From Table 1, it is clear that aid measures under General Block Exemption (hereinafter referred to as GBE) comprised the largest part of the spending between 2011 and 2021. Notified aid was the other very important element in this period. The statistics suggest that agriculture and fisheries block exemptions did not play a prominent role during the investigation period. More interesting is the change in the ratio between GBE and notified aid in recent years. The latter overtook the former in 2020 and 2021 compared to previous years, when GBE was higher. This is illustrated in Figure 1.

³⁹ Nyikos, 2022, pp. 20–24.

⁴⁰ European Commission, 2023a, p. 167.

Figure 1: State aid spending in Hungary in billion EUR (2011-2021)
(current prices)⁴¹



Hungarian commentators draw attention to the fact that the Commission approved all notifications of Hungary between 12 March 2020 and 31 December 2022. In this period, the legal basis of state aid was Art. 107 para. (3) point (b) of the TFEU in 20 cases out of the 25 notifications from Hungary.⁴² The Hungarian Government published a long list on aid granted by its individual decisions.⁴³ During the investigation period, it was found that a substantial part of these aids was for undertakings in the automotive industry and for battery manufacturing. Data for the current year (2023) show new beneficiary schemes such as aid for installing solar panel systems, constructing solar power plants, and enhancement of thermal insulation of buildings.⁴⁴ These are in accord with the RRF of Hungary.

2.2. COVID-19 era

In 2020, European governments enforced strict public health measures in an attempt to stem the spread of the COVID-19 pandemic. The European economy faced a double shock of supply and demand. A drop in production and consumption was observed. This led to a decline of 6.3% in the European GDP in 2020.⁴⁵ What was the

⁴¹ European Commission, 2023a, p. 168.

⁴² Horváth, Bartha and Lovas, 2023, pp. 466–468.

⁴³ *Szerződések/megállapodások, EKD támogatások* [Online]. Available at: <https://kormany.hu/dokumentumtar/szerzodesek-megallapodasok> (Accessed: 2 October 2023).

⁴⁴ Owing to lack of access to control data on the governmental homepage, no specific figures are provided here. For instance, the governmental homepage does not communicate decision numbers.

⁴⁵ Collin et al., 2022, p. 1.

Commission's reaction to this situation? The State Aid Temporary Framework⁴⁶ was adopted on the 19th of March 2020 to enable Member States to use the full flexibility foreseen under state aid rules to support the economy in the context of the coronavirus outbreak. This framework, which was amended seven times, expired on the 30th of June 2022 with some exceptions. Investment and solvency support measures may continue until 31 December 2023. Furthermore, the framework already provides for a flexible transition, under clear safeguards, particularly for the conversion and restructuring options of debt instruments, such as loans and guarantees, into other forms of aid, such as direct grants, until 30 June 2023.⁴⁷

Under the Temporary Framework, 23 state aid measures were adopted in relation to Hungary.⁴⁸ In 2021, the COVID-19 related expenditure for Hungary amounted to EUR 2,448.3 million, that is, 45.9% of the total state aid expenditure. In 2020, this amounted to EUR 1,781.6 million, that is, 41.3% of the total.⁴⁹ This ratio seems high, but it must be noted that the COVID-19 related expenditure at the EU-27 level was higher by 10–15% in both years than the level in Hungary. Thus, although the share of COVID-19 state aid expenditure was substantial, it was not as decisive as it could be. In almost half of the cases (45.9%) in 2021, the state aid objective was the remedy for a serious disturbance in the economy, as laid down in Art. 107 para. 3 point (b) of the TFEU. Since this was the outstanding objective, it is worth examining its conditions briefly.

The Commission considered the remedy for a serious disturbance in the economy as compatible with the internal market, provided a few conjunctive conditions were met: (i) The aid did not exceed EUR 800,000 per undertaking in the form of direct grants, repayable advances, tax, or payment advantages; (ii) The aid was granted on the basis of a scheme with an estimated budget; (iii) The aid was granted to undertakings that were not in difficulty within the meaning of the General Block Exemption Regulation on 31 December 2019;⁵⁰ it could be granted to undertakings that that were not in difficulty on 31 December 2019, but faced difficulties thereafter as a result of the COVID-19 outbreak; (iv) Aid was granted no later than 31 December 2020;⁵¹ (v) Aid was granted to undertakings active in the processing and marketing of agricultural products conditional on not being partly or entirely passed on to primary producers and not fixed on the basis of the price or quantity of products purchased from the primary producers or put on the market by the undertakings concerned.

46 Communication from the Commission: Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, 2020/C 91 I/01, HL C 91I., 2020.3.20, 1–9.

47 *The State Aid Temporary Framework* [Online]. Available at: https://competition-policy.ec.europa.eu/state-aid/coronavirus/temporary-framework_en (Accessed: 2 October 2023).

48 16 measures in 2020, 5 measures in 2021, 2 measures in 2022.

49 European Commission, 2023a, p. 171.

50 This definition is very elaborate. See: Art. 2 para. 18 of Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty, OJ L 187, 26.6.2014, 1–78.

51 As is mentioned above, the deadline was extended, with some original exceptions to this date.

In the 21st century, COVID-19 caused the second big economic crisis. The first was experienced in 2008/2009 caused by turmoil in the financial market. The Temporary Framework was more generous in comparison with the support offered during the 2008/2009 financial crisis, considering that it allowed for significantly larger amounts of compatible aid. Another remarkable difference between the two state aid responses was in terms of the sectors of the economy supported. In 2008/2009, state aid was limited to undertakings in the financial market. Of course, this is only logical since COVID-19, unlike the previous crisis, hit almost all sectors.⁵²

2.3. Russia-Ukraine war period

On 23 March 2022, the European Commission adopted a Temporary Crisis Framework to enable Member States to support the economy in the context of Russia's invasion of Ukraine. The Temporary Crisis Framework complements the existing state aid toolbox with many other possibilities already available to Member States. The Commission amended the framework twice and finally adopted a new one, which is presently applicable.⁵³ The new regime is called Temporary Crisis and Transition Framework.

Two legal grounds exist for state aid under this framework. Pursuant to Art. 107 para. (3) point (b) of the TFEU, the Commission may declare compatibility with the internal market aid 'to remedy a serious disturbance in the economy of a Member State'. The other ground for the new temporary framework is Art. 107 para. (3) point(c) of the TFEU, which states that aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest, may be considered by the Commission to be compatible with the internal market.

Aggression against Ukraine by Russia and its direct and indirect effects, including the sanctions imposed by the EU or its international partners and the countermeasures taken, were considered by the Commission to disrupt trade flows and supply chains and lead to exceptionally large and unexpected price rise, especially in natural gas and electricity, and in numerous other input and raw materials and primary goods. These effects, taken together, caused a serious disturbance of the economy in all Member States; the need now is to facilitate energy management. For example, aid may be approved for (i) promoting energy use from renewable sources and energy storage, (ii) increasing the electricity generation capacity of existing installations to the maximum, (iii) substantially reducing greenhouse gas emissions, and (iv) producing relevant equipment for the transition towards a net-zero economy, namely, towards batteries, solar panels, wind turbines, heat-pumps, electrolyzers, and equipment for carbon capture, usage, and storage.

⁵² Tóth, 2020, pp. 69–71.

⁵³ Communication from the Commission: Temporary Crisis and Transition Framework for State Aid measures to support the economy following the aggression against Ukraine by Russia, Brussels, 9.3.2023 C(2023) 1711 final.

On these grounds, the Commission launched 8 types of state aid to support Member States in addressing the serious disturbance in the economy. Undertakings affected by the Russian aggression against Ukraine and/or by its direct or indirect effects may be subsidised by Member States through these tools: type (i) limited amounts of aid, type (ii) liquidity support in the form of guarantees, type (iii) liquidity support in the form of subsidised loans, type (iv) aid for additional costs due to exceptionally severe increases in natural gas and electricity prices, type (v) aid for accelerating the rollout of renewable energy and energy storage relevant for REPowerEU,⁵⁴ type (vi) aid for the decarbonisation of industrial production processes through electrification and/or the use of renewable and electricity-based hydrogen fulfilling certain conditions and for energy efficiency measures, (vii) aid for additional reduction of electricity consumption, and (viii) aid for accelerated investments in sectors strategic for the transition towards a net-zero economy.

Until the end of August 2023, in 13 cases, the Commission considered aid given by Hungary as compatible with the internal market.⁵⁵ Moreover, the Commission decided not to raise any objections to the aid. The legal grounds for the aid were Art. 107 para. (3) point (b) of the TFEU in 10 decisions and Art. 107 para. (3) point (c) of the TFEU in the remaining 3 decisions. These are instant and a substantial boost for Hungarian undertakings amounting to a total of 27.3 billion EUR. Table 2 presents the most relevant information of the measures.

Table 2: Approved state aid for Hungarian undertakings under the Temporary Crisis and Transition Framework⁵⁶

Decision number	Aim of state aid	Legal ground	Estimated budget in billion EUR	Date of decision
SA.102986	Crisis Agricultural Guarantee Programme	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 2	0.226	17.6.2022

⁵⁴ In response to the hardships and global energy market disruption caused by Russia's invasion of Ukraine, the European Commission is implementing its REPowerEU Plan. Launched in May 2022, REPowerEU is helping the EU save energy, produce clean energy, diversify its energy supplies. *REPowerEU – Affordable, secure and sustainable energy for Europe* [Online]. Available at: https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/repowereu-affordable-secure-and-sustainable-energy-europe_en (Accessed: 2 October 2023).

⁵⁵ *Az ideiglenes válság- és átállási keret (TCTF) alapján elfogadott magyar intézkedések listája* [Online]. Available at: <https://tvi.kormany.hu/tctf-magyar-intezkedesek> (Accessed: 2 October 2023).

⁵⁶ Compiled by the author based on the website of SAMO.

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Decision number	Aim of state aid	Legal ground	Estimated budget in billion EUR	Date of decision
SA.103089	Hungarian umbrella scheme to support companies in the context of Russia's invasion of Ukraine	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 1	1.14	20.6.2022
SA.103315	'Krizis 2' (Crisis 2) Guarantee Program	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 2	0.5	11.7.2022
SA.104009	Hungarian umbrella scheme to support companies in the context of Russia's invasion of Ukraine (amendments to SA.103089)	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 1	1.58	31.8.2022
SA.104515	Support scheme in the form of guarantees and subsidised loans	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 2, 3	1.25	26.10.2022
SA.104850	Amendments to SA.102986, SA.103089 (as amended), SA.103315 and SA.104515	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 1, 2, 3	4.2	9.12.2022
SA.106542	Amendments to SA.103089 (as amended) and SA.104515 (as amended)	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 1, 2, 3	6.87	9.3.2023
SA.104385	Aid for additional costs due to exceptionally severe increases in natural gas and electricity prices	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 4	1	13.4.2023

Decision number	Aim of state aid	Legal ground	Estimated budget in billion EUR	Date of decision
SA.107379	Fourth amendment to the umbrella scheme to support companies in the context of Russia's aggression against Ukraine (SA.103089)	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 1	7	13.06.2023
SA.102428	Aid for energy storage facilities for the integration of weather variable renewable energy sources	107 para. (3) point (c) of the TFEU; Temporary Crisis and Transition Framework type 5	1.134	21.6.2023
SA.107772	Hungarian Development Bank agricultural, fishing, and food industry working capital loan scheme in the form of subsidised loans	107 para. (3) point (b) of the TFEU; Temporary Crisis and Transition Framework type 3	0.0771	26.6.2023
SA.107689	scheme for accelerated investments in sectors strategic for the transition towards a net-zero economy	107 para. (3) point (c) of the TFEU; Temporary Crisis and Transition Framework type 8	2.36	28.7.2023
Total estimated budget		27.3371		

2.4. Proven practices from the Hungarian point of view

What does a successful notification procedure to support large investments require? A researcher working for the SAMO posed this question in an article in 2022. Eighteen state aid decisions of the Commission were analysed. All decisions – except four – authorised state aid. Six investments were located in Hungary, and the rest were in France, Germany, Italy, Poland, Portugal, and Slovakia. The following recommendations are worth keeping in mind because between 2014 and 2021, seven large investment projects were approved for Hungary, whereas only ten were approved in the rest of the previous six states altogether. Further, the value of these large investments projects was higher for Hungary than the sum-total value of the other six Member States. Hungary's large investments were higher in terms of number and value.⁵⁷

⁵⁷ Hargita, 2023, pp. 41–62.

Individual aid notified under the guidelines on national regional aid⁵⁸ (hereinafter referred to as regional guidelines) are authorised if it complies with the common assessment principles. The Commission assesses whether (i) a credible counterfactual scenario exists, (ii) aid has an incentive effect, (iii) aid contributes to regional development, and (iv) the contribution of the aid to regional development outweighs its negative effects on trade and competition.

Considering the first criterion: a counterfactual scenario is for illustrating what would happen if no aid was provided. The emphasis is on ‘credibility’. The company has to prove that there exists at least one realistic alternative site; a fictional alternative is not credible. Further, it is important that the story about the alternative project not only must be credible and have a realistic alternative site, but also must prove that the selection process is supported by contemporary internal company documents generated in the company’s decision-making process, demonstrating that the options in question were actually explored by the beneficiary in its decision-making process. This means that the beneficiary hoping to receive the grant must maintain detailed records not only of the final decision but also of the entire decision-making process, namely, the main steps followed and its outcome. Supporting documents must also be presented to the Commission, and submission of these documents to the Commission cannot be denied on the grounds that they contain confidential information.

Considering the second criterion: to demonstrate the incentive effect, the guidelines recognise two scenarios. (i) Without the aid, the investment would not be sufficiently profitable for the aid beneficiary anywhere in the EU. (ii) The investment would have been made elsewhere, and the aid only compensates for the cost disadvantage of the less developed region. A vast majority of the notifications from Member States fall under the latter scenario.

Considering the third criterion: the primary objective of regional aid is to improve economic and social cohesion by reducing disparities in the level of development between areas. The notification procedure must include a detailed demonstration of the contribution of the investment to the development of the region lagging behind. According to SAMO, the frequently used points to demonstrate the contribution to regional development are direct and indirect job creation, knowledge transfer, technology transfer, clustering effect, duration of the investment, environmental aspects, and social responsibility.

Considering the fourth criterion: according to the Commission, the following points manifest negative effects that cannot be offset by the positive effects of the investment and, therefore, it does not authorise the aid. For instance, (i) when the planned aid exceeds the amount calculated based on the reduced aid intensity; the action to be supported or the conditions of the aid infringe on EU law; (ii) when the investment leads to an increase in capacity in an absolutely declining market; (iii)

58 Communication from the Commission: Guidelines on regional state aid, 2021/C 153/01, OJ C 153, 29.4.2021, 1–46.

when significant market power exists; (iv) the investment is in a region that is no less developed than an alternative scenario, which is called the anti-cohesion effect, a remarkable point for the Commission not to authorise the aid; or (v) the investment is relocated from another EU Member State and a causal link exists between the aid and the relocation.⁵⁹

3. CJEU cases relating to Hungary

A few important and relatively new cases of the CJEU can be cited in the field of indirect (fiscal) and direct state aid.⁶⁰ Of course, these cases have other aspects – especially limitation of fundamental freedoms and violation of the non-discrimination principle – that are beyond the scope of this chapter.⁶¹ National courts do not play a decisive role in state aid law because – with exceptions⁶² – they do not have the competence to determine whether governmental subsidy violates EU law.⁶³

3.1. Hungarian tax on turnover linked to advertisements

On 15 August 2014, the act on progressive tax on revenue linked to the publication and broadcasting of advertisements came into force in Hungary. The intent of the new Hungarian tax policy of that time was to impose sectoral turnover taxes to shift the tax burden from the general direct taxes on income of persons and corporations. The more specific goal was to make budgetary leeway to decrease taxes on labour income. The new tax was contested, because two taxpayers had to bear almost the entire burden of tax in the whole country. The biggest taxpayer was a part of the foreign group. The advertisement tax, based on the net turnover of taxable persons who broadcast or publish advertisements (print media, audiovisual media, or billposters), prevailing in Hungary, initially included a scale of six progressive rates based on turnover; later, it was adapted to include only two brackets, accompanied by the option, for taxable persons whose profits before tax in 2013 were

⁵⁹ Hargita, 2023, pp. 45–56.

⁶⁰ The latest Hungarian related case is the judgement of the General Court of 13 September 2023, T-57/22, *Hungary v. Commission*, ECLI:EU:T:2023:546. The court dismissed the action brought by the Hungarian Government. Hungary sought the partial annulment of the Commission Implementing Decision (EU) 2021/2020 of 17 November 2021 excluding from the European Union financing certain expenditure incurred by the Member States under the European Agricultural Guarantee Fund and under the European Agricultural Fund for Rural Development.

⁶¹ Note that this book contains a separate chapter written by Balázs Károlyi who covers these issues.

⁶² See the exception: CJEU, 19 June 1973, C-77/72, *Carmino Capolongo v. Azienda Agricola Maya*, ECLI:EU:C:1973:65; CJEU, 11 December 1973, C-120/73, *Gebrüder Lorenz GmbH v. Federal Republic of Germany and Land Rheinland-Pfalz*, ECLI:EU:C:1973:152. Papp, 2022, p. 252.

⁶³ Széles, 2021, pp. 5–6. This is why the points below are about the jurisprudence of the CJEU.

zero or negative, to deduct from their tax base 50% of the losses carried forward from previous years. The Commission considered, by its decision of 4 November 2016,⁶⁴ that the tax measure adopted by Hungary, on account of both its progressive structure and the possibility of deducting the losses carried forward that it included, constituted state aid that was incompatible with the internal market and ordered the immediate and effective recovery of the aid paid to the beneficiaries thereof.

The General Court annulled this decision, holding that the Commission had erred in finding that the tax measure at issue and the mechanism for the partial deductibility of losses carried forward constituted selective advantages.⁶⁵ The Court of Justice, sitting as the Grand Chamber, dismissed the appeals brought by the Commission against the judgements under appeal.⁶⁶ In support of its appeals, the Commission claimed in particular that the General Court had infringed Art. 107 para. (1) of the TFEU in holding that the progressive nature of the taxes on turnover respectively at issue did not lead to a selective advantage.

The Court of Justice reaffirms, in the sphere of state aid, that, given the current state of harmonisation of EU tax law, Member States are free to establish the system of taxation they deem most appropriate so that the application of progressive taxation falls within the discretion of each Member State, provided the characteristics constituting the measure at issue do not entail any manifestly discriminatory element. Considering the fiscal autonomy that Member States are recognised to have outside the fields subject to harmonisation under EU law, they are free to establish the system of taxation they deem most appropriate and to adopt, as required, progressive taxation. In particular, EU law on state aid does not preclude Member States from deciding to opt for progressive tax rates, intended to consider the ability of taxable persons to pay; nor does it require Member States to reserve the application of progressive rates only to taxes based on profits, to the exclusion of those based on turnover. Furthermore, the Court of Justice found that the General Court did not err in considering that the transitional measure of the partial deductibility of losses carried forward did not lead to a selective advantage. The establishment of a transitional measure considering profits is not inconsistent with the redistribution objective pursued by the Hungarian legislature when establishing tax on advertisements. The Court of Justice highlighted in this regard that, in such a case, the criteria concerning the lack of profits recorded in the financial year preceding the entry into force of that tax were objective in nature, since the undertakings benefiting from the transitional measure of partial deductibility of the losses had, from that point of view, a lesser ability to pay than others.⁶⁷

64 Commission Decision (EU) 2017/329 of 4 November 2016 on the measure SA.39235 (2015/C) (ex 2015/NN) implemented by Hungary on the taxation of advertisement turnover, OJ 2017 L 49, p. 36.

65 CJEU, 27 June 2019, T-20/17, *Hungary v Commission*, ECLI:EU:T:2019:448.

66 CJEU, 16 March 2021, C-596/19 P, *Commission v Hungary*, ECLI:EU:C:2021:202.

67 C-596/19 P. See the critics in the literature: Varju and Papp, 2021, pp. 379–402; Deák, 2021, pp. 111–119; Szudoczky and Károlyi, 2020, pp. 251–270.

3.2. *Vodafone and Tesco cases*

Hungary levied special taxes on the turnover of telecommunications operators and of undertakings in the retail trade sector in 2010. The effective date of these taxes was originally between 2010 and 2012.⁶⁸ These taxes had progressive rates. These special taxes were mainly borne by undertakings owned by persons of other Member States owing to the fact that these undertakings achieved the highest turnover in the Hungarian markets concerned. The Court of Justice decided that these taxes do not breach the EU state aid law.⁶⁹ The Court recalled that these taxes do not fall within the scope of the provisions of the TFEU concerning state aid unless they constitute the method of financing an aid measure and form an integral part of that measure. For a tax to be an integral part of an aid measure, it must be hypothecated to the aid measure under the relevant national rules. In this case, the Court found, however, that the applications for exemption from the special taxes submitted by the applicant companies to the Hungarian tax authorities concern general taxes, the revenue from which is transferred to the state budget and that these taxes are not specifically allocated to the funding of a tax advantage for which a particular category of taxable persons qualify. The Court concluded that the special taxes imposed on these applicant companies are not hypothecated to the exemption for which some taxable persons qualify, and consequently any illegality under EU rules relating to state aid of such an exemption would not affect the legality of these special taxes themselves. Accordingly, the applicant companies cannot rely, before the national courts, on that possible illegality to avoid paying these taxes.

3.3. *Paks II case*

The Hungarian Government, prior to the energy crises caused by the Russian aggression over Ukraine, decided to establish a new nuclear power plant with two reactors in Paks, next to the currently operating one. According to the original plan, Russian technology was to assist in the installation and operation of the new nuclear power plant as was done in the case of the older plant. The plant was constructed under the legal personality of a state-owned company called MVM Paks II Nuclear Power Plant Development Private Company Limited by Shares (hereinafter referred to as Paks II). The Commission approved the investment aid, notified by Hungary, for Paks II, in 2017.⁷⁰ The above-mentioned investment aid, comprising two new nuclear reactors, free of charge, to Paks II, was largely financed by a loan in the form of a revolving credit facility of EUR 10 billion granted by Russia to Hungary

⁶⁸ Taxes following these were adopted by Hungary subsequently, but the objects of the cases were the taxes that were not in force since the 1st of January 2013.

⁶⁹ CJEU, 3 March 2020, C-75/18 and C-323/18, *Vodafone Magyarország*, ECLI:EU:C:2020:139.

⁷⁰ Commission Decision (EU) 2017/2112 of 6 March 2017 on the measure/aid scheme/State aid SA.38454.

in the framework of an intergovernmental agreement on cooperation for the use of nuclear energy for peaceful purposes. In accordance with this agreement, the task of constructing the new reactors was entrusted, by means of a direct award, to the company Nizhny Novgorod Engineering Company Atomenergoproekt (hereinafter referred to as JSC NIAEP). In the contested decision, the Commission declared the aid compatible with the internal market, subject to conditions, in accordance with Art. 107 para. (3) point (c) of the TFEU.

The General Court found that the decision to award the contract for the construction of the two new reactors, which preceded the aid measure at issue, did not constitute an aspect that is inextricably linked to the object of that aid. The carrying out of a public procurement procedure and the possible use of another undertaking for the construction of the reactors would alter neither the object of the aid, namely, the provision of two new reactors, free of charge, nor the beneficiary of the aid, which is Paks II. Furthermore, assuming that a tender procedure may have had an influence on the amount of the aid, which Austria has not proven, such a factor would not by itself have had any effect on the advantage that the aid constituted for its recipient, namely, the provision of two new reactors free of charge. This judgement does not show that the Court intended to broaden the scope of the review falling to the Commission in the context of a procedure to determine whether the state aid is compatible with the internal market by abandoning its case law under which a distinction should be drawn between aspects that are inextricably linked to the object of the aid and those that are not.⁷¹ Austria appealed against this judgement, but the Court of Justice has not yet delivered its decision.⁷²

4. Conclusions and recommendations

One needs to look at the big picture first. State aid in Hungary has been determined by political and economic factors since the transition in 1989/90. It is enough to recall that the Hungarian economy competes with that of the EU Member States (and does this worldwide). Hungary has been holding its place on the development lists since it joined the EU. No significant change in the ‘pecking order’ has been observed with respect to Hungary, despite the fierce competition. This could not have been achieved without an adequate and efficient state aid policy, as state aid is required to correct market failures and to channel political motives that keep society stable and the economy in balance with national interests. Beyond this, the reality is that the Hungary government’s budget is very tight to score well in a free competition among Member States if state aid was not forbidden by the EU law,

⁷¹ CJEU, 30 November 2022, T-101/18, *Austria v Commission*, Paks2, ECLI:EU:T:2022:728.

⁷² Case number is C-59/23 P.

according to the main rule. Hence, the argument made here is that Hungary has a strong interest in maintaining effective prohibition of state aid and making the most successful use of exceptions to the main rule. A sovereign state aid policy cannot be run as a Member State because EU law clearly defines the legal framework of this sphere. The lord of the state aid is the Commission owing to its competences over the competition law of the EU.

How can success be measured? From a statistical point of view, this chapter contains strong points of reference to conclude that Hungary is at the forefront of approving large investments. Hungary has made good use of the State Aid Temporary Framework and the Temporary Crisis Framework. Nevertheless, these frameworks originated during times of crisis. Their future success will certainly be a different scenario determined by the usage of the RRF.

From a legal point of view, the changes in state aid law related to Hungary and, further, the results of the notifications procedures in front of the Commission and of the litigation in front of the CJEU are decisive. The regional state aid map for Hungary is better in the current period than it was during the previous period. County Pest can be now the venue of the projects financed through state aid. Between 12 March 2020 and 31 December 2022, the Commission approved all notifications from Hungary. This is undoubtedly a good sign, but it does raise a policy question that is discussed below. The CJEU declared in a few cases that Hungary has sovereignty to apply progressive tax rates even if the respective tax base is not the income of the taxpayer, but is the revenue or the turnover. The mere fact that taxpayers with parent companies in other Member States suffer as a result of progressive tax rates does not infringe on the prohibition of state aid. These judgements surprised some researchers who thought tax sovereignty would bow to the EU state aid law. In essence, thanks to the decisions of the CJEU, the Hungarian government has preserved some room for manoeuvre in its tax policy even if multinational companies bear the larger brunt of the taxes when compared to their domestic competitors. Paks II is of paramount importance from the point of view of future Hungarian energy security. Austria and all Member States running an anti-nuclear energy policy have to accept that state aid law by itself is not an adequate measure to prevent the installation of new nuclear power plants.

From a policy perspective, it must be stressed that the limited power of the Hungarian budget to grant state aid ought to be used as efficiently as possible. Even though diversified allocation of budgetary resources can have benefits, state aid policy may be more successful in choosing few sectors of the economy for governmental support. Hungary has a targeted state aid policy. Automotive industry and, most recently, battery factories are backed by state aid. Examining the sustainability of this policy is beyond the scope of this chapter. Nevertheless, it should be noted that strict prohibition of state aid appears to erode in times of crisis as was seen during the recent COVID-19 situation and the Russia-Ukraine war. Crises management prevails over the prohibition of state aid. Of course, it is the Commission's prerogative to enforce state aid law, but Hungary is happy to follow this path as it

is justified. Implementing RRF will be key for Hungary's future development. To restore a level playing field among undertakings in the EU, which is in Hungary's best interest, once the crises are over, the policy should return to the general rules: state aid is prohibited with rare exceptions.

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POLAND: STATE AID IN THE SHADOW OF RETAIL SALES TAX



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Abstract

The issue of admissibility of state aid and the rules of its application by Member States of the European Union has become, in recent years, an issue of particular importance in preventing distortion of competition in the internal market, especially in the context of the COVID-19 pandemic and the ongoing economic crisis. Regulating this issue has proved inadequate both at the level of the EU and at the level of national legislation, thus requiring analyses under new conditions and considering completely different needs of practice. The need to mitigate the negative effects of the economic crisis and to cater to a greater demand for various forms of public support, individual states demonstrated considerable legislative activity in this area and applied various solutions. In Poland, differentiated measures of state aid provided for in the scope of individual sections of the Temporary Framework were used in practice considering the size of the economic activity and its specificity. Although Poland encountered some problems in the performance of tasks in this area under the conditions of the COVID-19 pandemic, for example, in interpreting provisions concerning fundamental issues in the application of the Temporary Framework and EU regulations, it should be noted that both in terms of the amounts allocated to public aid, the number of its beneficiaries, and the variety of solutions and benefits introduced, the activity of the state, also in terms of notifying the European Commission of its own aid programmes, was significant.

Keywords: *state aid, aid programme, entrepreneur, competition rules, internal market*

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1. Legal bases

The principles of admissibility of public aid and, simultaneously, its regulation have been specified in the provisions of many normative acts, including in the EU treaty law, regulations at the level of ordinances, and in the provisions of Polish law. Discussing the issue of state aid in Poland requires referring to the basic regulations applicable in this area in EU law. These are included primarily in Arts. 107, 108, and 109 of the Treaty on the Functioning of the European Union (TFEU), which define the EU rules on the admissibility of Member States to use solutions constituting state aid. However, a special starting point in this case is Art. 3 para. 1 point (b) of the TFEU, according to which the EU has exclusive competence to establish the competition rules necessary for the functioning of the internal market; this, therefore, means that legal regulations defining the principles of operation of the competitive mechanism, also in the field of state aid, fall within the competence of the EU.

Provisions of Art. 107 para. 1 of the TFEU introduce a general prohibition on granting state aid: they do not define it, but list the elements based on which this definition was developed in the literature on the subject. Pursuant to the above-mentioned provision, the criteria determining the institution of state aid include all aid granted by a Member State using state resources in any form.¹ Art. 107 para. 1 of the TFEU also includes the premise of distortion or threat of distortion of competition by favouring certain undertakings or the production of certain goods and incompatibility with the internal market to the extent that state aid affects trade between Member States.² The practical importance of the above-mentioned premises is because their analysis in a specific case determines the recognition of certain forms of aid as inconsistent with the principles of the functioning of the internal market. Further, in Art. 107 para. (2) of the TFEU, establishing exceptions to the prohibition set out in Section 1, categories of aid that are considered compatible with the internal market (primarily aid of a social nature granted to individual consumers, considering the issue of discrimination related to the origin of products, and aid to repair damage caused by natural disasters or other exceptional events) are defined. In Section 3, categories of state aid that may be considered compatible with the internal market (e.g. aid intended to promote the economic development of regions, aid intended to promote culture and the preservation of cultural heritage, and aid intended to remedy a serious disturbance in the economy of a Member State) are listed. Other categories of aid are also permitted, as the Council may determine, in such a case acting on a request from the European Commission (Art. 107 para. (3) point c of the TFEU).

Art. 108 of the TFEU establishes the rules of the notification procedure and proceedings before the Commission, as well as the powers of the Council and the

¹ Szydło, 2002, p. 34.

² Götz, 1999, pp. 957–962; Jaźwiński, 2007, pp. 85–86; Postuła, 2005, p. 41.

European Commission to shape the rules for granting state aid by Member States in accordance with Art. 107 of the TFEU.

However, Art. 109 of the TFEU gives the Council competence to adopt regulations on the application of Arts. 107 and 108 of the TFEU. The TFEU also regulates issues relating to granting of state aid in agriculture (Art. 42), transport (Arts. 93, 96, and 98), public enterprises (Art. 106 para. (2)), and the arms industry (Art. 346 para. (1) point (b)).

The EU regulations defining the rules of conduct in the case of granting state aid by Member States include, first, Council Regulation (EU) No. 2015/1589 of 13 July 2015, which prescribes detailed rules for the application of Art. 108 of the TFEU Commission Implementing Regulation (EC) No. 794/2004.³ The first of the above-mentioned regulations defines the system of rules applicable to state aid. The Implementing Regulation applies to aid in all sectors, with explicit rules laid down on the form, content, and details of notifications and annual reports, apart from rules on the calculation of deadlines for all state aid procedures and the interest rate for the reimbursement of unlawful aid (Art. 1 of Regulation No. 794/2004).

In the Polish legal system, state aid issues are regulated by the Act of 30 April 2004 on proceedings in matters relating to state aid.⁴ This Act constitutes the basis for the implementation of the provisions of the TFEU and EU regulations specifying the conditions for the prohibition of state aid and applicable exceptions. The subject of the regulations of the Act are the rules of procedure in matters relating to state aid that meet the conditions set out in Art. 107 para. 1 of the TFEU, including, in particular, proceedings regarding the preparation for notification of draft aid programmes, individual aid projects, and individual aid projects for restructuring, as well as the principles and procedure for the return of public aid and its monitoring (Art. 1 of the Act).⁵ Many implementing acts have been issued for the Act in question, which particularly concern the issue of *de minimis* aid,⁶ regional aid,⁷ rules for calculating the value of various forms of public aid,⁸ and providing information and reports on public aid granted.⁹

3 See: Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EU) 2015/1589 laying down detailed rules for the application of Art. 108 of the Treaty on the Functioning of the European Union, OJ L 140, 30.4.2004, 1–134.

4 Consolidated text: Journal of Laws of 2023, item 702.

5 Juryk, 2023, commentary to Art. 1; Podsiadło, 2016, pp. 173–174.

6 Regulation of the Council of Ministers of 29 March 2010 on the scope of information presented by an entity applying for *de minimis* aid (Journal of Laws No. 53, item 311, as amended).

7 Regulation of the Council of Ministers of 29 March 2010 on the scope of information presented by an entity applying for *de minimis* aid (Journal of Laws No. 53, item 311, as amended).

8 Regulation of the Council of Ministers of 11 August 2004 on the detailed method of calculating the value of public aid granted in various forms (consolidated text: Journal of Laws of 2018, item 461).

9 Regulation of the Council of Ministers of 7 August 2008 on reports on public aid granted, information on failure to grant such aid, and reports on entrepreneurs' arrears in payments of benefits due to the public finance sector (consolidated text: Journal of Laws of 2016, item 1871, as amended).

In accordance with the provisions of the Polish Act on proceedings in matters relating to state aid, the beneficiary of this aid is an entity conducting a business activity – an entrepreneur (Art. 2 point 16). The statutory definition of such an entity is covered by the provisions of the Act of 6 March 2018 – Entrepreneurs' Law.¹⁰ Pursuant to Art. 4 para. 1 of the above-mentioned Act, an entrepreneur is a natural person, a legal person, and an organisational unit that is not a legal person, which is granted legal capacity by a separate act and conducts a business activity. The Act also treats partners in a civil partnership as entrepreneurs in the scope of their business activities (Art. 4 para. 2).¹¹

From the point of view of the application of EU regulations, focus must also be on the regulations in force in the Polish legal system determining the size of an enterprise. Pursuant to Art. 7 para. 1 point 1 of the Entrepreneurs' Law, a micro-entrepreneur refers to an entrepreneur who, in at least one of the last two financial years, has met two conditions in total: first, considered the annual average employment of less than 10 employees, and second, has achieved an annual net turnover from the sale of goods, products, and services and financial operations, not exceeding the PLN equivalent of EUR 2 million, or the total assets of its balance sheet prepared at the end of one of these years not exceeding the PLN equivalent of EUR 2 million.

A small entrepreneur is an entity that, in at least one of the last two financial years, has jointly met the condition related to employing an average of less than 50 employees per year and achieved an annual net turnover from the sale of goods, products, and services and from financial operations not exceeding the equivalent in PLN 10 million, or the total assets of its balance sheet prepared at the end of one of these years has not exceeded the PLN equivalent of EUR 10 million, and provided that the entity is not a micro-entrepreneur (Art. 7 para. 1 point 2 of the Entrepreneurs' Law).

The Entrepreneurs' Law defines a medium-sized entrepreneur as an entity that has, in at least one of the last two financial years, met the requirement of employing, annually, less than 250 employees on an average and achieved an annual net turnover from the sale of goods, products, and services and from financial operations not exceeding the PLN equivalent of EUR 50 million, or the total assets of its balance sheet prepared at the end of one of these years not exceeding the PLN equivalent of EUR 43 million; additionally, is not a micro-entrepreneur or a small entrepreneur (Art. 7 para. 1 point 2 of the Entrepreneurs' Law).

Of key importance here is the Commission Regulation (EU) No. 651/2014 of 17 June 2014 declaring certain types of aid compatible with the internal market in applying Arts. 107 and 108 of the TFEU.¹² This regulation defines a micro-enterprise

¹⁰ Consolidated text: Journal of Laws of 2023, item 221, as amended.

¹¹ Lubeńczuk, 2019, commentary to Art. 4; Kozieł, 2019, commentary to Art. 4; Sieradzka, 2018, pp. 36–37; Powalowski, 2018, pp. 1–4.

¹² OJ L 187, 26.6.2014, 1–78.

and a small- and medium-sized enterprise;¹³ it also indicates the types of aid that they can benefit from without the notification procedure. Regulation No. 651/2014 refers to the definition contained in Commission Recommendation 2003/361/EC of 6 May 2003 of micro-, small-, and medium-sized enterprises,¹⁴ which is intended to facilitate the coordination of national and EU initiatives regarding small- and medium-sized enterprises, ensure administrative transparency and legal certainty, and eliminate differences in interpretation that may distort competition.

However, the provisions of Recommendation 2003/361/EC do not provide – as is the case with the above-mentioned provisions of the Entrepreneurs’ Law – an exclusion, which means that the category of small enterprises cannot include those that are micro-enterprises, while the category of medium-sized enterprises cannot include those that are small- or micro-enterprises. Therefore, the structure adopted in Art. 7 para. 1 points 1–3 Entrepreneurs’ Law, differs from the standards set out in the provisions of Recommendation 2003/361/EC in terms of the separate definitions of small-, medium-sized and micro-entrepreneurs.¹⁵

The regulations in force within the Polish legal system regarding state aid – apart from those mentioned above – also include numerous acts regulating specific cases of granting it (e.g. to entities in a special economic zone,¹⁶ for entrepreneurs of particular importance for the labour market,¹⁷ and support for the implementation of new investments¹⁸), and special situations (an emergency state,¹⁹ including in the event of a natural disaster²⁰) for granting it.

2. Purpose and forms of public aid

As already noted above, the provisions of the TFEU introduce a general prohibition on granting state aid, while establishing exceptions to this prohibition in the form of specific categories of aid considered compatible with the internal market, as well as categories of state aid that may be considered as such. Other categories of

13 See: Arts. 1 and 2 of Annex I.

14 OJ L 124, 20.5.2003, 36–41.

15 Lubeńczuk, 2019, commentary to Art. 7.

16 See: Act of 20 October 1994 on special economic zones (consolidated text: Journal of Laws of 2023, item 1604).

17 See: Act of 30 October 2002 on state aid for entrepreneurs of particular importance for the labour market (consolidated text: Journal of Laws of 2021, item 239, as amended).

18 See: Act of 10 May 2018 on supporting new investments (consolidated text: Journal of Laws of 2023, item 74, as amended).

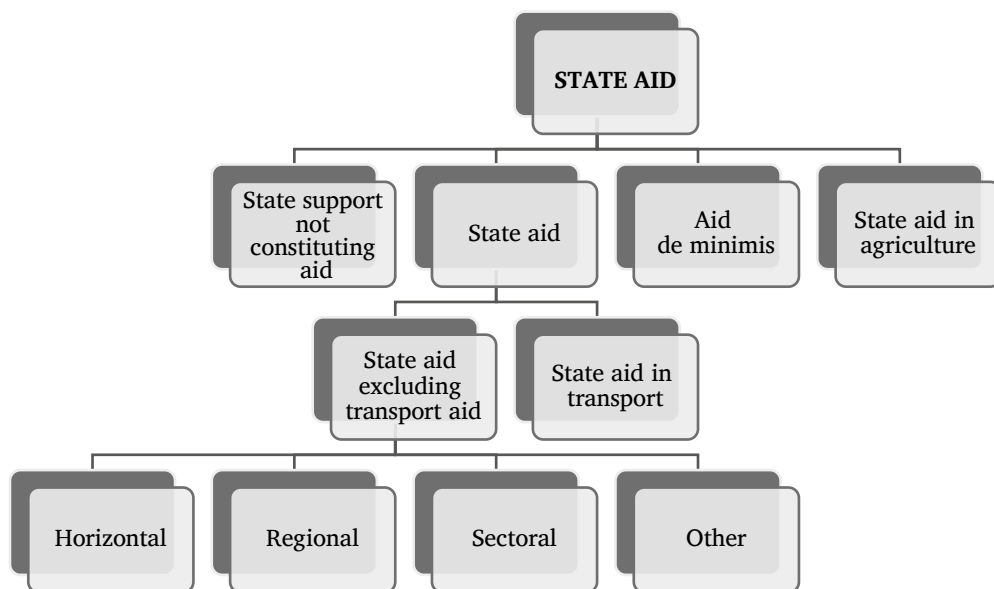
19 See: Art. 228 of the Constitution of the Republic of Poland. See also: Banaszak, 2009, pp. 968–975; Bosek, 2022, pp. 133–134.

20 See: Act of 18 April 2002 on the state of natural disaster (consolidated text: Journal of Laws of 2017, item 1897).

state aid, which are determined by a decision of the Council, and are offered at the request of the European Commission (Art. 107 of the TFEU) are also permissible.

However, public support implemented in Poland has a broader scope, and public aid is one of its elements. In accordance with the applicable state aid regulations, Figure 1 presents the different categories of state aid that can be adopted.

Figure 1: Individual categories of state aid²¹



In keeping with the generally accepted division, state aid granted in Poland – considering its purpose – can be grouped into horizontal, regional, and sectoral, with the reservation, however, that in the case of sectoral aid, specific rules exist in granting it for a given economic sector. In recent years, this aid has been provided in similar categories – in the case of horizontal aid granted in 2021, 15 items are in this category (as in 2020); in the case of regional aid, three items are in this category (in 2020, two categories of public aid, creation of new jobs and large investment projects, were added), and six items are under sectoral aid (in 2020).

²¹ Source: Own study based on data included in the report on sector aid in Poland granted to entrepreneurs in 2021 by the Office of Competition and Consumer Protection. Urząd Ochrony Konkurencji i Konsumentów, 2022, p. 6.

Table 1: Purpose and types of state aid (excluding aid granted in the transport sector and emergency aid) in 2021²²

No.	Horizontal aid
1	Research, development and innovation
2	Environmental protection and energy objectives
3	Small and medium-sized enterprises
4	Employment
5	Training
6	Rescue
7	Restructuring, including temporary restructuring aid
8	Support for domestic entrepreneurs operating as part of a business venture undertaken in the European interest
9	Supporting culture and preserving cultural heritage
10	Social assistance for individual consumers
11	High risk capital
12	Access of small- and medium-sized enterprises to financing
13	Facilitating development of certain economic activities or certain economic regions
14	Local infrastructure
15	Sports and recreational activities
Sectoral aid	
1	Coal mining sector
2	Energy sector
3	Cinematography sector
4	Natural gas sector
5	Telecommunications sector
6	Banking sector

²² Source: Own study based on data included in the report on sector aid in Poland granted to entrepreneurs in 2021 by the Office of Competition and Consumer Protection. Urząd Ochrony Konkurencji i Konsumentów, 2022, pp. 11–12.

Regional aid	
1	Supporting new investments
2	Operational aid
3	Aid for urban development
Other	
1	Compensation for the provision of services of general economic interest

According to the guidelines of the European Commission, forms of assistance are grouped into four and marked with letters: A (subsidies and tax reliefs), B (capital and investment subsidies), C (so-called ‘soft lending’) and D (sureties and guarantees). Additionally, depending on the source of the aid, subsequent letters are assigned the number 1 (budget expenditure) or 2 (decrease in budget inflow).

Table 2: Forms of state aid in 2021²³

Group	Sub-group	Form of aid
Group A subsidies and tax reliefs	A1 subsidies	subsidy and other non-refundable benefits
		interest subsidies on bank loans (directly for entrepreneurs)
		other expenses related to the operation of budgetary units or the implementation of their statutory tasks
		refund
		compensation
	A2 tax reliefs	tax exemption
		tax deduction
		a reduction or reduction resulting in a reduction of the tax base or the tax amount
		fee lowering
		fee exemption
		abandonment of tax collection

²³ Source: Own study based on data included in the report on sector aid in Poland granted to entrepreneurs in 2021 by the Office of Competition and Consumer Protection. Urząd Ochrony Konkurencji i Konsumentów, 2022, pp. 9–10.

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Group	Sub-group	Form of aid
Group A subsidies and tax reliefs	A2 tax reliefs	abandonment of fee collection
		write-off of all or part of tax arrears together with interest
		waiving all or part of interest on tax arrears
		waiving all or part of interest for late payment (contributions, payments, penalties)
		remission of penalties or waiving the imposition of a penalty
		putting into use property owned by the State Treasury or local government units and their associations on terms that are more favourable to the entrepreneur than those offered on the market
		sale of property owned by the State Treasury or local government units and their associations on more favourable terms than those offered on the market
		write-off of enforcement costs
		one-time depreciation
		write-off of court proceedings costs
Group B capital and investment subsidies	B1	contribution of capital
	B2	conversion of receivables into capital
Group C so-called 'soft lending'	C1 preferential and con- ditionally written-off loans	preferential loans
		preferential credits
		interest subsidies on bank loans (for banks)
		loans conditionally written off
		refundable advance payment
Group C so-called 'soft lending'	C2 deferral and payment in instalments	deferral or instalment of payment of tax or tax arrears together with interest for late payment
		deferral or instalment of payment of a fee (contributions, payments), overdue fee (premiums, payments) or overdue fee (premiums, payments) along with interest
		deferral or instalment payment of overdue fees (contributions, payments, penalties)

Group	Sub-group	Form of aid
Group C so-called 'soft lending'	C2 deferral and payment in instalments	deferral or instalment of enforcement costs into instalments
		deferral or payment of interest into instalments
		deferral or spreading the costs of the court proceedings into instalments
Group D sureties and guarantees	D1	sureties and guarantees

In accordance with the data presented by the Office of Competition and Consumer Protection in the report on public aid in Poland granted to entrepreneurs in 2021, in general terms the following data are indicated: (i) number of entities that provided aid – 481; (ii) number of beneficiaries – 45.8 thousand; (iii) number of acts of aid (usually an agreement or decision) – 50.2 thousand; (iv) number of aid acts per one beneficiary on average – 1.1; (v) number of aid cases – 408.7 thousand; (vi) number of aid cases per beneficiary on average – 8.9; (vii) value of aid per beneficiary on average – PLN 1,046.9 thousand.²⁴

The total value of state aid granted to entrepreneurs in 2021 was set at PLN 47,942.2 million (equivalent to EUR 10,496.6 million²⁵). State aid granted in 2021 amounted to 1.83% of the GDP (equal to PLN 2,622,184 million). The value of state aid granted, excluding aid in transport, amounted to PLN 42,030.5 million (1.60% of GDP), while the value of public aid granted in the transport sector amounted to PLN 5,911.7 million (0.23% of GDP).²⁶

When assessing the trends in the volume of public aid in Poland in 2017–2021, it can be noted that after a significant increase in the value of aid granted in 2017 (resulting primarily from the implementation of operational programmes co-financed from EU funds in 2014–2020, financial value of aid granted in the transport sector and aid constituting compensation for the provision of services of general economic interest), a significant decrease was observed in 2018. Starting from 2019, the total value of state aid increased again, and in 2021 its value (excluding transport) increased by almost 30% compared to 2020. The main reason for this increase is the aid granted in the banking sector under the compulsory bank restructuring.²⁷

24 See: Urząd Ochrony Konkurencji i Konsumentów, 2022, p. 14.

25 Considering the average exchange rate from 2021, EUR 1 = PLN 4.5674.

26 See: Urząd Ochrony Konkurencji i Konsumentów, 2022, p. 14.

27 Urząd Ochrony Konkurencji i Konsumentów, 2022, p. 15.

Table 3: Amount of state aid in 2017–2021²⁸

year	2017	2018	2019	2020	2021
Total value of aid granted [PLN million], including:	42,251.9	26,972.0	36,763.2	37,832.0	47,942.2
– value of the aid excluding transport [PLN million]	30,572.8	22,116.9	24,382.5	26,047.5	42,030.5
– value of aid granted in the transport sector [PLN million]	11,679.1	4,855.1	12,380.7	11,784.5	5,911.7
– share of the value of aid granted in the transport sector in the total value of aid	27.6%	18.0%	33.7%	31.1%	12.3%
Share of the total value of aid in GDP, including:	2.12%	1.27%	1.60%	1.62%	1.83%
– share of the aid value excluding transport in GDP	1.54%	1.04%	1.06%	1.11%	1.60%
– share of the value of aid granted in the transport sector in GDP	0.59%	0.23%	0.54%	0.50%	0.23%

3. Tax relief and state aid

Polish tax law also provides for special solutions specifying the rules for granting relief to taxpayers running a business. Art. 67b of the Act of 29 August 1997 – Tax Ordinance²⁹, which regulates this issue, was included in the provisions of the Act after Poland's accession to the EU and has been in force since 1 September 2005.³⁰ As in other cases, granting a specific relief to a taxpayer qualifies as public aid if it meets the conditions specified in Art. 107 of the TFEU. Therefore, tax relief that may

28 Source: Own study based on data included in the report on sector aid in Poland granted to entrepreneurs in 2021 by the Office of Competition and Consumer Protection. Urząd Ochrony Konkurencji i Konsumentów, 2022, p. 15.

29 Consolidated text: Journal of Laws of 2022, item 2651 as amended.

30 See: Act of 30 June 2005 amending the Tax Ordinance Act and amending certain other acts (Journal of Laws No. 143, item 1199, as amended).

lead or does lead to disruptions in trade between EU Member States should be considered as prohibited state aid. Hence, granting the above-mentioned aid in a case where such a disruption cannot be identified will not be classified as prohibited state aid, and the tax authorities must determine this circumstance in each individual case. The interpretative procedure is recognising that each tax relief referred to in Art. 67b para. 1 of the Tax Ordinance, is, in principle, prohibited state aid.³¹ It also depends largely on the scale of the entrepreneur's business and cooperation and connections with foreign entrepreneurs.³²

In the case of taxpayers running a business, relief in the repayment of tax liabilities is granted at the taxpayer's request (as is the case with other taxpayers applying for such relief under Art. 67a of the Tax Ordinance). The premises that justify the possibility of using the relief by a specific entrepreneur are 'important interest of the taxpayer' or 'public interest', and the decision is made within the scope of administrative discretion.³³ Reliefs in the repayment of tax liabilities in the case of taxpayers running a business are, however, granted subject to the limitations set out in Art. 67b para. 1 of the Tax Ordinance. Pursuant to the above-mentioned provision, the tax authority may, in such a case, grant reliefs specified in Art. 67a of the Tax Ordinance (postponing the deadline for tax payment, spreading the tax payment into instalments, deferring or spreading the payment of tax arrears into instalments together with interest for late payment or interest on unpaid tax advances, write-off of tax arrears in whole or in part, and determine interest for late payment or extension fee) which (i) do not constitute state aid; (ii) constitute *de minimis* aid – to the extent and under the terms provided for in directly applicable acts of Community law regarding *de minimis* aid; (iii) constitute state aid: (iiia) granted to repair damage caused by natural disasters or other extraordinary events, (iiib) granted to prevent or eliminate serious disruptions in the economy of a cross-sectoral nature, (iiic) granted to support national entrepreneurs operating as part of an economic project undertaken in the European interest, (iiid) granted to promote and support culture, national heritage, science, and education, (iiie) granted as compensation for the provision of services of general economic interest entrusted on the basis of separate regulations, (iiif) granted for training, (iiig) granted for employment, (iiih) granted for the development of small- and medium-sized enterprises, (iiij) granted for restructuring, (iiik) granted for environmental protection, (iiil) granted for research and development work, (iiim) granted

31 Judgement of the Supreme Administrative Court of 27 August 2014, II FSK 2067/12, Legalis; Tezcan, 2018, pp. 31–32. See also: judgements of the Supreme Administrative Court: judgement of 20 August 2010, II FSK 610/09, Legalis; judgement of 23 January 2014, II FSK 532/12, Legalis; judgement of 10 March 2016, II FSK 75/14, Legalis; judgement of 14 March 2017, II FSK 3249/16, Legalis; and judgement of the Provincial Administrative Court in Poznań of 21 February 2019, I SA/Po 693/18, Legalis; judgement of the Provincial Administrative Court in Łódź of 26 April 2019, I SA/Łd 38/19, Legalis.

32 See: Dzwonkowski and Kurzac, 2020, commentary to Art. 67b and the literature cited there.

33 Derach, 2023, commentary to Art. 67b.

for regional development, (iiim) granted for other purposes specified pursuant to para. 6 by the Council of Ministers.

Therefore, in granting a relief constituting state aid, the provisions of the Tax Ordinance indicate specific objectives whose implementation is its concern. In addition, a delegation is envisaged for the Council of Ministers, which may, by way of regulations, specify the purposes of aid granted in the form of relief in the repayment of tax liabilities other than those mentioned above, as well as the detailed conditions for granting these reliefs for specific purposes, together with an indication of the cases in which the relief is granted as individual aid, considering the admissibility and conditions of granting state aid specified in the provisions of Community law (Art. 67b para. 6 of the Tax Ordinance).

Art. 67b para. 2 of the Tax Ordinance specifies that relief in the repayment of tax liabilities granted to compensate for damage caused by natural disasters or other extraordinary events (Art. 67b para 1 point 3 letter a) may be granted as individual aid or as part of aid programmes. However, in accordance with point 3, in other cases (defined in Art. 67b para. 1 point 3 letters b–l), relief may be granted as individual aid in accordance with government or local government programmes or as part of aid programmes specified in separate regulations.

4. Retail sales tax

An example of the problems in interpreting Polish regulations and their compatibility with EU law is the judgement of the Court of Justice of the European Union of 16 March 2021 regarding the introduction of a retail sales tax.³⁴ On 1 January 2021, the provisions of the Act of 6 July 2016 on retail sales tax³⁵ became effective in Poland, but its enforcement was significantly postponed in waiting for the aforementioned judgement, which finally confirmed that the Polish retail sales tax (trade tax) does not violate EU law.

The retail sales tax act in force in Poland imposes on retailers a tax levied on sales revenue (Art. 5). The taxable base in this case is the excess of retail sales revenue achieved in a given month over the amount of PLN 17 million. On the contrary, revenue from retail sales is constituted by amounts received by the taxpayer on account of sales, including advance payments, instalments, prepayments, and deposits, also in the event of such amounts being received by the taxpayer before goods were supplied. The provisions of the Act specify that the revenue earned in a given month shall be reduced by the amounts paid in that month for the return of goods after deduction of the goods and services tax (Art. 6). The tax rates are,

34 CJEU, 16 March 2021, C-562/19 P, *European Commission v. Republic of Poland*, ECLI:EU:C:2021:201.

35 Consolidated text: Journal of Laws of 2023, item 148.

respectively, 0.8% of the tax base – when it does not exceed the amount of PLN 170 million, and 1.4% of the tax base when it exceeds the amount of PLN 170 million (Art. 9).³⁶

The tax was originally introduced in Poland in July 2016, despite objections raised by the European Commission. In November 2016, it issued the first of the decisions later challenged by Poland, under which it opened a formal investigation and – in accordance with its powers – applied an interim measure in the form of an order to suspend tax collection until the matter was clarified. The investigation resulted in a second decision by the EC, which found the Polish legislation incompatible with EU law because the progressive construction of commercial tax leads to a much lower taxation of smaller companies compared to other taxpayers, giving grounds to consider it as unlawful state aid. The European Commission's position was based on the claim that the introduction of a trade tax would hit large retail chains and therefore affect the market structure of retailers. The EC stated that this would lead to a distortion of competition in the EU market.

Poland suspended tax collection, but appealed the European Commission's decision to the General Court of the European Union, which, in the judgement of 16 May 2019,³⁷ upheld the complaint and annulled the Commission's decision. Following the European Commission's appeal to the Court of Justice of the European Union, in October 2020, the Advocate General of the CJEU decreed that the appeal should be dismissed by the Court and the judgement of the EU General Court should be upheld. Then, the Polish government waived the suspension of tax collection, with the result that the retail sales tax legislation became effective in Poland on 1 January 2021.

In the judgement of 16 March 2021 referred to above, the CJEU – confirming the judgement of the General Court of the EU – pointed out, first, that 'outside the areas in which Union tax law is subject to harmonisation, the determination of the constitutive features of any tax is a matter for the discretion of the Member States, respecting their fiscal autonomy, a power which must in any event be exercised in compliance with Union law. That applies in particular to the choice of the rate of tax, which may be proportional or progressive, but also to the determination of the tax base and the chargeable event'. The Court of Justice of the European Union thus held that the determination of the design of a tax system – to the extent that it is not subject to harmonisation at EU level – is an autonomous power of the Member States, and that the mere setting of a progressive rate of a given tax need not be considered to infringe the EU rules on state aid, since it does not in itself constitute a selective advantage granted to certain undertakings.³⁸

³⁶ See: Maruchin, 2021, p. 26.

³⁷ CJEU, 16 May 2019, T-836/16 and T-624/17, *European Commission v. Republic of Poland*, ECLI:EU:T:2019:338 (the second case concerned Hungary).

³⁸ See also: Stępkowski, 2021, pp. 12–13.

5. State aid during the COVID-19 pandemic

The period of the COVID-19 epidemic and the experience it brought in many aspects of the functioning of EU Member States have shown the importance of state aid regulations in not only preventing distortions of competition in the internal market, in circumstances of greater demand for various forms of public support, but also possibly mitigating the negative effects of the economic crisis.

In circumstances where the EU rules for granting state aid became insufficient, the European Commission issued the Communication called ‘Coordinated economic response to the COVID-19 epidemic’,³⁹ which emphasised that although the situation has a serious impact on the state of the European economy, the limited size of the EU budget would entail that most of the funds to fight the crisis will have to come from the budgets of EU Member States. The European Commission’s Communication also defined the principles according to which Member States may develop their own support measures. Subsequently, the European Commission issued a Communication on 20 March 2020 ‘Temporary framework for state aid measures to support the economy in the context of the ongoing COVID-19 epidemic’,⁴⁰ which specified the conditions for granting state aid and the conditions for recognising it as admissible.⁴¹

In Poland, one of the first legal regulations relating to the situation caused by COVID-19 and of key importance in this respect was the Act of 2 March 2020 on special solutions related to the prevention, counteracting, and combating of COVID-19, other infectious diseases, and the crisis situations caused by them.⁴² This Act was subject to numerous changes that were a consequence of the changing situation in Poland. Most aid programmes aimed at mitigating the negative economic consequences caused by COVID-19 have been developed based on this Act, in line with the state aid rules set out in the Temporary Framework.⁴³

In the case of Poland, various public aid measures provided for in individual sections of the Temporary Framework have been applied in practice, including, for example, redeemable loans, interest subsidies on loans granted by banks, support provided by the Polish Development Fund for small- and medium-sized enterprises, loan guarantees, tax facilitations (e.g. regarding real estate tax, relief in repayment

39 Communication from the Commission to the European Parliament, the European Council, the European Central Bank, the European Investment Bank Eurogroup, 13 March 2020. A coordinated economic response to the epidemic, COM(2020) 112 final.

40 Commission Communication ‘Temporary framework for state aid measures to support the economy in the context of the ongoing COVID-19 epidemic’, OJ C 91I, 20.3.2020, 1–9.

41 See also: Mazur, 2023, pp. 62–64.

42 Consolidated text: Journal of Laws of 2023, item 1327, as amended.

43 See also: for example, the Act of 19 June 2020 on interest subsidies on bank loans granted to entrepreneurs affected by COVID-19 and on simplified proceedings for the approval of an arrangement in connection with the occurrence of COVID-19 (consolidated text: Journal of Laws of 2022 item 2141) and the Act of 16 July 2020 on support for the trade receivables insurance market in connection with counteracting the economic effects of COVID-19 (Journal of Laws of 2020, item 1422, as amended).

of tax liabilities⁴⁴), co-financing of part of employee remuneration costs, co-financing of social security contributions for small- and medium-sized enterprises, and co-financing of business costs for entrepreneurs who are natural persons and do not employ employees. In 2021, Poland obtained consent from the European Commission for the implementation of the government programme 'Financial Shield for SMEs 2.0', through the Polish Development Fund addressing small- and medium-sized enterprises and providing for subsidies to co-finance the uncovered fixed costs of these enterprises, in accordance with the conditions set out in Section 3.12 of Temporary Framework. Additional aid programmes have also been approved, providing, for example, aid for Polish airports as compensation for damage resulting directly from air traffic restrictions due to the COVID-19 pandemic and the cancellation of preferential loans granted by the Polish Development Fund to large entrepreneurs.⁴⁵

Activities related to state aid in Poland were encumbered by certain problems, such as the rules for cumulating aid, limits in aid granted as specific amounts, as well as the interpretation of regulations regarding often basic issues in the context of the application of the Temporary Framework and EU regulations during the conditions of the COVID-19 pandemic, for instance, recognising the status of small- and medium-sized enterprises in certain circumstances.⁴⁶

6. Conclusions

According to the data presented by the Office of Competition and Consumer Protection in the report on state aid in Poland granted to entrepreneurs in 2020, support was provided to 2.3 million beneficiaries in 2020, among which the largest group was micro-enterprises (number of entities that granted aid – 1,002). The average value of aid granted per beneficiary was determined at PLN 41.5 thousand, and each beneficiary on average benefited from aid three times. Overall, the number of aid cases was determined at 7.6 million.

In 2020, owing to the crisis caused by the COVID-19 pandemic, Poland notified the European Commission of 22 aid programmes under which aid worth PLN 93,959.5 million was granted; it should be emphasised that the amount of funds from the state budget allocated to the fight against COVID-19 and eliminating the negative consequences of the pandemic were much greater because not all solutions used constituted public aid (e.g. benefits for the protection of jobs from the Guaranteed Employee Benefits Fund, standstill benefits).⁴⁷

44 Linka, 2020, pp. 31–32; Olczyk, 2021, pp. 14–15.

45 Kopeć, 2021, pp. 89–90.

46 Kopeć, 2021, pp. 91–97.

47 Urząd Ochrony Konkurencji i Konsumentów, 2021, pp. 83–84.

In 2021, 369,000 beneficiaries received crisis aid, among which (as in 2020) the largest group was that of micro-enterprises (number of entities that provided assistance – 1,307). The average value of crisis assistance provided per beneficiary was determined at PLN 51.2 thousand and was higher by approximately PLN 10,000 than the average value of assistance provided within the same scope in 2020. On average, the assistance received by each beneficiary was five-fold. Overall, the number of cases of assistance was determined at 1.98 million.

The situation caused by the COVID-19 pandemic led the European Commission to issue over 50 decisions for Poland as crisis aid support by the end of 2021, 39 of which were approvals for crisis aid programmes for entrepreneurs and entities operating outside the agriculture and fisheries sectors. According to data from the Office of Competition and Consumer Protection, in 2021, aid was granted under 28 aid programmes, and its value was estimated at PLN 18,902.9 million. However, from December 2020, it was also possible to grant *de minimis aid* to offset the effects of the COVID-19 pandemic, which in 2021 was set at PLN 9,500.6 million.⁴⁸

48 Urząd Ochrony Konkurencji i Konsumentów, 2022, pp. 81–82.

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ROMANIA: STATE AID LAW IN ROMANIA



EMŐD VERESS

Abstract

This chapter examines the state aid law in Romania, focusing on its legal framework, key provisions, and recent developments. It provides an overview of the regulatory framework governing state aid in Romania, including the relevant legislation, regulations, and guidelines. Apart from analysing the criteria and procedures for granting state aid, it also discusses the role of the Romanian competition authority in enforcing state aid rules. Examining recent case laws and decisions related to state aid in Romania, it highlights the legal realities of state aid. Overall, it offers insights into the state aid regime in Romania and its implications for businesses, government entities, and the broader economy.

Keywords: *State Aid Law, Romania, Legal Framework, Competition Authority, Government Entities*

1. Introductory aspects

State aid constitutes a set of policies regulated by European Union (EU) law, with Member States having only a limited margin of manoeuvre as determined by the EU law. The underlying aim of these policies is to preserve competition as the basis of the market economy. According to the Constitution of Romania, Art. 135:

Emőd Veress (2024) 'Romania: State Aid Law in Romania'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 337–365. Miskolc–Budapest, Central European Academic Publishing.

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Romania's economy is a free market economy, based on free enterprise and competition. The state must secure: a) a free trade, protection of fair competition, provision of a favourable framework in order to stimulate and capitalize every factor of production; b) protection of national interests in economic, financial and currency activity; c) stimulation of national scientific and technological research, arts, and protection of copyright; d) exploitation of natural resources, in conformity with national interests; e) environmental protection and recovery, as well as preservation of the ecological balance; f) creation of all necessary conditions so as to increase the quality of life; g) implementation of regional development policies in compliance with the objectives of the European Union.

For an effective competitive environment, economic operators must enjoy equal treatment and opportunities. Following this principle, the state must treat profit-making entities with no bias, without directly or indirectly favouring any of them.¹ Of course, in many cases, state intervention in the economy becomes an imperative necessity, justified on substantial objective grounds. Hence, a total ban on state aid would produce negative effects, absolutizing the concept of free competition, to the detriment of economic imperatives and of national interest. This is precisely why state aid law exists: to balance the conflict between the principle of free competition and equal treatment, on the one hand, and the need for state intervention in cases where other imperatives require it, on the other. A distinction must be made between *measures of a general nature*, which are aimed at certain state economic strategies in certain sectors, and *measures of an individual nature*, which are aimed at a particular company and pose a much greater risk of discrimination. Thus, state aid policy and state aid law are both based on a simultaneously prohibitive and permissive set of rules. European and national state aid laws are interlinked, with the former dominating the latter.² The importance of state aid is revealed by its intensity: companies in Romania received state aid totalling around RON 29.5 billion in 2023, about 2% of its Gross Domestic Product (GDP).

2. Sources of law

In addition to the mandatory application of European state aid law, the Romanian government (the Cabinet) has adopted an important piece of national legislation in the form of an emergency ordinance to reflect the rapid changes at the European

¹ Almășan, 2021.

² For an economic analysis of state aid in Romania, see: Pop, Iootty De Paiva Dias, Bruhn and Ruiz Ortega, 2021.

level in this area, namely, the Government Emergency Ordinance No. 77/2014, on national state aid procedures.³

An emergency ordinance is an act of legislation adopted by the Cabinet (called *Guvern* in Romanian, hence the name ‘government emergency ordinance’, which is a slight misnomer) during extraordinary situations when the regulation cannot be delayed. It has a legal force equivalent to that of an organic law (which requires a qualified majority) adopted by Parliament. The Parliament retains a *post facto* right of control and approval over such ordinances. These ordinances constitute only ‘provisional’ law, coming into effect from when they are published in the *Monitorul Oficial*, the official journal of Romania. Parliament may then approve, reject, or amend them after adoption. Bearing in mind the fact that such ordinances may be overused in the Romanian legal order, the adoption of such a source of law in the field of state aid has been justified by arguments such as: (i) the need to bring national state aid legislation in line with the EU law; (ii) the need to create a legislative framework that guarantees the fulfilment of the *ex-ante* conditions imposed by the European Commission on Romania for accessing European funds in the 2014–2020 programme period; (iii) the need to better control how public funds (national and European) intended for the business environment are utilised; (iv) to ensure that the vast majority of state aid facilities are verified mainly at the national level as intended by the European reform in the field of state aid since the European Commission conducts only an *ex post* control of compliance with the conditions laid down in the relevant EU rules; (v) the need to establish a control mechanism at the national level, establishing the powers and obligations of providers, beneficiaries, and the Romanian Competition Council in the implementation of state aid and *de minimis* measures to facilitate the absorption of European funds and avoid their recovery; (vi) urgent measures taken to create a legislative framework at the national level that meets the European Commission’s requirements in the field of both state aid and European funds.

Since all these issues are in public interest and deemed to constitute urgent and extraordinary situations, when implementing measures cannot be postponed, adopting an emergency ordinance is justified. Parliament subsequently approved this emergency ordinance with amendments by means of Act No. 20/2015.

Romanian national state aid law aims to regulate national state aid procedures for the application of Arts. 106 to 109 of the Treaty on the Functioning of the European Union (TFEU), and the secondary legislation adopted on the basis thereof. Thus, national regulation is (only) an implementing act for European legislation, facilitating the application of European rules at the Member State’s level.

³ Regarding the constitutionality of some provisions of this emergency ordinance, see: Toader and Safta, 2016. For a general overview on the evolution of the Romanian state aid law, see: von Borries, 2006; Schütterle, 2007.

3. Concepts and definitions

Under national law, state aid is defined as an economic advantage granted through state resources or resources managed by the state in any form whatsoever that distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, insofar as it affects trade between Member States.⁴

Economic advantage is any type of quantifiable pecuniary advantage, whatever its form: subsidies, cancellation of debts or the taking over of losses, tax exemptions, reductions or deferrals of taxes, the foregoing of normal revenue from public funds, including granting of loans at preferential rates of interest, guarantees granted on preferential terms, equity participation by the state, central, or local government or other bodies administering state or local authority funds, if the rate of return on these investments is lower than the normal rate of return expected by a prudent private investor, discounts on goods and services provided by central or local government or other bodies administering state or local authority funds, including the sale of land belonging to the private domain of the state or local government below market price, the creation of a market or the strengthening of the beneficiary's position in a market, etc.

The concept of enterprise is broad, covering any entity, irrespective of its legal status and method of financing, including non-profit entities, which carries out an economic activity. State sources and resources are public funds or funds of public authorities, institutions, or undertakings.

Exempt aid is a state aid measure that fulfils the criteria specified in the European Commission regulations, with direct applicability, allowing a state aid measure to be established without prior authorisation by the European Commission. Unlawful aid is aid granted without complying with national and the EU state aid procedures. Misused aid is aid used by the beneficiary without respecting the conditions under which it was granted. *De minimis* aid is aid limited under EU rules to a level that does not distort competition and/or trade with Member States.

4. National procedures

Unless otherwise provided for in the EU regulations adopted pursuant to Art. 108 of the TFEU or other relevant provisions thereof, any intention to grant new state aid must be notified to the European Commission in time. The notification must be in the specific form accompanied by the relevant documentation to be submitted to the European Commission to establish the character of state aid and analyse the

⁴ For further details, see: Niță, 2018. See also: Art. 2 para. (1) point (d) of Emergency Ordinance No. 77/2014.

compatibility of the draft support measures with EU law. The documentation is the draft legislative or administrative act establishing the support measure, as well as any other act relevant for the analysis of the compatibility of the measure with the EU rules on state aid.

New state aid, subject to the notification requirement, may be granted only after it has been authorised by the European Commission or after it is deemed to have been authorised in accordance with Art. 4 para. (6) of Regulation (EU) 2015/1589.⁵ State aid that is not subject to the notification requirement may be granted only on compliance with the provisions of EU and national state aid law.

State aid or *de minimis* measures are introduced following an analysis on its appropriateness; introducing these measures requires the initiator or provider, where applicable, to draw up, under the law, regulatory or administrative acts, as necessary, establishing state aid or *de minimis* schemes or individual state aid or *de minimis* aid. It must mention at least the objective, method of granting state aid or *de minimis* aid, beneficiaries, period of application, amount of funds allocated for this purpose from the supplier's budget, and the applicable provision of the EU law under which the state aid or *de minimis* aid measure has been established in accordance with the relevant legislation.

Specific allocations under an aid scheme authorised by the European Commission, following the notification process in accordance with Art. 108 para. (3) of the TFEU,⁶ or covered by the Block Exemption Regulations,⁷ may be granted only if the conditions laid down in that aid scheme are fulfilled. Individual state aid, whether authorised by the European Commission following an individual notification or initiated under the provisions for block exemptions, may be granted only if it fulfils the conditions laid down in the act approving the granting of the aid.

Regional state aid may be granted in accordance with the relevant regulations drawn up by the European Commission and the Regional Aid Map approved by the Government. The regional aid map is to be notified to the European Commission for approval, in accordance with the procedure laid down in Art. 108 para. (3) of the TFEU, and approved by government decision.

More importantly, in the context of public procurement,⁸ where the contracting authority finds that a tender has an unusually low price because the tenderer benefits from state aid, that tender may be rejected on that ground alone only if, following

⁵ Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union, OJ L 248, 24.9.2015, 9–29.

⁶ Art. 108 para. (3) of the TFEU requires Member States to notify the Commission of any plans to grant or alter aid – the notification obligation – and to refrain from placing the proposed aid into effect until the Commission has taken a final decision on its compatibility with the internal market (the standstill clause).

⁷ *Competition Policy – Block Exemption Regulations* [Online]. Available at: https://competition-policy.ec.europa.eu/antitrust-and-cartels/legislation/block-exemption-regulations_en (Accessed: 15 January 2024).

⁸ For a general analysis on state aid and public procurement in Romania, see: Almășan and Bogrea, 2019.

the clarifications requested, the tenderer has not been able to demonstrate, within an appropriate time limit set by the contracting authority, that the state aid was granted legally.⁹ In such a case, when the contracting authority rejects a tender on these grounds, it must inform the European Commission after consulting with the Competition Council. This rule has been subject to criticism. In order to avoid exclusion, the economic operator is given an adequate period of time to prove the legality of the state aid. On the one hand, it is not clear what the legislator means by an appropriate time limit. On the other hand, it is rather strange that the economic operator must overturn an implicit presumption of illegality of state aid, instead of the contracting authority being obliged to prove its illegal nature (acts of the public administration are as a rule presumed legal under Romanian law and court case law until proven otherwise). The law also creates an obligation for the contracting authority to refer the matter directly to the European Commission but not through the Competition Council.¹⁰

5. The Competition Council as the National State Aid Authority

5.1. Generalities

In terms of power to authorise and recover state aid, for the period from 1 January 2000 to 31 December 2006, under the provisions of Act No 143/1999, the Competition Council and the courts, and not of the tax authorities, were responsible for examining the lawfulness or otherwise of state aid and the procedures for recovering and repaying state aid. After 1 January 2007, the date of Romania's accession to the EU, according to the provisions of Government Emergency Ordinance 117/2006 (later replaced by Government Emergency Ordinance No 77/2014, in force at this moment), the competence to declare unlawful state aid and the procedures for recovery and reimbursement of unlawful aid were transferred to the European Commission, with the Competition Council acting as the contact authority between the European Commission and the state aid providers.¹¹

⁹ Art. 210 para. (5) of Act 98/2016 on public procurement.

¹⁰ For details on the role of the Competition Council as the national contact authority in relations with the European Commission, see section 5.

¹¹ High Court of Cassation and Justice, chamber for administrative and fiscal litigation, decision no. 5731/2009; Suceava Court of Appeals, chamber for administrative and fiscal litigation, decision no. 2132/2011; High Court of Cassation and Justice, chamber for administrative and fiscal litigation, decision no. 4061/2014.

The Competition Council acts as the national contact authority in relations between the European Commission and public authorities and institutions, other state aid providers, and state aid beneficiaries involved in state aid procedures.

Providers, beneficiaries, and initiators of state aid and any other undertakings are required to submit to the Competition Council, within the time limits set by the Council, all information necessary for the proceedings before the European Commission. The deadlines set by the Competition Council may not be less than 10 working days, unless the data, information, and documents relating to state aid are required by the European Commission or EU regulations within shorter deadlines. Central and local public authorities, suppliers, and initiators are obliged to consult with the Competition Council when drafting replies, explanations, position papers, or other documents, with a view to forwarding them to the European Commission via the Competition Council and the Permanent Representation of Romania to the EU. The Competition Council together with the supplier or administrator involved will, if necessary, argue the cases before the European Commission.

The Competition Council, upon timely request by the originator or supplier, can withdraw a notification before a decision is issued by the European Commission. A request for withdrawal will be communicated to the European Commission by the Competition Council through the Permanent Representation of Romania to the EU.

The Competition Council informs, within five working days of receipt, the initiators or suppliers about the decisions adopted by the European Commission, received through the Permanent Representation of Romania to the EU, in addition to sending a copy of the decision in question.

The Competition Council publishes on its website, which constitutes the national information point, public information on the adoption of decisions by the European Commission in the field of state aid. The Competition Council informs authorities, other state aid providers, or administrators, beneficiaries, and the public about the EU's state aid rules by publishing guides, monthly newsletters, legislative and case law summaries, and other information material, and by organising seminars, workshops conferences, and the like.

The Competition Council provides expert assistance in the field of state aid to the authorities, other state aid providers, and beneficiaries to ensure that Romania fulfils its obligations as a Member State of the EU, including in the process of drafting regulatory or administrative acts establishing state aid or *de minimis* measures. The Competition Council cooperates with public institutions, other providers, administrators, and beneficiaries of state aid and supports them in the proper application of the EU state aid rules. The Competition Council collaborates with the competent authority to represent Romania before the competent courts at EU level in state aid cases.

The Competition Council, at the request of the supplier, or initiator, may start consultations with the European Commission and issue pre-notifications concerning draft support measures that may constitute state aid.

The Competition Council reports to the government every six months on its activity in the field of state aid.

Any draft measure likely to constitute state aid or *de minimis* aid – initiated by ministries or other specialised bodies of the central public administration, by public authorities or institutions subordinated, coordinated, or under their authority, respectively, as well as by other entities assimilated to them, with attributions in the implementation of the government's policy – must be accompanied by a memorandum approved by the government on the appropriateness of the promotion of the measure and its compliance with the government's economic, budgetary, and financial policies. The memorandum is submitted to the government for approval after obtaining the opinion of the Competition Council.

The institutions initiating state aid or *de minimis* aid measures jointly draft the memorandum referred to above, as a rule, every six months after completing the following stages: (i) obtaining the views of the ministry coordinating policy in the field of European funds regarding ensuring the complementarity of the state aid or *de minimis* aid measure in question with programmes financed by European funds; (ii) consulting with the suppliers within the interministerial council called the Council for the Application of State Aid Policy; (iii) obtaining the opinions of the Ministry of Public Finance on whether the memorandum is in line with the government's economic, budgetary, and financial policies.

However, measures of a *de minimis* or state aid nature are exempted from notification to the European Commission, established by acts adopted, or initiated by the government; further, all measures financed by European funds and those initiated by local public administration authorities do not require drafting of the memorandum. In this case it must be expressly stated that the measures in question fall within the category of exempted state aid or *de minimis* aid.

The mandatory consultations for the application of state aid policy are usually conducted twice a year, during periods set by the Council.

In draft measures likely to represent state aid or *de minimis* aid initiated by local public administration authorities, to ensure coherence with the economic, budgetary, and financial policies of the Romanian state, they must be accompanied by proof that the prefect's institution of the given jurisdiction (county) and the county council have been informed of the intention to establish the respective support measure. The law does not make the submission of an application to the Competition Council conditional on prior approval or endorsement by the prefect or the county council; only a mandatory information procedure needs to be followed. However, this gives rise to a question: When the county council, as a local government authority, initiates such a measure, how can it inform itself?¹²

12 For details on state aid at local level, see Section 5.4.

5.2. Endorsement procedure

Any draft measure likely to constitute state aid or *de minimis* aid, initiated by the supplier, or initiator, must be forwarded to the Competition Council for its endorsement, accompanied by an analysis of its appropriateness. The application for endorsement of measures likely to constitute state aid or *de minimis* aid, drawn up by the supplier, or initiator, must be submitted at the draft stage to the Competition Council, after finalising the consultation procedure. The Competition Council issues an endorsement on the compliance, correctness, and fulfilment of the obligations laid down in European state aid law. The endorsement is published on its website immediately after its adoption. Specific allocations to be notified to the European Commission, granted on the basis of a state aid scheme, are subject to the endorsement of the Competition Council and are exempt from the obligation to prepare the memorandum, appropriateness analysis, and submission to the State Aid Policy Council.

The Competition Council works with the originator or the provider to complete and improve the notifications, information, and documentation relating to the *de minimis* measures to comply with EU rules. Where notifications, information, or documentation relating to *de minimis* measures are amended after the endorsement of the Competition Council has been issued but before transmission to the European Commission or adoption, the amendments should be submitted to the Competition Council for a new endorsement.

For endorsement, the Competition Council may request additional data and information from the originator, or provider. If the requested information is not submitted within the time limit set by the Competition Council, it must issue the endorsement on the basis of the data made available to it and indicate this in the endorsement.

The Competition Council must deliver its endorsement within 10 to 60 days of receipt of the request for an endorsement. Where additional information is required, the time limit is from the date on which the information requested by the Competition Council has been provided. Where pre-consultations have been completed and the pre-notification procedure before the European Commission has been finalised, the Competition Council delivers its endorsement within a maximum of 15 days after receipt of the request for an endorsement, unless the originator, or provider, requests in writing an extension of the time limit for completing the notification or information. If the endorsement issued by the Competition Council does not propose any changes or make any recommendations, the Competition Council, at the request of the initiator or supplier, sends the notification to the European Commission, in the form approved, after the government has approved the memorandum on the appropriateness of promoting the measure in question and its compatibility with the government's economic, budgetary, and financial policies. If the notification does not propose any changes to the information or documentation relating to the *de minimis* measures, the supplier or the initiator may adopt the state aid or *de minimis* measure, subject to the legal provisions in force.

For state aid measures that require the European Commission's authorisation, if the Competition Council's endorsement has proposed changes, and the initiator or the provider agrees with them, it has to submit to the Competition Council the notification amended in accordance with the endorsement for transmission to the European Commission, following the government's approval of the memorandum referred to above. If the Competition Council's endorsement proposes changes to the information or documentation relating to the *de minimis* measures, and the initiator or the supplier agrees with them, it may adopt the state aid or *de minimis* measure, subject to the legal provisions in force.

If the initiator or the provider does not agree with the changes proposed by the Competition Council, based on EU rules and national legislation, it submits to the Competition Council a reasoning for the non-acceptance of the proposed changes, within 20 days of receiving the endorsement.

The Competition Council will examine the documents submitted by the originator or supplier and will issue a new endorsement within a maximum of 30 days of receipt of the reasoning from the originator or supplier.

5.3. Amendment of regulatory or administrative acts

Amendments to the legal or administrative acts implementing state aid or *de minimis* aid, which may affect the assessment of the compatibility of the aid measure, with reference to duration, granting instrument, eligibility, and granting conditions, or increase the budget of the measure or the number of beneficiaries by more than 20%, can be made with the endorsement of the Competition Council.

Amendments to the regulatory or administrative acts implementing state or *de minimis* aid are exempted from drafting a memorandum and submitting it to the Interministerial Council for the Implementation of State Aid Policy.

5.4. State aid at the local level

When examining the legality of administrative acts establishing support measures by local authorities, the prefect¹³ is obliged to verify the existence of the endorsement issued by the Competition Council. In the case of *de minimis* aid measures, when

13 The prefect is the representative of the government in each county and in the Municipality of Bucharest. At the county level, the prefect directs the decentralised structures subordinate to the various ministries and other bodies of the central public administration. Between the prefects, on the one hand, and the local councils and the mayors, as well as the county councils and their presidents, on the other, no relationships of formal subordination exist. However, the prefect exercises vast influence over councils, mayors, and presidents of county councils, as the Romanian concept of public administration is based on the cvasi-centralised model in which the prefect represents the national interest, which, in practice, limits the idea of local self-government. One of the main tasks of the prefect is to exercise control of legality over the acts of local governments. In this sense, the prefect may challenge, before the administrative court, an act of the county council, a local council, or a mayor, in case it is deemed unlawful. The act thus challenged shall be suspended *ope legis*.

examining the existence of the endorsement of the Competition Council, the prefect will also verify compliance with the legal provisions on state aid. In the case of measures adopted by local public authorities for granting an economic advantage to an enterprise, the prefect requests the Competition Council for endorsement, if it does not have one, based on national and EU rules on state aid.¹⁴

5.5. Optional consultations

In addition to mandatory consultations, optional consultations also exist. Central and local public authorities and institutions, as well as other entities controlled by the state or administering state resources, may initiate prior consultations with the Competition Council to establish the classification of the measures to be introduced by those acts as state aid or *de minimis* aid and the conditions under which the measures may be implemented. The initiators of such draft acts must submit to the Competition Council, in good time, the documentation on the projects establishing measures that may constitute state aid or *de minimis* aid. The Competition Council will decide on the documentation received and invite the providers, or initiators, if any, to submit applications for the endorsement of projects concerning measures likely to constitute state aid or *de minimis* aid within 10 to 20 working days from the time of completion of documentation. During prior consultations with the Competition Council, the Romanian authorities may also initiate consultations with the European Commission through the pre-notification procedure.

5.6. Notification and information procedure

The final form of the notification or information is to be submitted to the Competition Council by the originator or supplier for transmission to the European Commission. In the case of measures for which a memorandum has to be drawn up, the notification or information is to be submitted to the European Commission after the memorandum approved by the government has been communicated to the Competition Council.

The notifications must be sent to the European Commission, via the Competition Council and the Permanent Representation of Romania to the EU, in the format prescribed in the relevant European legislation, within a maximum of 20 working days from the adoption of the legislative or administrative act establishing the state aid measure.

If the initiator or the supplier does not request the submission of the notification within 30 days from the service of the endorsement of the Competition Council or the approval of the memorandum, it will be deemed to have waived it. If, after the expiry of this period, the originator or the supplier wishes to submit the notification or the information to the European Commission, the procedure must be resumed from the start.

¹⁴ For further details, see: Alexe, 2017.

5.7. Procedure for granting *de minimis* aid

The final form of the regulatory or administrative acts implementing *de minimis* aid should be submitted to the Competition Council for information within 15 days of the date of adoption and then published on the website of the supplier and the Competition Council.

The provider or the administrator of *de minimis* aid measures informs the beneficiaries, at the time the aid is granted, of the *de minimis* character of the aid and verifies compliance with the *de minimis* ceiling imposed by the EU law.

5.8. Procedure when aid is compensation for provision of a service of general economic interest

Draft legislative or administrative acts establishing schemes or individual aid in the form of compensation for the provision of a service of general economic interest or a public service obligation, for which notification to the European Commission is not required, should be forwarded to the Competition Council for its endorsement.

Draft laws, regulations, or administrative provisions establishing schemes or individual aid in the form of compensation for the provision of a service of general economic interest or a public service obligation, for which notification to the European Commission is required, should be forwarded to the Competition Council for its endorsement.

5.9. Monitoring of state aid and *de minimis* aid

State aid or *de minimis* aid granted is monitored for each individual measure by the provider or the administrator of the measure. On-the-spot checks in accordance with the legal provisions in force may be conducted to verify compliance with the conditions for granting the aid and appropriate measures may be taken if these conditions have not been met. The supplier or the administrator may issue decisions ordering the suspension or recovery of state aid or *de minimis* aid granted. Such decisions are enforceable.

Providers and beneficiaries of state aid are responsible, according to the law, for the accuracy and completeness of the data and information submitted to the Competition Council.

Aid providers are obliged to submit to the Competition Council, in the format requested by the Council, all data and information necessary for the monitoring of state aid or *de minimis* aid at the national level, including for the preparation of the state aid and *de minimis* aid inventory and the reports and information necessary to fulfil Romania's obligations as a Member State of the EU. Beneficiaries of state aid or *de minimis* aid are obliged to submit to the provider, or administrator, periodic reports and other information on the aid granted, as requested by the provider, or administrator, under the sanctions provided for in Emergency Ordinance No. 77/2014.

The Competition Council monitors state aid and *de minimis* aid at the national level on the basis of reports, information, and data submitted by suppliers. The Competition Council may request data and information from the supplier when, on the basis of the information provided, the conditions for granting state aid or *de minimis* aid may not have been met. After analysing the data and information submitted by the supplier, the Competition Council may require the supplier to take the necessary measures to ensure compliance with state aid and *de minimis* legislation. The supplier may, within 20 working days of receipt of the request, raise objections, which will be forwarded to the Competition Council for its consideration and endorsement. If the data and information submitted by the supplier do not clarify the issues raised, the Competition Council may order an inspection of the undertaking benefiting from the support measure in compliance with the legal provisions in force. The Competition Council's inspection team will be accompanied by representatives of the supplier. The conclusions of the Competition Council's analysis or verification action are recorded in a report, which, if appropriate, will require the supplier to take the necessary measures to ensure compliance with the state aid legislation. The supplier may, within 20 working days of receipt of the request, raise objections, which will be forwarded to the Competition Council for analysis and endorsement.

The supplier is obliged to inform the Competition Council, within 30 working days from when the endorsement was sent, about the state of implementation of the measures ordered by the Competition Council; in case of non-implementation of the measures, within 20 working days from the receipt of the request, the supplier must send the reasons for non-implementation to the Competition Council.

If necessary, the Competition Council issues decisions to stop or recover *de minimis* aid. Decisions issued by the Competition Council are enforceable. These decisions must be forwarded, together with proof of receipt, by the beneficiaries, within 20 working days of the date of issue of the decision, with a view to recovery of the *de minimis* aid, including interest thereon, to the competent tax authorities, and the amounts thus realised will be paid to the state budget.¹⁵ Competition Council decisions can be challenged before the Bucharest Court of Appeal.

5.10. State aid inventory: State aid and de minimis aid register

The Competition Council drafts and updates the inventory of state aid and *de minimis* aid based on reports, data, and information received from suppliers, in accordance with the provisions of the applicable emergency ordinance. The Competition Council draws up the reports and provides the information necessary for the

¹⁵ Regarding the problem of interests see section 6 from the present chapter. The Competition Council will calculate the amount of interest for the period from the date of payment of the *de minimis* aid up to and including the date of issue of the recovery decision, and the tax authorities will calculate the amount of interest for the period from the date of issue of the recovery decision up to and including the date of recovery or full repayment.

fulfilment of Romania's obligations as a Member State of the EU and any other reports and studies in the field of state aid or *de minimis* aid, based on the state aid inventory, data, and information submitted by the suppliers, respectively, information provided on the request of the Competition Council by suppliers and beneficiaries. The data and information necessary for drafting and updating the inventory and for preparing reports and studies must be submitted by the state aid or *de minimis* aid providers in accordance with the procedures laid down in the Competition Council Regulations.

The Competition Council organises and maintains a register of state aid and *de minimis* aid granted in Romania. The register is maintained by the supplier, or administrator, where applicable, who is responsible for the accuracy and completeness of the data entered.

With a view to transposing the Commission Directive 2006/111/EC of 16 November 2006 on the Transparency of Financial Relations between Member States and Public Undertakings as well as on the Transparency of Financial Relations within Certain Undertakings, the Competition Council supervises the financial relations between the entities to which the scope of the Directive extends, including those entrusted with the provision of services of general economic interest on the basis of reports, information, and data submitted by public authorities. Public authorities are required to keep records of the financial relations between themselves and the public undertakings referred to above and provide the Competition Council, at its request, information in connection with these relations. Public undertakings, undertakings providing a service of general economic interest and undertakings benefiting from special or exclusive rights, which receive compensation in any form for these services and which also carry out other activities, are obliged to keep specific records by activity to ensure financial transparency, to transmit, at the request of the Competition Council, the information requested in relation to these relationships, and to communicate annually to the Competition Council whether the conditions for classification of these services as a public undertaking are fulfilled.

5.11. Procedural rules

The deadlines set by the Competition Council for the receipt of reports, information, and data in the monitoring process may not be less than 30 days, unless the data, information, and documents on state aid are requested by the European Commission or required by EU regulations within shorter deadlines.

While the European Commission carries out an on-the-spot check in accordance with the provisions of Art. 27 of Regulation (EU) 2015/1589, the Competition Council together with the supplier may raise duly substantiated objections to the appointment of experts chosen and authorised by the European Commission to assist with the check. The Competition Council, together with the state aid providers, appoints representatives authorised to assist the European Commission in the on-the-spot verification. The Competition Council, the authorities, other providers, and beneficiaries

of state aid cooperate with the staff mandated by the European Commission to carry out the on-the-spot verification in accordance with the legal procedures in force.

European Commission decisions ordering the recovery of unlawful or misused state aid, which have not been suspended in accordance with applicable EU law, are enforceable titles for the recovery of amounts by the supplier from the beneficiaries of unlawful state aid.

6. Repayment, recovery, suspension, or provisional recovery of state aid or *de minimis* aid ordered by the European Commission

The beneficiary of a state aid or *de minimis* aid is obliged to repay the amount of state aid or *de minimis* aid whose recovery has been ordered by the European Commission unless the implementation of the European Commission's decision has been suspended in accordance with EU rules. Specific problems were raised in the context of insolvent beneficiaries of state aid. The fact that the Commission's decision constitutes a special enforceable title does not entitle the Romanian court to hold that the claim thus recognised enjoys special priority, nor that the decision will apply absolutely independently of the national rules, which, in the present case, considering the recovery rates in both proposed scenarios, cannot be regarded as affecting the immediate and effective recovery of the aid. Romanian courts did not find in the case-law of the Court of Justice of the European Union (CJEU) any recognition of a special priority for creditors providing state aid if the debtor is in insolvency, but rather constant references to national rules that must be applied to ensure immediate and effective recovery of state aid.¹⁶

State aid or *de minimis* aid to be repaid or recovered must include interest thereon from the date of its payment until the date of its recovery or full repayment.¹⁷ The procedure for calculating the interest is laid down in instructions issued by the Competition Council. The provider or administrator of state aid or *de minimis* aid calculates the interest amount. The Romanian courts state that the particular situation of a debtor becoming insolvent cannot be ignored. State aid law cannot be considered to have a special norm in relation to the provisions of insolvency law; on the contrary, it is a rule of general character for the recovery of unlawfully granted state aid, which is applicable insofar as no other special rules apply. However, the debtor is in insolvency; hence, recovery of state aid can be affected not in accordance with

¹⁶ Pitești Court of Appeals, second civil, administrative and fiscal chamber, decisions no. 529 and 530 of 25 June 2020.

¹⁷ The applicable interest rate is that set in accordance with Regulation (EU) 2015/1589.

the provisions of the general law on the subject, but only in the light of the special rules applicable to insolvency.¹⁸

To tackle this problem, Act No 20/2015 and Emergency Ordinance No 6/2020 created a special regime for insolvent companies, generating a framework of priority for state aid recovery. In cases where recovery of state aid, or *de minimis* aid, has been ordered and the beneficiary of the aid is under insolvency proceedings, the national court handling the insolvency proceedings must ensure the immediate and effective implementation of the recovery decision. The court will agree to enter the claim for repayment of the aid in question in the list of claims, together with the interest accrued thereon, up to the time limits laid down by national insolvency law applicable to all creditors. The ranking of the claim is to be determined in accordance with the insolvency legislation and will not be lower than that of ordinary unsecured claims. By way of derogation from the provisions of insolvency legislation, the entry of the claim arising from a decision to recover aid must be followed by the recovery of the full amount of the aid or, if this is not possible, by the liquidation of the undertaking and the definitive cessation of its activity. It should also be added that this is mandatory if the undertaking is under a preventative restructuring or it functions under a reorganisation plan. In the case of recovery decisions issued by the European Commission, recovery must be affected within the time limit set by the Commission.

Where suppliers or administrators do not have their own enforcement bodies or when more than one public authority supplier exists, they may forward recovery decisions together with proof of receipt by the beneficiaries within 20 working days of the date of issue of the decision at the latest, with a view to recovering state aid or *de minimis* aid, including interest thereon, to the competent tax authorities. Providers or administrators shall calculate the amount of interest for the period between the date of payment of the state aid or *de minimis* aid and the date of issue of the recovery decision included and inform the competent tax authorities of it. The competent tax authorities will then calculate the amount of interest for the period between the date of issue of the recovery decision and the date of recovery or reimbursement in full. The sums thus realised will be paid to the state budget, unless otherwise provided by law.

The beneficiary may not receive any further state aid or *de minimis* aid until the repayment obligation has been fulfilled.

The Competition Council must forward to the state aid provider a copy of the European Commission's decision ordering the recovery of unlawful state aid or misused aid, received via the Permanent Representation of Romania to the EU. The state aid provider must forward a copy of the European Commission's decision to the beneficiary within five working days of receipt. State aid providers or administrators, where applicable, are obliged to take the necessary legal measures to implement the European Commission's decision. The state aid provider must inform the beneficiary

¹⁸ Pitești Court of Appeals, second civil, administrative and fiscal chamber, Decision No 504/R-COM of 18 June 2020.

of the state aid, within a maximum of five working days of receipt of the decision, of the obligation to repay or recover the unlawful or misused state aid resulting from the European Commission's decision.

The Competition Council acts as the national contact authority between the European Commission and state aid providers in the procedure for adopting decisions to suspend or provisionally recover state aid, in accordance with the provisions of Art. 13 of Regulation (EU) 2015/1589.

The Competition Council must, within five working days of receipt, send a copy of the decision ordering the suspension or provisional recovery of state aid to the supplier. State aid providers or administrators are obliged to take the necessary measures to implement the European Commission's decision. Pursuant to Art. 13 para. (1) of Regulation (EU) 2015/1589, the state aid provider will suspend the granting of state aid from the date of receipt of the European Commission's decision via the Competition Council. The act by which the state aid provider orders the suspension of state aid will have the effect of immediately terminating the grants of state aid until the compatibility of the financial support measure with EU rules has been established.

Providers of state aid or *de minimis* aid must submit information to the Competition Council information and documentation on the status of recovery, provisional recovery, or suspension of state aid on a monthly basis.

7. European Commission decisions ordering the initiation of the investigation procedure

Where the European Commission orders the opening of an investigation into the existence of unlawful state aid, the Competition Council must forward to the state aid provider a copy of the decision, received via the Permanent Representation of Romania to the EU, and the state aid provider must forward a copy of such a decision to the beneficiary, within a maximum of five working days from receipt. State aid providers or administrators are obliged to take the necessary legal measures to implement the European Commission's decision. The state aid provider notifies the beneficiary of the state aid of the investigation within a maximum of five working days of receipt of the decision.

If the investigation procedure is initiated by the European Commission concerning the granting of allegedly unlawful aid, the provider must request the imposition of safeguard measures, under the terms of the Tax Procedure Code, on the assets of the beneficiary of state aid, for an amount equivalent to the amount of unlawful state aid considered by the European Commission, as estimated by the provider.

Where the European Commission has decided to start an investigation procedure in respect of state aid measures ordered by an enforceable title consisting of

a judgement or arbitration award (issued in favour of the beneficiary), from the date of communication of the European Commission's decision to open the investigation procedure to the supplier, any enforcement of this title may not start or will be suspended *ope legis*.¹⁹

To implement the enforceable title, the state aid provider must (within one working day from the date of service regarding the investigation to the beneficiary) apply to the State Treasury with which it has opened accounts for the opening of a special interest-bearing account in the name of the creditors and, where applicable, at the disposal of the bailiff. The interest applicable to the funds in the special-purpose account shall be the sight interest charged by the State Treasury, and the source of payment of such interest shall be the State Treasury budget. The application for opening the account shall contain the names of the creditors and, where applicable, of the bailiff for whom the account is opened. Within a maximum of 30 days from the date on which the account is opened in the name of the creditors and, where applicable, at the disposal of the bailiff, the state aid provider must enter in the account opened with the State Treasury the amount required to discharge the obligation covered by the enforceable title and the costs of enforcement incurred till the date of the automatic suspension, less the obligations discharged up to the date of the automatic suspension. In calculating the amounts credited, the supplier must consider the method of calculating interest used in determining the amounts in enforceable titles, including those issued by the bailiff. Once the sums have been credited to the account opened with the State Treasury, the supplier must immediately inform the creditors and the bailiff.

19 For the reasons of these rules see for example: Matei, 2016; Momic, 2019; Bernabeu, 2020; Northmore-Ball, Harvey and Courtier, 2021; Struckmann and De Catelle, 2021; Finckenberg-Broman, 2022; Hestermeyer, 2022; Pérez-Bernabeu, 2023. The Micula case involved a dispute over state aid granted to the Micula brothers (originally from Romania but bearing Swedish nationality). In the late 1990s, the Micula brothers invested in various sectors in Romania, and the Romanian government granted them incentives to encourage economic development in disadvantaged regions. However, in 2007, Romania joined the EU and committed to aligning its policies with EU rules, including those on state aid. Subsequently, Romania withdrew the incentives and demanded the Micula brothers to repay the aid received. The Micula brothers initiated arbitration proceedings against Romania, claiming that the withdrawal of incentives violated their rights and the bilateral investment treaty between Romania and Sweden. The arbitration tribunal ruled in favour of the Micula brothers, ordering Romania to compensate them for the withdrawal of state aid. Romania challenged the decision, arguing that it violated the EU state aid rules. The European Commission also opposed the enforcement of the award, contending that it would undermine the EU state aid framework. The case led to complex legal disputes involving issues of international investment law, EU law, and the interaction between the two. The legal battle raised questions about the relationship between investor-state arbitration and EU law, as well as the balance between protecting investors' rights and preserving the EU's ability to enforce its competition rules. The General Court stated that the European Commission had retroactively applied its competences to facts pre-dating the accession of Romania to the European Union on 1 January 2007, but the European Court of Justice (ECJ) treated the arbitral award as state aid, which was granted after Romania's accession to the European Union. See: CJEU, 25 January 2022, C-638/19 P, *Commission v. European Food SA and Others*, ECLI:EU:C:2022:50.

On the date on which the sums are entered, the enforcement measures by which attachments have been made and those by which distraints have been imposed on the assets of the state aid provider up to the date of suspension automatically lapse. The other acts of enforcement remain subject to the time limits and conditions for appeal laid down in the Code of Civil Procedure.

Proof of the deposit of the sums, by which the enforceable title has been enforced, shall be communicated by the provider to all persons against whom attachments and seizures have been established, who shall also be notified of the automatic termination of these measures.

Creditors who are dissatisfied with the amount of the sums recorded and the bailiff who is dissatisfied with the amount of the enforcement costs recorded may request the supplier to increase the amount. Within 15 days of receipt of the request for an increase, the state aid provider is obliged to settle the request. The person claiming to have suffered damage may lodge an action before the administrative court against the decision or the refusal to decide on the request within the time limit referred to above.

The state aid provider is obliged to amend the amount of the aid in the light of court rulings in any legal proceedings, by increasing or decreasing the amount of the aid within 30 days of the date on which those rulings become final.

Failure to pay the sums in time or to alter the amount within the legal time limit would result in the suspension of enforcement being lifted. If it is impossible to secure these funds, the sums required for deposit with the State Treasury may be allocated, by government decision, to the chief authorising officers from the budgetary reserve fund available to the government.

If the sums are deposited in the name of creditors, at the request of the state aid provider, accompanied by a copy of the decision of the European Commission on the initiation of the investigation procedure, the State Treasury shall freeze the amount deposited until the European Commission's decision on the compatibility of the state aid with the internal market is served to the provider.

Two possibilities exist: the European Commission may find the state aid compatible with the internal market, or it may find it incompatible.

In the first situation, upon completion of the investigation, the state aid provider must, within a maximum of five working days of receipt, communicate a copy of the European Commission's decision on the compatibility of the state aid with the internal market to the creditors and, where appropriate, to the bailiff. Upon receipt of the European Commission's decision finding the state aid to be compatible with the internal market, based on that decision, the freezing of the amount of aid or, where appropriate, the suspension of enforcement ceases. The state aid provider shall forward to the State Treasury the European Commission's decision and the list of individualised amounts that may be used by each creditor or bailiff as well as the identification data and specimen signatures of the persons who may order transactions from the account. Amounts credited in excess of the amounts due to creditors

or bailiffs shall be transferred by the State Treasury to a separate budget revenue account at the request of the state aid provider.

In the second case, within a maximum of five working days of receipt of the European Commission's decision finding the state aid incompatible with the internal market, the state aid provider shall serve this decision, which is enforceable, to the State Treasury and shall request enforcement by transferring the sums credited to a separate budget revenue account. From the date of service, the suspension of enforcement ceases, and enforcement may continue for any amounts still to be enforced as the difference between the enforceable title materialised by the European Commission's decision and the enforceable title invoked by the beneficiary in its favour.

Continuation of enforcement after the *ope legis* suspension and until its termination constitutes disciplinary misconduct and may, depending on the seriousness of the offence, be punishable by disqualification from the profession, if the acts do not constitute an act sanctioned under criminal law. The enforcement acts followed during the suspension become null and void. The disciplinary offence shall be established and sanctioned in accordance with Act No 188/2000 on bailiffs, republished, with subsequent amendments and additions.

8. Repayment, recovery, suspension, or provisional recovery of unlawful aid and misused state aid ordered by suppliers

Providers or administrators must order the recovery of state aid or *de minimis* aid where the conditions for granting the aid have not been respected, and where unlawful aid has been granted without fulfilling the compatibility conditions laid down in the applicable European legislation. The legal provisions on interest and recovery by the competent tax authorities are also applicable in this situation if the provider or administrator does not have its own enforcement bodies.

Pending the decision ordering the recovery of the state aid granted, the provider or the administrator may request the competent tax authorities to take preventative measures against the assets of the beneficiaries of state aid in an amount equivalent to the amount of unlawful or misused state aid estimated by the provider or the administrator.

Providers are obliged to inform the Competition Council within five working days after the final decision of the national courts on the recovery of state aid or *de minimis* aid. Suppliers are also required to submit to the Competition Council, for information, within five working days of adoption, their own decisions ordering the recovery of state aid or *de minimis* aid.

9. Role of national courts in the field of state aid

National courts will ensure the direct applicability of Art. 108 para. (3) of the TFEU by adopting any necessary measures in accordance with the applicable national procedural rules. The court's judgement may order, *inter alia*: suspension of payment of unlawful aid, recovery of unlawful aid, recovery of appropriate interest, and compensation for affected competitors. Courts will consider, in applying national legal provisions, the European Commission's decisions ordering the recovery of aid. National courts are obliged to verify whether the contested measure has been declared state aid by the European Commission or by the supplier. If the measure has been declared as state aid by the European Commission, the national court cannot alter the state aid character of the support measure. The Competition Council and/or the European Commission may intervene in the case as *amicus curiae*.

If the provider grants the aid in breach of the notification obligation or the cease-and-desist clause, national courts may take the necessary measures to protect the parties concerned, including by way of interim measures if appropriate. The beneficiary of unlawful state aid may not receive any further aid until all the measures ordered by the national court decision ordering recovery of the aid have been complied with, except aid to make good the damage caused by certain natural disasters.

Undertakings affected by the granting of unlawful aid may lodge an action against this measure before the Bucharest Court of Appeal.

In cases where recovery of state aid or *de minimis* aid has been ordered and the aid beneficiary is subject to insolvency proceedings, the national court conducting the insolvency proceedings will ensure immediate and effective enforcement of the recovery decision. The court will agree to enter the claim for repayment of the aid in question in the schedule of claims, together with the interest accrued thereon, up to the time limit laid down by national insolvency law applicable to all creditors. The ranking of the claim will be determined in accordance with Act No. 85/2014 on insolvency prevention and insolvency proceedings, as subsequently amended and supplemented, and will not be lower than that of ordinary unsecured claims. By way of derogation from the provisions of Act No 85/2014, the entry of the claim arising from a decision to recover aid must be followed by the recovery of the full amount of the aid or, if this is not possible, by the liquidation of the undertaking and the definitive cessation of its activity. In the case of recovery decisions issued by the European Commission, recovery must be affected within the time limit set by the Commission.

In a particular case, as the applicant pointed out, the granting of state guarantees to a company for taking a loan for the acquisition of another company constitutes individual state aid. As a result, the implementation of this individual state aid without notification to the European Commission constitutes illegal state aid. In this respect, it is for the national courts to prevent the implementation of unlawful state aid. National courts are often called upon to intervene in cases where a Member State authority has granted aid without respecting the obligation not to implement

the intended measures. This situation arises either because the aid was not notified or because the authority implemented the aid before obtaining the Commission's approval. The role of national courts in such cases is to protect the rights of persons affected by the unlawful implementation of aid. In the present case, it is important to note that, when the applicability of a state aid scheme is challenged with regard to a particular state aid measure, the national court can only assess the fulfilment of all the conditions of that scheme. The national court cannot and should not assess the compatibility of an aid measure where these conditions are not fulfilled, as this assessment remains the sole responsibility of the Commission. Further, for the national court to verify whether a measure is state aid or not, the state aid must actually be granted; hence, the application for annulment is premature. The Court held also that any interested party may also inform the Commission of any alleged unlawful aid and of any alleged misuse of aid.²⁰

10. Obligations of the provider or administrator and beneficiary of state aid or *de minimis* aid: Transparency

The provider or the administrator of a state aid or *de minimis* aid measure is obliged to inform the Competition Council of the entry into force of the support measure, as well as of any changes to the support measure, no later than 5 days after this event has taken place. These entities are also obliged to keep a record of the information regarding the aid granted for a period of at least 10 years from the date on which the last specific allocation was granted. This record must contain the information necessary to demonstrate compliance with all the conditions laid down in the granting act, such as, but without being limited to identification of the beneficiary, duration, eligible expenditure, amount, timing and method of granting the aid, origin of the aid, duration, method of calculation of the aid granted.

The beneficiary of a state aid or *de minimis* aid measure is required to maintain a record of the information regarding the aid received for at least 10 years from the date on which the last specific allocation was granted. This record must contain the information necessary to demonstrate compliance with all the conditions laid down in the granting act, such as: identification of the beneficiary, duration, eligible expenditure, amount, timing and method of granting the aid, origin of the aid, duration, and the method of calculating the aid granted.

The beneficiary is obliged to reply, within the deadline set by the Competition Council, to any request for information on the state aid or *de minimis* aid received. The deadline set by the Competition Council may not be less than five working days.

²⁰ Bucharest Courts of Appeals, chamber VIII for administrative and fiscal litigation, decision no. 676/2010.

The Competition Council's state aid website²¹ is the only national state aid website within the meaning of the EU rules for ensuring transparency of state aid measures. The Competition Council will publish on the state aid website all information related to state aid and *de minimis* aid measures implemented in Romania, in accordance with the EU rules on state aid.

Providers or administrators, where applicable, are also obliged to publish on their own websites the state aid and *de minimis* aid measures.

11. Contraventions and sanctions

National state aid rules are protected by a system of administrative liability. Thus, certain acts of state aid beneficiaries – such as providing incomplete information and documents, as well as failure to provide the requested information and documents within the deadlines set by the Competition Council or public authority suppliers; refusal to submit to control; failure to keep specific records on the state aid received – constitute contraventions and are punishable by a fine of between RON 5,000 and RON 40,000. The finding of contraventions and the application of sanctions shall be made by the persons empowered by the Competition Council or the suppliers. Complaints may be lodged with the District Court of Sector 1 Bucharest within 15 days of notification against the official reports of the finding and sanctioning of the contraventions provided for in the above.

The following acts of the suppliers or administrators also constitute contraventions and are punishable by a fine of between RON 5,000 and RON 40,000: providing incomplete information and documents, as well as failure to provide the requested information and documents within the deadlines set by the Competition Council; failure to comply with the procedure for approving regulatory acts with an impact on state aid; failure to take recovery measures ordered by decision of the European Commission; failure to forward to the Competition Council their own decisions on the recovery of state aid; and failure to maintain specific records on state aid granted.

These infringements shall be established and sanctioned by decision of the Competition Council Commission comprising three members of the Plenary of the Competition Council appointed by order of the President of the Competition Council. As an exception, these infringements shall be established and sanctioned by the decision of the Plenary of the Competition Council, at the reasonable request of at least one member of the Commission, formulated in cases with a high degree of complexity. The Competition Council's decisions will be argued and served to the parties involved within a maximum of 120 days of the deliberation and will be published on

21 *Consiliul Concurenței România* [Online]. Available at: www.ajutordestat.ro (Accessed: 15 January 2024).

the Competition Council's website for the legitimate interest of any party involved. Sanctions shall be imposed by the same decision that establishes the infringement. Decisions of the Competition Council establishing and imposing sanctions may be challenged by way of administrative action, which must be lodged at the Bucharest Court of Appeal, Administrative Litigation Section, within 30 days of the service of the contested decision.

Enforcement of fines for all contraventions listed here is subject to prescription (arising from the statute of limitations) within 3 years from the date of the offence.

The law also allows the Competition Council, if there is opposition to any control measure, to request the police to accompany and provide the necessary support to the control teams in the exercise of their powers.

12. Transitory state aid measures in crises

A recent testing of the state aid system was the context of the economic crisis created by the COVID-19 pandemic. Romania, like many other countries, implemented various measures to provide financial support and aid during the pandemic. The total cost of support measures related to COVID-19 amounted to 4.85% of the GDP in 2020.²² The main legal norm regulating these transitory tools of state economic intervention was Emergency Ordinance No 29/2020 on some economic and fiscal-budgetary measures, and its later modifications (Emergency Ordinances 90/2020, 99/2020 and 181/2020). The measures taken included economic stimulus packages and state aid for businesses. The Romanian government launched several economic stimulus packages to support businesses and individuals affected by the pandemic. These packages included financial assistance, tax breaks, and subsidies for various sectors. In March 2020, Romania announced an initial economic stimulus package to address the immediate impacts of the pandemic. This package included measures such as postponing tax payments, providing liquidity support to businesses through state-guaranteed loans, interest subsidies and subsidies for furloughed employees (75% of the employee's gross monthly salary, without exceeding 75% of the gross average wage). In July 2020, the Romanian government unveiled a second economic stimulus package aimed at supporting businesses and stimulating economic recovery. This package included measures such as reducing VAT rates for certain sectors, extending payment deadlines for taxes and utility bills, and providing financial aid to small- and medium-sized enterprises (SMEs). Throughout the pandemic, Romania continued to introduce additional economic stimulus measures to address evolving challenges and support businesses. These measures included targeted support for industries severely affected by the pandemic, such as tourism,

²² Fegyveresi and Szentpáli-Gavallér, 2022, p. 238.

hospitality, and transportation. Romania also provided state aid to businesses affected by the pandemic to help them stay afloat and retain employees and to cover expenses such as rent, utilities, and employee wages. These grants were often targeted toward SMEs and sectors facing significant financial hardships. The aid often was in the form of grants, loans, and subsidies. Businesses in Romania were granted tax relief measures, including deferrals of tax payments and reductions in tax rates for certain sectors. These measures aimed to alleviate financial burdens on businesses and improve cash flow during the challenging period. The government facilitated access to financing for businesses by offering state-guaranteed loans with favourable terms and conditions. These loans were provided through financial institutions and aimed to support businesses in maintaining operations and retaining employees. Certain industries, such as tourism, hospitality, and entertainment, received targeted state aid to help them deal the adverse effects of the pandemic. This support included financial assistance, tax incentives, and promotional campaigns to stimulate demand (sector-specific support). These economic stimulus packages and state aid measures were part of Romania's broader efforts to mitigate the socio-economic impact of the COVID-19 pandemic and support businesses through unprecedented challenges.²³

13. Indirect aid

Tax relief in Romania is a form of indirect state aid aimed at promoting specific economic activities, regions, or sectors while providing financial incentives to eligible taxpayers. Tax relief measures are governed by national legislation and the EU state aid rules. Tax relief measures in Romania are primarily regulated by Law No. 227/2015 of the Tax Code. This law establishes the general framework for taxation in Romania and includes provisions related to tax incentives, exemptions, deductions, and credits. As a principle, the Tax Code states in Art. 4 that any measure of a fiscal nature that constitutes state aid shall be granted in accordance with the legal provisions in force on state aid. The detailed fiscal measures are regulated by Law No. 207/2015 regarding the Tax Procedure Code. Romania offers various tax incentives to stimulate economic growth, investment, and innovation. These incentives may include reduced corporate income tax rates for certain activities or regions, tax deductions for research and development expenditures, and tax credits for investments in specific sectors. Tax relief measures may also be used to support regional development objectives in line with the EU state aid rules. Romania has implemented regional aid schemes to promote investment and job creation in less developed regions, including tax incentives for companies operating in designated areas. Tax relief measures must comply with the EU state aid rules to prevent distortions of

23 For further details, see: Fegyveresi and Szentpáli-Gavallér, 2022, pp. 238–243.

competition in the internal market. The European Commission's guidelines on regional aid and other forms of state aid provide criteria and conditions for assessing the compatibility of tax relief measures with EU regulations.

Tax relief measures in Romania serve as important tools to support economic development, stimulate investment, and encourage innovation while ensuring compliance with the EU state aid rules. Eligible taxpayers may benefit from various tax incentives designed to promote specific activities or regions and contribute to the country's overall growth and competitiveness.

14. Decisions regarding illegal state aid and general conclusions

The reality of state aid is a highly complex and interesting phenomenon in the economy of every state. It is worth looking at how it works through a few examples. The European Commission launched a total of 22 formal investigations regarding state aid in Romania between 2007 and 2024 and issued eight negative decisions with recovery, as shown in Table 1:

Table 1: European Commission decisions regarding illegal state aid in Romanian cases

Case number	Illegal aid	Last decision date	Type of illegal state aid (aid instrument)
SA.62829	Restructuring aid to Blue Air	16.02.2024	Guarantee
SA.36086	Aid to Olthchim	30.06.2022	Debt write-off
SA.48394	Restructuring of National Uranium Company (Companiei Nationale a Uranului CNU)	24.02.2020	Debt write-off Direct grant Equity intervention
SA.43549	Aid to CFR Marfa	24.02.2020	Equity intervention
SA.38517	Micula v Romania (ICSID arbitration award)	07.12.2018	Tax advantage or tax exemption
SA.43785	Aid to CE Hunedoara	08.11.2018	Loan/repayable advances
SA.33475	Incompatible aid through preferential tariffs in contracts between Hidroelectrica S.A. and thermoelectricity sellers	20.04.2015	Preferential tariffs

Case number	Illegal aid	Last decision date	Type of illegal state aid (aid instrument)
SA.24127	Privatisation of Automobile Craiova, Romania	27.02.2008	Debt write-off Guarantee

An ongoing complex case is of the national air operator Tarom, recipient of important state aid packages and practically in a permanent status of crisis (17 general directors in 7 years; approximate state aid of EUR 120 million in the last three years; 18 years of economic losses). The continuous restructuring of the company is expected to resume in 2024, anticipating the approval of the European Commission for new state aid. Questions are raised on (i) whether the proposed restructuring plans are adequate to resolve Tarom's difficulties and to restore its long-term viability within a reasonable timescale without further state aid; (ii) whether Tarom or market operators would sufficiently contribute to the restructuring costs, thereby ensuring that the restructuring plan does not rely excessively on public funding and that the aid is proportionate; and (iii) whether the restructuring plan would be accompanied by appropriate measures to limit the distortions of competition created by the aid.²⁴ The company's restructuring plans are mainly aimed at fleet renewal, restructuring measures, and commercial optimisation (re-optimisation of routes, renegotiation of contracts with suppliers, closure of unprofitable agencies, etc.), organisational efficiency measures, measures to cost optimisation measures (e.g. aimed at reducing fuel consumption and handling costs), as well as covering cash shortfalls. The total cost of the restructuring is estimated at EUR 408.4 million. To make it functional, the restructuring needs to be financed by state aid of EUR 190.7 million (rescue aid, grants, and capital increase to cover advance payments for acquisition of new aircrafts). Recently (January 2024), in the case *Wizz Air Hungary v Commission*²⁵ the Court of Justice of the EU considered that one of the important aids granted to Tarom is compatible with European Union law. The Court emphasised that the size of the market in question does not diminish the significance of a service provided within it, such that its disruption could lead to severe social hardship or constitute market failure. This is evident in the case of Tarom's potential cessation of operations, which would adversely affect connectivity in regions exclusively served by the airline and the economic conditions of those areas. Consequently, the Commission was not obligated to consider the size of Tarom's operating market or its market share when assessing the risk of disrupting a service crucial to Romanian society. Additionally, the Court rejected Wizz Air's arguments regarding the potential replacement of Tarom by its competitors on domestic routes exclusively serviced by the former, as well as the recurrent provision of state subsidies to Tarom and other legal arguments presented by Wizz Air.

²⁴ See: case SA.59344.

²⁵ CJEU, 11 January 2024, C-440/22, *Wizz Air Hungary v Commission*, ECLI:EU:C:2024:26.

The latest (February 2024) case is related to the air operator Blue Air. The Commission ordered recovery of EUR 33.84 million (RON 163.8 million) state aid. The European Commission concluded that Blue Air's restructuring plan was not capable of restoring the airline's long-term viability and is therefore incompatible with the EU state aid rules, specifically with the guidelines on state aid for rescuing and restructuring non-financial firms in difficulty (the Rescue and Restructuring Guidelines').²⁶

Despite efforts to maintain and operate the state aid system in line with EU law, occasional investigations by the European Commission into the legality of state aid measures underscore the importance of ensuring compliance with established regulations. These investigations are vital because they serve as a mechanism for upholding fair competition, preventing market distortions, and safeguarding the integrity of the EU's single market.

When the European Commission opens investigations into state aid measures, it does so to evaluate whether these measures comply with EU regulations. This scrutiny is necessary because state aid, if misused or provided in a manner that distorts competition, can have adverse effects on the functioning of the internal market. It can lead to unfair advantages for certain companies, hinder cross-border trade and investment, and disrupt the level playing field essential for healthy competition. In cases where state aid measures are found to be illegal, the European Commission takes corrective actions to address the situation. This could include requiring the Member State to recover the aid from the beneficiary, imposing fines, or demanding changes to the aid measure to make it compliant with EU rules.

Despite occasional instances of state aid measures being found illegal, operating a state aid system in line with EU law remains essential for the economy as a market corrective. State aid, when used appropriately, can play a constructive role in addressing market failures, fostering innovation, and promoting regional development. It can support strategic industries, facilitate research and development, and contribute to job creation and economic growth. However, it is crucial that state aid is provided in a transparent, non-discriminatory, and market-oriented manner, consistent with EU rules. By ensuring compliance with these principles, state aid system can effectively contribute to a fair, competitive, and well-functioning internal market within the EU.

In summary, while investigations into state aid measures may occur, operating a state aid system in line with EU law remains indispensable for correcting market failures and promoting economic development. These efforts help maintain fair competition, prevent market distortions, and uphold the principles of the EU's single market, ultimately benefiting businesses, consumers, and the economy as a whole.

²⁶ Case SA.62829.

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SERBIA: AN ONGOING HARMONISATION OF STATE AID RULES



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Abstract

European state aid control extends its influence beyond the borders of the European Union. Traces of the methods and approaches enshrined in Arts. 107 and 108 of the Treaty on the Functioning of the European Union can be found both in the domestic legal order of non-EU jurisdictions and in the trade agreements concluded between EU and non-EU countries, like the Republic of Serbia. The legislative framework for state aid control in Serbia is broadly in line with the EU *acquis* and the relevant provisions of the Stabilisation and Association Agreement concluded between EU and Serbia. Considering how European integration of Serbia is an ongoing process leaves limited space for an autonomous state aid policy in areas that are not yet fully aligned with EU law. Fiscal aid schemes have been identified as a domain in which Serbian state aid law differed from its EU counterpart for a significant period of time. Moreover, Serbia is yet to adopt its regional aid map. The drafting of the map is entrusted to the ministry in charge of regional development, and the draft map is to be assessed by both the Commission for State Aid Control and the European Commission. Until a regional aid map is drawn up, the entire national territory is considered an area with a GDP per capita of less than or equal to 45% of the EU-27 average.

Keywords: *state aid, Serbia, competition policy, European integration, regional aid*

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1. Introduction

The aim of state aid policy is to prevent distortion of fair competition, while achieving worthy policy objectives, such as regional development, environmental protection, or promotion of research, development, and innovation in industry. A state aid is traditionally understood as any transfer of public resources in favour of certain undertakings or the production of certain goods, which, by providing a selective economic advantage, distorts or threatens to distort competition. European state aid control extends its influence beyond the borders of the European Union.¹ Traces of the methods and approaches enshrined in Arts. 107 and 108 of the Treaty on the Functioning of the European Union (TFEU) can be found both in the domestic legal order of non-EU jurisdictions and in the trade agreements concluded between EU and non-EU countries, such as the Republic of Serbia. As an important pre-condition for accession to the European Union, the Republic of Serbia, like other South-East European (SEE) countries, is required to introduce a national system of state aid control. The duty to establish a national state aid legal framework stems not only from Serbia's participation in the Stabilisation and Association Process, but also from the Central European Free Trade Agreement and the Energy Community Treaty. The national state aid control systems are meant to be used as transitional mechanisms, since the monitoring of state aid will be carried out by the European Commission once the country joins the Union.²

The system of state aid control in Serbia is presented in this chapter through an analysis of (i) the requirements of the Stabilisation and Association Agreement (SAA), Central European Free Trade Agreement (CEFTA), and Energy Community Treaty (EnCT), (ii) the role and competences of the Commission for State Aid Control, (iii) the country's (partially autonomous) national state aid policy, and (iv) the state aid measures adopted in reaction to the coronavirus crisis.

2. Development of Serbian State Aid Law in line with SAA, CEFTA, and EnCT requirements

The Stabilisation and Association Agreements (hereinafter: the SAAs), such as the ones concluded with Serbia and other SEE countries, establish a general obligation

1 Blauberger and Cramer, 2010, p. 4.

2 One of the justifications of European state aid control advanced in economic theory is based on a potential commitment problem faced by national governments. The idea is that governments may not be able to commit to clear rules and a fixed budget ex-ante. In such a situation, firms have smaller incentives to become efficient, as they anticipate that the government will have no choice but to bail them out when the need arises. As a result, efficiency and welfare are reduced. See: Friederiszick, Röller and Verouden, 2006, p. 640.

for a candidate or potential candidate country to adopt national state aid legislation and establish a state authority competent for enforcing the said rules. The (potential) candidate country needs to ensure that its legislation is aligned with the EU *acquis* and is properly enforced by the competent authority.³ Regarding state aid, each of the SAAs concluded with the SEE countries provide that any

[...] state aid which distorts or threatens to distort competition by favoring certain undertakings or certain products, as they may affect trade between the Community and the [associated country], shall be incompatible with the proper functioning of the Stabilisation and Association Agreement.⁴

This definition is modelled on how incompatible state aid is defined in 107, para. 1 of the TFEU. The agreements concluded with SEE countries also mention that suspected practices shall be assessed based on the criteria arising from the application of the competition rules applicable in the Community, particularly from Art. 107 of the TFEU and interpretative instruments adopted by the Community institutions.⁵ Therefore, the associate countries need to assess state aid schemes based on the criteria arising from the application of secondary legislation, frameworks, guidelines, and other relevant administrative acts in force in the EU and those that will be adopted following the entry into force of the SAA; and based on the criteria developed in the case law of the EU courts and from any decision taken by the Association Council.

The duty to establish a national state aid legal framework stems not only from Serbia's participation in the Stabilisation and Association Process, but also from the Central European Free Trade Agreement (hereinafter: the CEFTA) with which this country is associated as well. The original CEFTA was concluded in 1992 by the members of Visegrad Group – Poland, Czech and Slovak Federative Republic and Hungary. It was conceived as a free trade agreement to facilitate the transition of former communist Central European countries into the market economies of West Europe. CEFTA membership is temporary in nature: once the participating country joins the European Union, its CEFTA membership ends. Art. 21 of the CEFTA lays down a general prohibition on state aid:

[...] any aid granted by a Party or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain goods shall, insofar as it may affect trade between the Party concerned and other Parties to this Agreement, be incompatible with the proper functioning of this Agreement.

³ Popović and Caka, 2017, p. 335.

⁴ See: SAA with Albania, Art. 71 para. (1) point (iii); SAA with Bosnia-Herzegovina, Art. 71 para. (1); SAA with the FYR Macedonia, Art. 69 para. (1) point (iii); SAA with Montenegro, Art. 73 para. (1) point (iii); SAA with Serbia, Art. 73 para. (1) point (iii).

⁵ SAA with Serbia, Art. 73 para. (2).

The CEFTA also requires that parties to the agreement assess state aid schemes under the conditions laid down by Art. 107 of the TFEU. Parties are required to ensure transparency in the area of state aid, *inter alia* by reporting to the CEFTA Joint Committee on the total amount and the distribution of aid and by providing to other parties information on aid schemes. Although a direct reference to Art. 107 of the TFEU is found in the Agreement, the CEFTA state aid framework differs significantly from the one provided under SAAs. CEFTA Member States are not explicitly required to establish a national state aid control authority.

Finally, the requirement to introduce a state aid control stems from the membership of the Republic of Serbia in the Energy Community, an international organisation dealing with the energy policy. This international organisation was established by the European Union, and it brings together the EU, the SEE countries (Albania, Bosnia-Herzegovina, Kosovo,⁶ the FYR Macedonia, Montenegro, Serbia), and countries from the Black Sea region (Moldova, Ukraine). Under Art. 18 of the Energy Community Treaty (hereinafter: the EnCT), any public aid that distorts or threatens to distort competition by favouring certain undertakings or certain energy resources shall be considered incompatible with the proper functioning of the Treaty. Any such practices should be assessed based on the criteria arising from the application of the rules of Art. 107 TFEU. Similar to the CEFTA, the EnCT does not explicitly require contracting parties to establish a state aid monitoring authority. However, a party that does not comply with EnCT requirements (e.g. by favouring its own national energy producers and distributors) may face sanctions.

In line with the requirements stemming from SAA, CEFTA and EnCT, the Republic of Serbia adopted its first State Aid Control Act (hereinafter: SACA, 2009)⁷ and established the Commission for State Aid Control in 2009. Ten years later, the National Assembly adopted the new State Aid Control Act (hereinafter: the SACA 2019),⁸ which is still in force.

3. Commission for State Aid Control

Under the auspices of the Ministry of Finance, the Commission for State Aid Control was established following SACA 2009. The members of the Commission were appointed by the Government from among persons who possess ‘expert knowledge in the field of state aid, competition, and/or EU legislation’,⁹ as proposed by the

6 The asterisk (*) indicates that the territory of Kosovo is member of this organisation in line with the United Nations Security Council Resolution 1244 (1999).

7 *Official Journal of the Republic of Serbia* 51/2009.

8 *Official Journal of the Republic of Serbia* 73/2019.

9 SACA, 2009, Art. 6 para. 4.

ministries of finance, economy, infrastructure, and environmental protection, as well as the Competition Authority. The member proposed by the Ministry of Finance was appointed chairperson of the Commission for State Aid Control, while the representative of the Competition Authority was appointed deputy chairperson. The Act on State Aid Control attempted to resolve the potential conflict of interest by ruling that a member of the Commission who is at the same time a representative of the aid grantor does not have the right to participate in the decision-making process, although the member may provide additional information within the state aid control procedure.¹⁰ The potential for conflict of interests within the Serbian state aid authority had drawn sharp criticism from the European Commission on several occasions. For example, in its 2016 Progress Report, the European Commission emphasised that the operational independence of the Commission was yet to be demonstrated.¹¹ Further to the issue of composition of the Commission for State Aid Control, its ambiguous legal status was also considered problematic as it could generate increased dependency on the executive power. The SACA 2009 did not define the legal status of the Commission apart from stating that the latter shall be ‘operationally independent in performing its duties’.¹² Therefore, the Commission could not have been classified as the Government’s working group, an independent agency, or an administrative organisation within the meaning of the Act on general administrative procedure. The proclaimed operational independence of the Commission was additionally compromised by its financial dependency on the Ministry of Finance, since the Commission did not have a separate budget.

The institutional design of a state aid authority, as prescribed by the SACA 2009, was actually ‘transplanted’ from countries of Central and Eastern Europe. Similar authorities existed in the majority of countries of Central and Eastern Europe in the pre-accession period. For example, in Slovenia, Hungary, Estonia, and the Czech Republic, the state aid control was implemented through a department within the Ministry of Finance. In Latvia, state aid policy was enforced by an interministerial state aid commission, supported by the office within the Ministry of Finance. Only Poland departed from this model, by choosing to empower the president of the national competition authority (not the Authority itself) with state aid control.¹³

Following the adoption of SACA 2019, the guarantee of independence of the Commission for State Aid Control was strengthened by modelling its institutional design on the Competition Authority.¹⁴ The status of the Commission shifted from being a body attached to the Ministry of Finance to an independent authority vested with public powers. The Commission comprises the council and a president. The council

¹⁰ SACA, 2009, Art. 21 para. 2.

¹¹ Serbia 2016 Progress Report, SWD(2016) 361 final, p. 38.

¹² SACA, 2009, Art. 6 para. 7.

¹³ Piszcz, 2011, p. 42.

¹⁴ The Competition Authority is empowered to enforce the Competition Act (*Official Journal of the Republic of Serbia* 51/2009 and 95/2013), which prohibits anti-competitive agreements, abuse of a dominant position, and concentrations that may restrict competition in the relevant market.

members, including the president, are appointed by the National Assembly for a period of five years. The Commission is supported by professional case handlers.¹⁵ The institutional re-design of the Commission for State Aid Control was welcomed by the European Union, which stated in its 2022 Serbia Progress Report that the SACA 2019 secures the Commission's legal independence.¹⁶ However, the European Commission insisted that the enforcement capacity of the Commission for State Aid Control is further strengthened, as it presently has 22 members of staff including the president, four council members and 11 case handlers, which is significantly lower than the 27 case handlers allowed.¹⁷

4. National state aid policy

The fact that European integration of Serbia is still an ongoing process leaves limited space for an autonomous state aid policy in areas that are not yet fully aligned with EU law. The Regulation on Regional State Aid (hereinafter: the RRSA)¹⁸ lays down explicit conditions and criteria for the compatibility of state aid designed to promote the economic development of areas with a low standard of living and to facilitate the development of certain economic activities or certain economic areas in the Republic of Serbia. The RRSA clarifies the regional state aid compatibility criteria, such as transparency and incentive effect. The transparency criterion implies that regional state aid is deemed compatible if the precise amount of the gross monetary equivalent can be calculated in advance. Regional state aid is also deemed compatible if it has an incentive effect. For this, applications for state investment aid must be submitted to the grantor before work on a project commences.¹⁹ The RRSA also establishes the methodology for setting the maximum state aid intensity, namely, (i) up to 50% of the eligible costs in level two areas of the nomenclature of statistical territorial units, the GDP per capita of which is less than or equal to 45% of the EU-27 average; (ii) up to 35% of eligible costs may be allocated for areas where GDP per capita ranges from (or is equal to) 45% to 60% of the EU-27 average; (iii) up to 25% of eligible costs for areas where GDP per capita ranges from (or is equal to) 60% to 75% of the EU-27 average. The RRSA indicates that until the regional aid map is drafted, the Republic of Serbia is deemed an area whose GDP per

¹⁵ SACA, 2019, Arts. 9–24.

¹⁶ Commission Staff Working Document, Serbia 2022 Report, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM(2022) 528 final, p. 97.

¹⁷ Ibid., p. 98.

¹⁸ *Official Journal of the Republic of Serbia* 23/2021.

¹⁹ RRSA, Arts. 4–6.

capita is less than or equal to 45% of the EU-27 average.²⁰ A formula for setting the maximum amount of aid for large investment projects (the initial investment eligible costs of which exceed EUR 50 million) has also been introduced. Under the RRSA, the regional state aid for investments that exceed the maximum intensity for large investments can be considered compatible if it meets the supplementary conditions, for example, if it is proportionate, it contributes to an objective of common interest, if there is a need for state aid intervention, if the positive impact on trade between the EU and Serbia prevails over the negative effects, etc. Regional investment aid is granted for initial investments related to the establishment of new enterprises, capacity expansion, production diversification, and significant changes in the entire production process. The RRSA also regulates regional operating aid, which includes aid to reduce the operating costs of undertakings operating in sparsely populated areas.

Fiscal aid schemes have been identified as a domain in which Serbian state aid law differed from its EU counterpart for a significant period of time. Under Art. 73 of the SAA, Serbia was required to compile a comprehensive list of state aid schemes set up before the establishment of the Commission for State Aid Control and align them with the state aid rules by 1 September 2017. The failure of Serbia to comply with the obligation to align its fiscal schemes with the state aid rules caused a delay in the accession negotiations with the EU. In March 2022, the Commission for State Aid Control issued a notice on the obligation and manner of alignment of state aid schemes within the competence of the Ministry of Finance (hereinafter: the Notice).²¹ Under the Notice, the following fiscal schemes are designated as incompatible: (i) four schemes under the Corporate Income Tax Act (CITA), specifically: tax exemption for concession grantors, tax holiday for large investments, tax exemption for employment of persons with disability, and tax credit for risk investment; (ii) wage tax refund under the Personal Income Tax Act; (iii) refund of social security contributions under the Mandatory Social Security Contributions Act; and (iv) exemption from tax and other duties under the Free Zones Act. The Commission for State Aid Control emphasised that state aid under the designated fiscal schemes must be assessed in the context of the particular category of state aid to which it belongs, which is either horizontal or sector-specific aid. Alternatively, some aid may be granted as *de minimis*, in accordance with the regulation on rules and conditions for granting *de minimis* aid.²² The Commission further noted that as an alternative to making the said aid schemes compatible with state aid rules, the Government may abolish the schemes altogether.

²⁰ RRSA, Art. 15.

²¹ Notice no. 401-00-00259/2021-01/6 of 31 March 2022 and Supplemented Notice no. 401-00-00259/2021-01/7 of 8 June 2022. Both documents are available at: <https://www.kkdp.gov.rs/> (Accessed: 18 September 2023).

²² *Official Journal of the Republic of Serbia* 13/2010, 100/2011, 91/2012, 37/2013, 97/2013, 119/2014, 23/2021, 62/2021, 99/2021, 20/2023, 43/2023 and 48/2023.

The Notice designates tax exemptions for concession grantors as the first type of fiscal scheme that is incompatible with state aid rules. Under the CITA, revenues of the concession grantor generated from the transfer of assets without compensation received from the private partner as part of the implementation of the concession agreement (such as BOT agreements) shall not be included in the tax base of the concession grantor in the relevant tax period. Further, capital gains made on the transfer of real estate from a private partner to the concession grantor as part of a concession arrangement shall not be included in the tax base of the private partner in the relevant tax period. In each case mentioned, the estimated value of the concession is above EUR 50 million.²³ Under the Notice, this type of aid instrument is not available unless the circumstances of the specific investment make the aid compatible with the provisions of the SACA 2019 on the relevant type of aid (e.g. regional aid) and cumulation of state aid or if the aid qualifies as *de minimis*. Alternatively, these measures could be amended to remove the EUR 50 million threshold. This would make the measure general and not selective, and thus the measure would not be considered state aid. Tax holiday for large investments is the second type of incompatible fiscal scheme. The CITA provides for a 10 year corporate income tax holiday for any company that invests or ensures an investment in its fixed assets that have not been previously used in Serbia, to a value of more than RSD 1 billion and employs at least 100 persons for an indefinite period during the investment period.²⁴ Under the Notice, the corporate income tax holiday for greenfield investment can be compatible with state aid rules only if it can qualify as regional or other horizontal aid (e.g. energy) and if it does not violate the rules on cumulation. The Notice designates tax exemption for employment of persons with disability as the third type of incompatible fiscal scheme. The CITA provides for tax exemption for undertakings that engage in the employment and professional rehabilitation of persons with disability, proportionate to the participation of persons with disability to the total number of employees within the company.²⁵ This type of fiscal scheme is incompatible with the regulation on horizontal state aid.²⁶ Under the said regulation, the aid intensity is set at 75% of eligible costs (i.e. the costs of salaries of persons with disability), capped at EUR 10 million annually per undertaking, while the CITA does not place any limitation on this aid. Finally, the fourth type of fiscal scheme under the CITA, which the Notice designates as incompatible, is the tax credit for risk investment. The CITA provides to an incumbent company that makes a capital contribution toward an innovative start-up a tax credit for 30% of the investment, capped at RSD 1 million.²⁷ The Notice designates this scheme as incompatible with the regulation on horizontal

23 *Official Journal of the Republic of Serbia* 25/2001, 80/2002, 80/2002, 43/2003, 84/2004, 18/2010, 101/2011, 119/2012, 47/2013, 108/2013, 68/2014, 142/2014, 91/2015, 112/2015, 113/2017, 95/2018, 86/2019, 153/2020 and 118/2021, Art. 25a para. 3 and Art. 30a.

24 CITA, Art. 50a.

25 CITA, Art. 46.

26 *Official Journal of the Republic of Serbia* 62/2021.

27 CITA, Art. 50j.

state aid, both with respect to general criteria for granting horizontal state aids (such as transparency and incentive effect), and with respect to the specific rules for state aid for financing risk investments (e.g. additional conditions for investment).

The Notice also designates wage tax refund under the Personal Income Tax Act (hereinafter: the PITA)²⁸ as incompatible with state aid rules. The PITA provides for a partial refund to the employer tax paid on wages for newly hired employees before 31 December 2022, provided such employment increases the number of employees compared to the number of employees the employer had as of 31 March 2014. The refund depends on the number of new employees hired in the relevant period: if the employer hired up to nine new employees, 65% of the paid wage tax is refunded. If the employer hired 10 to 99 new employees in the relevant period, 70% of the wage tax paid is refunded. Finally, if the employer hired at least 100 new employees in the relevant period, a refund equal to 75% of paid wage tax is provided. Additional rules apply to hiring interns and persons under the age of 30. For employers to be eligible for the benefits, a newly hired person must have been unemployed for at least six months (three months in case of interns) immediately prior to being hired. Employers of micro and small enterprises, entrepreneurs, and agricultural workers are entitled to a refund of 75% of paid wage tax for any newly hired employee, provided they employ at least two persons.²⁹

Finally, the Notice designates the refund of social security contributions prescribed under the Mandatory Social Security Contributions Act (hereinafter: the MSSCA)³⁰ and the exemption from tax and other duties prescribed under the Free Zones Act (hereinafter: the FZA)³¹ as potentially incompatible aid. The Notice requires that a full or partial refund of social security contributions paid on wages, prescribed under the MSSCA, which qualify for wage tax refund under the PITA, be further aligned with rules on horizontal aid. Further, the Notice singled out as potentially incompatible the provisions of the FZA which provide that customs duties and other import duties are not payable for importation of goods intended for the conduct of business activity and construction of facilities in the zone.³² The permissibility of this measure would depend on the business activity of the beneficiary and the type of investment in a free zone. Consequently, this type of aid can be considered compatible only if granted as, for example, regional investment aid.

28 *Official Journal of the Republic of Serbia* 24/2001, 80/2002, 80/2002, 135/2004, 62/2006, 65/2006, 31/2009, 44/2009, 18/2010, 50/2011, 91/2011, 7/2012, 93/2012, 114/2012, 8/2013, 47/2013, 48/2013, 108/2013, 6/2014, 57/2014, 68/2014, 5/2015, 112/2015, 5/2016, 7/2017, 113/2017, 7/2018, 95/2018, 4/2019, 86/2019, 5/2020, 153/2020, 156/2020, 6/2021, 44/2021, 118/2021, 132/2021, 10/2022, 138/2022, 144/2022 and 6/2023.

29 PITA, Arts. 21v and 21d.

30 *Official Journal of the Republic of Serbia* 84/2004, 61/2005, 62/2006, 5/2009, 52/2011, 101/2011, 7/2012, 8/2013, 47/2013, 108/2013, 6/2014, 57/2014, 68/2014, 5/2015, 112/2015, 5/2016, 7/2017, 113/2017, 7/2018, 95/2018, 4/2019, 86/2019, 5/2020, 153/2020, 6/2021, 44/2021, 118/2021, 10/2022, 138/2022 and 6/2023.

31 *Official Journal of the Republic of Serbia* 62/2006.

32 FZA, Arts. 19 and 29 para. 3.

5. State aid and reaction to the coronavirus pandemic

In extraordinary situations, state aid rules need to be adapted to respond to the novel circumstances. In recent history, two episodes have already tested the European state aid control regime in times of emergency: the 9/11 attacks and the financial crisis. In the first, airlines became the prime beneficiaries of state aid, while in the second banks were rescued.³³ Given that the state aid rules were introduced in Serbia only in 2009, the first time the former needed to be adapted to extraordinary events was during the coronavirus pandemic. Following the declaration of state of emergency in Serbia due to the coronavirus outbreak, the Government issued in April 2020 two regulations that determine the conditions and criteria for compliance of state aid: (i) for remedying the negative effects caused by COVID-19; and (ii) for remedying a serious disturbance in the economy caused by COVID-19. The two regulations laid down rules on the types of state aid allowed, instruments for such aid, and the thresholds that need to be met for the aid to be compatible with SACA 2019. The Serbian state aid rules adopted in reaction to coronavirus pandemic were generally in line with the EU Temporary Framework, which concerned aid to remedy the serious disturbance in the economy of Member States caused by the coronavirus outbreak.³⁴

The regulation for remedying the negative effects caused by COVID-19³⁵ established conditions under which state aid can be granted as compensation for damages directly caused by the COVID-19 pandemic. State aid granted in accordance with the criteria provided in this regulation will represent a compatible state aid within the meaning of the SACA 2019. Aid can be provided under the following conditions: (i) total amount of aid is not higher than the expenses incurred by the beneficiary due to the COVID-19 outbreak; (ii) state aid is provided as a scheme with an estimated duration, budget, instrument, intensity, and beneficiaries; (iii) the actual loss did not occur due to the non-compliance with the rules during the COVID-19 epidemic, that is, if such expenses would be incurred regardless of the COVID-19 outbreak; and (iv) the beneficiary is not directly liable or it did not wilfully, that is, with gross negligence contribute to the incurrence of damage.³⁶ Aid can be granted up to 100% of incurred standardised expenses, if the beneficiary provides the grantor with a report from an independent evaluator on the expenses incurred, informs the grantor of its existing insurance policies, as well as any previous aid received for these purposes, and states that it will return any excessive amount of state aid received. These expenses shall be reduced for the amount of advance payment made by the grantor, business insurance, or other fees (obtained in court or similar proceedings

³³ Costa-Cabral et al., 2020, p. 3.

³⁴ The Temporary Framework is a set of guidelines that the European Commission announced for the assessment of compatibility of state aid in response to the COVID-19 outbreak. See: Bouchagiar, 2021, pp. 2–3; Biondi, 2020, pp. 23–26; Motta and Peitz, 2020, p. 73.

³⁵ *Official Journal of the Republic of Serbia* 54/2020, 126/2020, 17/2021 and 125/2021.

³⁶ Art. 4 of the regulation for remedying the negative effects caused by COVID-19.

concerning the coronavirus pandemic). This regulation remained valid until the end of June 2022.

The regulation for remedying a serious disturbance in the economy caused by COVID-19³⁷ established rules of state aid granted to undertakings to remedy the liquidity shortages caused by the coronavirus outbreak.³⁸ The state aid under this regulation can be granted only to undertakings that were not in difficulty on 31 December 2019. The aid instruments that concern direct grants for employee salaries and postponement of tax and social contributions do not amount to state aid during the application of this regulation if they are provided under a scheme encompassing all the undertakings. Certain instruments were considered permissible state aid up to certain thresholds. Direct subsidies, debt cancellation, favourable payment terms, tax, and other reliefs can be granted as a scheme if the nominal amount of aid does not exceed a gross amount of EUR 800.000 per single undertaking, and the scheme contains a total estimate of the amount of aid that will be provided. Direct subsidies for salaries to avoid layoffs that are provided via a scheme encompassing all undertakings do not amount to state aid. In case the scheme does not encompass all undertakings, such aid will be deemed permissible state aid if (i) the aim of the aid is to preserve jobs; (ii) the aid is targeted toward certain regions, sectors, or undertakings that are in particular affected by COVID-9; (iii) the direct grant encompasses salaries (up to 12 months) for employees who would be laid off due to the termination or reduction of business activities due to COVID-19; and (iv) monthly direct grant does not exceed 80% of the gross salary of employees for which the grant is provided. Finally, the postponement of tax and social contribution obligations does not amount to state aid if it encompasses all the undertakings. If it, however, does not encompass all the undertakings, it will be deemed a permissible state aid if it is a scheme targeted toward certain regions, economy sectors, or undertakings that are particularly affected by COVID-19, if granted before 31 December 2020.

6. Concluding remarks

The rules imposing state aid control in the Republic of Serbia have been introduced in line with the requirements of the SAA, CEFTA, and EnCT. These rules are enforced by the Commission for Control of State Aid, which was established under SACA 2009. The Commission was first established under the auspices of the

37 *Official Journal of the Republic of Serbia* 54/2020, 126/2020, 17/2021 and 132/2021.

38 In the European Union, during the corona crisis, a similar process took place where the first, most urgent, national measures were notified and approved as compensation for exceptional occurrences under Art. 107 para. (2) of the TFEU, while later measures had to stand the test of Art. 107 para. (3) of the TFEU. See: Bostoen et al., 2020, p. 86.

Ministry of Finance. In 2019, the institutional design of the Commission was drastically changed and improved, by its complete detachment from the Government. The Commission is now positioned as an independent authority whose members are appointed by the National Assembly.

Regarding the legislative framework, the SACA 2019 is broadly in line with the EU *acquis* and the relevant provisions of the SAA concluded between EU and Serbia. The fact that the process of European integration of Serbia is still ongoing leaves limited space for an autonomous state aid policy in areas that are not yet fully aligned with EU law. Fiscal aid schemes have been identified as a domain in which Serbian state aid law differed from its EU counterpart for a significant period of time. In March 2022, the Commission for State Aid Control issued a Notice on the obligation and manner of alignment of state aid schemes within the competence of the Ministry of Finance. Under the Notice, the following fiscal schemes are designated as incompatible: (i) four schemes under the CITA, specifically: tax exemption for concession grantors, tax holiday for large investments, tax exemption for employment of persons with disability, and tax credit for risk investment; (ii) wage tax refund under the Personal Income Tax Act; (iii) refund of social security contributions under the Mandatory Social Security Contributions Act; and (iv) exemption from tax and other duties under the Free Zones Act. The Commission for State Aid Control emphasised that state aid under the designated fiscal schemes must be assessed in the context of the particular category of state aid to which it belongs, which is either horizontal or sector-specific aid. Alternatively, some aid may be granted as *de minimis*. The Commission further noted that as an alternative to making the said aid schemes compatible with state aid rules, the Government may abolish the schemes altogether.

Regarding regional aid, Serbia still needs to adopt its regional aid map.³⁹ The drafting of the map is entrusted to the ministry in charge of regional development, and the draft map is to be assessed by both the Commission for Control of State Aid and the European Commission. Until a regional aid map is drawn up, the entire territory of the Republic of Serbia is considered an area with a GDP per capita of less than or equal to 45% of the EU-27 average.

39 On the concept of regional aid map, see: Pesaresi et al., 2016, pp. 704–705.

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SLOVAKIA: CONFLICT WITH EU LAW (?), MULTIPLE CRISES AND A RECOVERY AND RESILIENCE PLAN



MIROSLAV ŠTRKOLEC – ANNA VARTAŠOVÁ

Abstract

In this chapter, the state aid policy and rules in Slovakia are discussed, first, by defining the basic legal framework of state aid and the distinction it draws between direct and indirect aid. Second, case laws of the Court of Justice of the EU in this area that have had a significant impact on the policy, legal framework, and the case law of the Slovak courts are also examined (e.g. Frucona case and NCHZ case). A significant part of the chapter is devoted to state aid in times of crisis, such as in the context of the COVID-19 pandemic and the armed conflict in Ukraine. Further, the relationship between the Recovery and Resilience Facility and state aid rules are also discussed. Finally, the chapter concludes with an overview of fiscal measures as a form of indirect state aid. Regardless of the state of crisis, these are an immanent part of the measures that can be considered as state aid.

Keywords: *state aid, minimum aid, State aid in the times of crisis, Recovery and Resilience Plan, fiscal measures*

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1. State aid in Slovakia

The rules for granting state aid in Slovakia are set out in Act No. 358/2015 on the regulation of certain relations in the field of state aid and minimum aid, amending certain acts (the State Aid Act), which came into force in 2016. According to this Act, such aid can be granted only in accordance with the EU rules on state aid, under specific regulations¹ governing the relevant aid measures for defined purposes, particularly for regional development, support for small- and medium-sized enterprises (SMEs), research and innovation, support for education, employment, sport, culture, agriculture, transport, and compensation for damages caused by certain natural disasters, among other purposes defined by the EU Council.

State aid can be classified as direct aid and indirect aid. Direct aid is granted in the form of money and includes the provision of subsidies and grants, contributions, interest payments on loans or part of a loan, repayable financial assistance granted under conditions more favourable than market conditions, and capital increases in a manner not in line with market conditions. Indirect or non-monetary aid takes various forms, such as state or bank guarantees granted under conditions more favourable than market conditions, sale of real estate owned either by the state, a higher territorial unit or a municipality at below the market price, consultancy services provided free of charge or against partial payment, and fiscal measures (tax relief, relief of penalties, fines, penalty interest, or other sanctions, deferral of tax payments or permission to pay tax in instalments under conditions more favourable than market conditions).

State aid may be granted only after notification and subsequent approval by the European Commission, with the exception of minimum aid, state aid schemes in accordance with specific block exemption regulations, individual aid granted under state aid schemes, and *ad hoc* aid in accordance with specific block exemption regulations or specific regulations for the provision of services in the public interest. The basic framework of the nature of state aid, the rules on permissible and impermissible state aid and their context have been summarised in several works in the Slovak literature.² According to the case law, the obligation to comply with state aid rules applies to both national and local government authorities.³

Overall, Slovakia, as an EU Member State, does not have a strong state aid policy, and until the Covid-19 pandemic, when the amount of aid granted increased

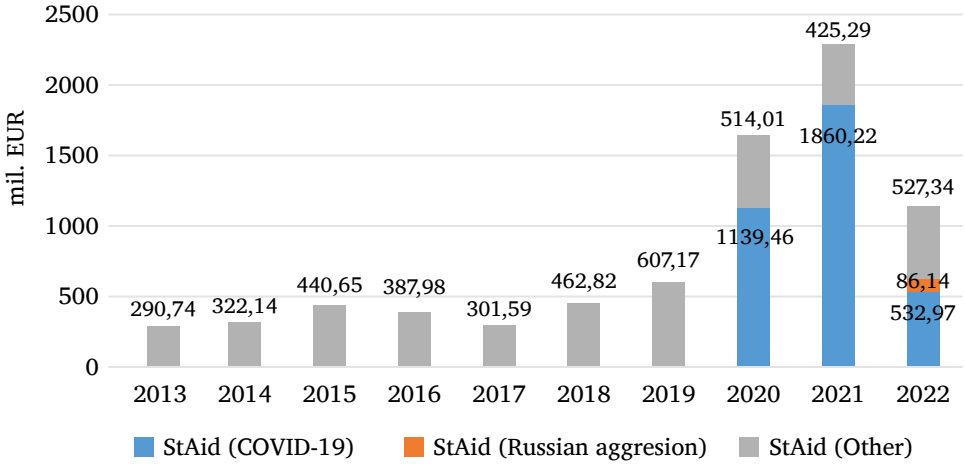
1 The following acts may be mentioned: Act No. 561/2007 on investment aid, amending certain acts, as amended, Act No. 57/2018 on regional investment aid, amending certain acts, Act No. 528/2008 on aid and support provided from European Community funds, as amended, Act No. 185/2009 on incentives for research and development, amending Act No. 595/2003 on income tax, as amended, and Act No. 292/2014 on the contribution provided from the European Structural and Investment Funds, amending certain acts.

2 Rusko and Ferencz, 2017; Úradník, 2019.

3 Blažo, 2020, p. 197.

significantly (see Figure 1), Slovakia ranked in the bottom quarter of Member States in terms of state aid spending as a percentage of GDP in a relevant year on an EU-wide basis.⁴

Figure 1: State aid paid in SR (2013-2022)



Data Source: Antimonopoly Office of Slovak Republic

The Slovak Audit Office (SAO) provides a comprehensive assessment of the policy applied in Slovakia in the field of investment aid as one of the forms of state aid for the period 2008–2017, including an assessment of the benefits of investment aid for individual regions. The SAO notes that of the 106 investment plans initially approved for EUR 658.4 million (later reduced to EUR 518.5 million), only 39.6% of the aid had actually been used at the time of the analysis. Most investment aid was directed to the Trnava and Košice regions, while investment aid to Western Slovakia and the Bratislava region accounted for up to 44.5% of total investment aid in Slovakia. The assessment of the regional effect of investment aid shows that the amount of investment aid per capita granted in Slovakia in 2008–2017 does not have a demonstrable effect in reducing regional disparities and supporting less developed regions. Paradoxically, the two relatively least developed regions (Banská Bystrica and Prešov regions) received the least investment aid per capita in relation to regional GDP per capita in purchasing power parity.⁵

⁴ For example: Slovakia was 17th in 2019, 16th in 2020, and reached 10th place in 2021. European Commission, 2024.

⁵ Fabuš and Csabay present similar conclusions about the disproportion in foreign direct investment inflows between East and West in Slovakia, stating that the Bratislava Region received up to 64.85% of total FDI over the period 2009–2015, which is comparable to the period 1993–2007, when it received 67.6%. Fabuš and Csabay, 2018, p. 483.

In terms of regional aid,⁶ the policy applied in Slovakia does not fully meet the objective of reducing regional disparities, as pointed out by a recent study⁷ on the monitoring of support to the local economy in districts with the highest long-term unemployment rates, which demonstrates that the level of support in less developed districts is below the level of aid directed into more developed regions not only in terms of the number of supported projects, but also in terms of the total amount of aid and the number of jobs created. It also shows that out of the 20 least developed districts monitored, only the results for Košice-okolie show a significant level of performance compared to the results of the other districts. This finding is alarming because it is an indication that the districts needing regional development support are left out.⁸

The SAO also notes that up to 94% of the approved investment aid went to the industrial production sector, dominated by the ‘manufacture of motor vehicles, trailers, and semi-trailers’ (24 approved investment projects). This sector received the largest amount of approved investment aid, EUR 182.7 million (27.8% of total approved investment aid), mainly in the form of tax relief (EUR 132.4 million). On the contrary, for ‘scientific research and development’, for example, EUR 1.5 million was approved (0.2% of the total approved investment aid). It is therefore recommended to reconsider the investment aid policy (strongly focused on the automotive industry) to focus more on the support of SMEs.

An aspect representing a relatively stable element of support for investment activity in Slovakia must also be mentioned: the construction of the so-called strategic parks⁹ (in the new terminology, a ‘strategic area’), which are large industrial parks (over 10 hectares) intended for large projects (typically car manufacturing plants) in accordance with Act No. 371/2021 Coll. on significant investments. Such support is not considered to be selective state aid, but rather public investment aimed at increasing the attractiveness of a particular area and enabling private investment; this was also confirmed by the conclusions of a formal investigation by the European Commission¹⁰ regarding possible additional non-notified state aid in relation to the Nitra Strategic Park (Industrial Park Project for Jaguar Land Rover), where the

6 Map of recent regional aid in Slovakia (under Art. 7 of the Communication from the Commission: Guidelines on regional State aid, 2021/C 153/01) for the years 2022–2027: Western Slovakia with a maximum aid intensity for large enterprises of 30%, Central Slovakia 40%, and Eastern Slovakia 50%; the maximum aid intensity may be increased by 10 percentage points for investments made by medium-sized enterprises and by 20 percentage points for investments made by small enterprises, for their initial investments with eligible costs up to EUR 50 million. For the years 2014–2020, this was: Western Slovakia maximum 25%, Central Slovakia and Eastern Slovakia 35% each. In both cases, the Bratislava Region is excluded from regional support.

7 Košdy, 2023.

8 Košdy, 2023, p. 57.

9 Terminology in accordance with the previous legislation – Act No. 175/1999 on certain measures concerning the preparation of major investments, amending certain acts.

10 Commission Decision (EU) 2019/1127 of 4 October 2018 on state aid SA.45359 – 2017/C (ex 2016/N) which Slovakia is planning to implement for Jaguar Land Rover Slovakia s.r.o.

Commission concluded that there was no state aid and that Slovakia did not grant any selective advantage to Jaguar Land Rover.¹¹

A relatively recent study provides an overview of state aid policy in the field of environmental protection¹² and shows that the number of recipients and the amount of aid approved are on the rise, and that the aid granted is producing results in terms of reducing nitrogen oxide (NOx) emissions, PM10 concentrations, and emissions related to energy and heat production using solid fuels. However, the European Commission concludes that the achieved results are not at the requisite level in Slovakia (e.g. in terms of the recycling rate of municipal waste).

1.1. Frucona case

Two companies in Slovakia were deemed by the Commission to have been granted unlawful state aid. The first, in particular, had a major impact on the development of both national legislation and case law.

The first case was the Commission decision of 2006 concerning Frucona,¹³ wherein tax debt was written off by the Košice IV Tax Office under a procedure of arrangement with the creditors.¹⁴ The written-off part of the unpaid excise duty amounting to SKK 416,515,990 (today approximately EUR 14 million) was assessed by the Commission as state aid incompatible with the single market. Slovakia was ordered to take the necessary steps to recover the unlawful state aid without delay. In view of the unsuccessful recovery process, the Commission brought action before the Court of Justice of the EU on 17 June 2008 for failure to recover the unlawful and incompatible aid. The Court confirmed the infringement by the Slovak Republic.¹⁵ Meanwhile, in January 2007, Frucona appealed against the Commission decision to the General Court of the EU, which dismissed its action; however, on appeal to the Court of Justice of the EU, the latter set aside the judgement of the General Court on the grounds that the Commission committed a manifest error of assessment in having failed to consider the private creditor test of the duration of the bankruptcy procedure. Insofar as this factor was considered by the Commission, the latter did not set out sufficient reasons for its decision.

11 Košdy, 2023, p. 56.

12 Novacek and Li, 2021.

13 2007/254/EC: Commission Decision of 7 April 2006 on State aid C 25/2005 (ex NN 21/2005) implemented by the Slovak Republic for FRUCONA Košice, a.s. (notified under document number C(2006) 2082).

14 This procedure was governed by the then applicable Act No. 328/91 on Bankruptcy and Arrangement with Creditors (Bankruptcy Act) whereby the indebted company pays off part of its debt and the remainder is written off. This agreement has to be approved by the supervising court.

15 CJEU, 22 December 2010, Case C-507/08, *Commission v Slovakia (Frucona Košice)*, ECLI:EU:C:2010:802.

The Commission therefore annulled its original decision of 7 June 2006 and adopted a new decision¹⁶ in which it again considered the measure to be unlawful state aid incompatible with the single market. However, Frucona again appealed against the new decision, and the General Court ruled in favour of the applicant,¹⁷ considering the errors of fact and of the law that had been identified as affecting the finding, that the bankruptcy procedure or the tax execution procedure would be a more advantageous alternative compared to the proposed arrangement. This judgement was appealed by the Commission; however, the Court of Justice of the EU dismissed the appeal,¹⁸ stating *inter alia* that where it appears that the private creditor test might be applicable, it is for the Commission to ask the Member State concerned to provide it with all the relevant information enabling it to determine whether the conditions for applying that test are satisfied,¹⁹ which was not the case in the Frucona decision. Therefore, infringement of the state aid rules was not definitively confirmed.

1.2. NCHZ case

The second case was the Commission decision of 2014 concerning Novácke Chemické Závody (NCHZ),²⁰ where the Commission found unlawful state aid of approximately EUR 4.78 million and a breach of Art. 108 para. (3) of the Treaty on the Functioning of the European Union (TFEU), in relation to two periods: (i) between December 2009 and December 2010 – NCHZ continued operation by virtue of the application of a special law²¹ – Act No. 493/2009 on certain measures concerning

16 2014/342/EU: Commission Decision of 16 October 2013 on State aid No SA.18211 (C 25/2005) (ex NN 21/2005) granted by the Slovak Republic for Frucona Košice a.s. (notified under document C(2013) 6261).

17 CJEU, 16 March 2016, Case T-103/14, *Frucona Košice v. Commission*, ECLI:EU:T:2016:152.

18 CJEU, 20 September 2017, Case C-300/16 P, *Commission v. Frucona Košice*, ECLI:EU:C:2017:706.

19 As follows from the judgement of 21 March 2013, C-405/11 P, *Commission v Buczek Automotive*, ECLI:EU:C:2013:186.

20 Commission Decision (EU) 2015/1826 of 15 October 2014 on the State aid SA.33797 – (2013/C) (ex 2013/NN) (ex 2011/CP) implemented by Slovakia for NCHZ (notified under document C(2014) 7359).

21 NCHZ is a chemical company in Slovakia with around 2000 employees. In October 2009, the company filed for bankruptcy. In November 2009, Slovakia adopted a law requiring administrators to ensure the continued operation of strategic companies during bankruptcy proceedings. In December 2009, NCHZ was proclaimed by the Government to be a strategic company. The law expired in December 2010, and NCHZ is the only company to which it ever applied. In relation to the period December 2009 – December 2010, the Commission concluded that the special law deprived the administrator and the creditors of their discretion to decide whether the continued operation was economically beneficial. The administrator only ordered a comprehensive economic analysis and called a meeting of the company's creditors to decide whether to operate NCHZ further when the special law was about to expire. Under the special law, NCHZ was required to pay only social security and health insurance contributions in part and therefore received an undue advantage over competitors who had to meet their obligations in full (European Commission, 2014).

strategic companies²² and (ii) between January 2011 and July 2012 – NCHZ continued operation on the basis of a decision of the creditors.

However, the decision was annulled by the General Court in relation to the second period in respect of the unlawful state aid found²³ and then re-examined by the Commission, which concluded that no unlawful state aid had been granted;²⁴ however, in relation to the first period on appeal by Fortischem a.s. (as successor in title) both before the General Court and subsequently before the Court of Justice,²⁵ the decision regarding unlawful state aid was upheld and the sum evaluated as unlawful State aid had to be recovered.

1.3. Implications of case law in Slovakia

In the Frucona case, as mentioned above, Slovakia faced difficulties in effectively recovering this unlawful aid, which led to the above-mentioned infringement procedure against Slovakia for failure to fulfil its obligations under the EC Treaty and to the amendment of the State Aid Act in force at the time.²⁶ According to the original legislation, in case of unwillingness of the recipient to repay state aid, which the Commission had decided was unlawful, it was necessary to bring an action in civil proceedings, which gave the amendment²⁷ an apt name, *Lex Frucona*.²⁸

The Slovak authorities initiated legal proceedings, but without success. The problem lay in the conflict between the State's obligation to recover unlawful state aid (imposed by the Commission decision) and the principle of *res iudicata* in relation to the restructuring procedure under which the aid was granted to Frucona,²⁹ since, according to the then Bankruptcy and Arrangement Act, if the order confirming the arrangement has become final and the debtor has fulfilled its obligations in full and on time, the debtor's obligation to repay the part of the debt that the debtor was not obliged to repay to the creditors according to the arrangement³⁰ is extinguished. Although the Court of Justice did not call into question this principle in its Judgment

22 Because of its clear purpose, it was given the label 'lex NCHZ'. Pardubský, 2009.

23 CJEU, 13 December 2018, Case T-284/15, *AlzChem AG v Commission*, ECLI:EU:T:2018:950, according to which the Commission did not sufficiently substantiate its assessment of the existence of an economic advantage and whether the decision to authorise the continued operation of NCHZ after 31 December 2010 was attributable to the State (i.e. a measure that was assessed as unlawful state aid).

24 'The Commission found that none of the public creditors had a veto right in the creditors' committee. Therefore, they could not block the other creditors or take decisive influence in the decision whether to continue operations. This decision is therefore not imputable to the State'. Commission Decision (EU) 2021/1943 of 14 June 2021 on the State aid SA.33797 (2013/C) (ex 2013/NN, ex 2011/CP) implemented by Slovakia for NCHZ (notified under document C(2021) 4185).

25 CJEU, 29 April 2021, Case C-890/19 P, *Fortischem a.s. v. Commission*, ECLI:EU:C:2021:345.

26 Act No. 231/1999 on state aid, as amended.

27 Act No. 102/2011.

28 Gyárfáš, 2011.

29 Gyárfáš and Csach, 2019.

30 Judgement of the Supreme Court of the Slovak Republic 5MObo/3/2009.

C-507/08, it did state that under national law, the Slovak authorities could avail resources which, if diligently used, could have ensured that the Slovak Republic was able to recover the aid at issue.³¹ The negative decision of the Supreme Court of the Slovak Republic (the court of last instance) was finally overturned by the Constitutional Court on the basis of a constitutional complaint lodged by the Košice IV Tax Office for violation of its right to judicial protection under Art. 46 para. (1) of the Constitution, as it was prevented from recovering the unlawful state aid. The Constitutional Court pointed out that the national courts have no jurisdiction either to review the validity of the Commission decision or to assess whether the advantageous measure constitutes state aid within the meaning of European law, should they depart from the Commission decision.³²

The next stage in this case was the amendment of the State Aid Act itself. According to the transitional provisions, it was supposed to also apply to claims that had not yet been recovered (in an attempt by the State to solve the problem of the courts refusing to recover aid), which was vetoed by the President of the Republic due to doubts about the constitutionality of the new provision on the grounds of retroactivity; however, the veto was eventually overridden by the parliament. This legislation was even subsequently challenged before the Constitutional Court, but its key provisions on the direct enforceability of Commission decisions obliging the State to recover state aid that it had declared unlawful were upheld by the Constitutional Court in its Ruling No. PL. ÚS 115/2011.

Under the current provisions of the State Aid Act, a recipient to whom, pursuant to a decision of the European Commission, unlawful state aid has been granted is obliged to repay it to the budget from which it was granted or to pay it to the budget to which it should have been paid, including interest, and this obligation extends to the successor in title. The European Commission's decision on unlawful state aid is directly enforceable against the recipient of the state aid from the day of its notification to the Slovak Republic; based on this, the grantor of the state aid is obliged to submit a proposal for its enforcement within 30 days from the receipt of the initiative of the state aid coordinator, and if it fails to do so, the central state administration authority is entitled to do so. According to the State Aid Act, the state aid coordinator is the Antimonopoly Office, which, however, does not have the power to impose fines for the failure to recover unlawful state aid, but it has the power to impose fines for the failure to notify the office prior to granting of state aid; thus, the Slovak legislation is more focused on the preventive protection of compliance with state aid rules.³³

³¹ For more details, see e.g. Csach, 2011.

³² The national court clearly exceeds the scope of the powers conferred on it by the operation of European law within the national constitutional order, particularly by appropriating powers conferred on other European Union bodies, for example, the power to assess the compatibility of state aid with European Union law. Macejková, 2016.

³³ Blažo, 2020, p. 199.

Regarding private recovery of state aid, that is, proceedings initiated by a private party before a national court to prevent state aid, seek its repayment or compensation for damage, the implementation of such a procedure is fraught with complex problems,³⁴ with the result that the number of such cases is minimal,³⁵ and the parties concerned rarely consider such a procedure realistically, preferring to submit their objections to the Commission.³⁶

2. State aid law in times of crisis

Individual countries in the last few years have been hugely impacted on the socio-economic front by the crises experienced, first in the form of a global pandemic and then a military conflict in Ukraine, a country in the eastern part of the EU. Subjectively assessed, these events had a serious impact on the business environment in Slovakia, especially the first one, which was transferred to the level of the State's intervention in the form of state aid, the amount of which increased enormously in 2020 (see Figure 1).³⁷

Despite this increase, some studies³⁸ report that the pandemic (i.e. in terms of the pandemic measures adopted) has had a negative impact on the quality of the business environment, despite the various types of state aid adopted for this purpose.

34 Gyárfáš, 2017a; Gyárfáš 2017b.

35 Gyárfáš and Csach mention two rulings: (i) Ruling of the District Court of Trnava in case 39C/30/2017: The City of Trnava (the plaintiff) filed an action for declaratory relief that the transfer of title to the land to a private investor (realised by the former mayor for 1 EUR) was null and void, or ineffective, because it constituted state aid granted without a notification pursuant to Art. 108 para. (3) of the TFEU. The court rejected the claim on a few grounds, but most importantly, the court held that the transfer of municipal land to a private investor was valid, even though the transfer may have constituted state aid. Even if it did constitute state aid, this would only give rise to the obligation to recover aid, but it would not render the transfer null and void or ineffective; (ii) Ruling of the Regional Court in Trnava in case 31CoKR/2/2015: The Social Insurance Agency (the plaintiff) sought to have the restructuring plan of an insolvent debtor set aside, because the write-off of public claims may have constituted state aid (the restructuring plan was approved despite the opposition of the Social Insurance Agency). The First Instance Court upheld the claim and set aside the restructuring plan and the appellate court confirmed the first-instance ruling. European Commission, 2019.

36 Gyárfáš and Csach, 2019.

37 *Správy o poskytnutej štátnej pomoci v Slovenskej republike za roky 2013 až 2022* [Online]. Available at: <https://shorturl.at/Cq2tR> (Accessed: 30 October 2023).

38 Svabova, Kramarova and Chabadova, 2022, p. 2.

2.1. Pandemic aid

During the COVID-19 pandemic, 16 state aid schemes were established under the Temporary Framework for State Aid measures to support the economy,³⁹ and 17 *de minimis* aid schemes were launched under Commission Regulation (EU) No. 1407/2013.

The Ministry of Transport and Construction notified the largest number of state aid schemes: (i) to support operators active in the tourism sector, (ii) to support the provision of essential air access to the region, (iii) temporary aid to support COVID-19 relevant research and development, (iv) to support international regular and occasional bus companies, and (v) to support the air carriers concerned.

Two schemes were implemented through the Sport Promotion Fund, launched to support sports in the context of the COVID-19 outbreak and to support professional sport clubs.

The other two schemes were provided by the Ministry of Economy (subsidy for fixed costs and subsidy for rent⁴⁰).

The EXIMBANKA bank implemented a scheme to support the increased liquidity needs of government funds in the context of COVID-19 for SMEs and large enterprises to tide over the adverse effects caused by the pandemic.

The Ministry of Labour, Social Affairs and Family launched a scheme for temporary assistance to preserve employment and support self-employed individuals, called First Aid,⁴¹ which subsidised the wages for employers who would otherwise have laid off their employees as a result of the coronavirus outbreak.

For the liquidity of travel agencies, whose activities were restricted or even suspended during the pandemic, in terms of organising tours owing to prohibition of travel for leisure purposes, as part of measures adopted by the Public Health Office, the Ministry of Finance provided a scheme amounting to aid of EUR 8.6 billion.⁴²

39 C(2020) 1863 of 19 March 2020, as amended.

40 The initial extension of the scheme until the end of 2021 was notified late to the Commission – it entered into force before the Commission's approval, which resulted in it being assessed as unlawful state aid, but in view of the purpose of the aid, the Commission decided not to raise objections to the scheme. Commission Decision of 07.10.2021 C(2021) 7267 final: State Aid SA.64688 (2021/NN) – Slovakia.

41 Michulek and Križanová, 2022.

42 Slovakia – *Details of Slovakia's support measures to help citizens and companies during the significant economic impact of the coronavirus pandemic* [Online]. Available at: https://commission.europa.eu/strategy-and-policy/coronavirus-response/supporting-jobs-and-economy-during-coronavirus-pandemic/state-aid-cases/slovakia_en (Accessed: 30 October 2023).

In the context of minimum aid, aid schemes were granted through the Ministry of Economy,⁴³ Ministry of Transport and Construction,⁴⁴ Sport Promotion Fund,⁴⁵ Ministry of Health,⁴⁶ Ministry of Culture,⁴⁷ and Ministry of Finance.⁴⁸

In general, the amount of State aid disbursed was significantly lower than the planned amount allocated to the above schemes, mainly due to the delays in the approval of disbursements caused by the slow preparation of the aid schemes⁴⁹ and the high bureaucratic complexity of the aid application required by the State from the applicant enterprises. However, in the end, state aid had meaning and, in addition to easing the pandemic measures, contributed to Slovakia's GDP returning to the pre-pandemic level in the second half of 2021, after the significant impact the pandemic had on (a steep decline) Slovakia's GDP in 2020. In fact, aid was mainly aimed at supporting employment in enterprises threatened by the crisis and lost revenues due to business cutbacks. Although the employment rate fell (by 1.9% in 2020 and 2.5% in 2021), the number of enterprise closures in 2020 decreased by 15.1% compared to the previous year, indicating the potential effectiveness of state aid for enterprises.

However, the effectiveness of the aid schemes adopted remained questionable in the tourism segment, as this type of enterprise represents a significant share (20%) among those that ceased their activity in 2020. A more detailed analysis of the rise of unemployment in this period in the context of State-supported jobs is presented in the study,⁵⁰ which shows that the average unemployment rate increased from 5.03% (March 2019) to 7.98% (March 2021), despite the State having subsidised over 465 thousand jobs under the scheme of the Ministry of Labour, Social Affairs and Family – the so-called First Aid – at the peak of the crisis situation and the most restrictive pandemic measures (April 2020). This exceeded the expected 'saving' of jobs (estimated at 400.000). Cumulatively, for the period from March 2020 to February 2022,

43 Rent subsidies to cover part of the fixed costs of eligible beneficiaries who were forced to close down or exclude the public from their premises as part of measures to prevent the spread of Covid-19; to support micro-, small-, and medium-sized enterprises by covering part of the fixed costs incurred as a result of the restriction of their activities during the pandemic or to compensate them for lost revenues as a result of the pandemic.

44 Guarantee instrument – provision of a guarantee and subsidisation of loans; support for operators active in the tourism sector – to cover part of the fixed costs incurred by the operators during their forced closure and to compensate them for damage suffered as a direct result of the measures adopted; support for certain operators active in road transport – to compensate them for lost revenues.

45 To support sports – to mitigate the negative effects of the pandemic on professional sport clubs whose economic activity was restricted and to compensate them for lost revenues; to support operators active in sport infrastructure – to cover part of the fixed costs during their forced closure and to compensate them for the damage suffered as a result of the measures adopted.

46 To strengthen the capacity of the health-care system.

47 To support cultural and creative industries whose activities were affected by COVID-19.

48 To support the preservation of SME operations and employment.

49 Svabova et al., 2022, p. 38.

50 Michulek and Križanová, 2022.

as of 15 June 2022, EUR 2.475 billion was paid to 55,000 employers and 131,000 self-employed individuals in support of job preservation.⁵¹

2.2. Armed conflict in Ukraine and state aid

In the context of Russia's aggression in Ukraine, state aid schemes were set up under the competence of several state or public authorities such as the Ministry of Economy,⁵² Ministry of Agriculture and Rural Development,⁵³ and the Social Insurance Agency.⁵⁴

2.3. The Recovery and Resilience Facility and legal framework between the EU and Slovakia

A fund to support the recovery and resilience of the EU was set up under the regulation (EU) 2021/241 of the European Parliament and of the Council on 12 February 2021, establishing the Recovery and Resilience Facility (hereinafter referred to as 'Regulation (EU) 2021/241'). This mechanism (Facility) should provide effective and significant financial support to increase the implementation of sustainable reforms and related public investment in the Member States.

The Facility aims to provide financial support to Member States to meet the milestones and reform and investment targets marked in their recovery and resilience plans.

It is also necessary to state that the Facility itself (and the use of resources) refers to these policy areas of European relevance: (i) green transition, (ii) digital transformation, (iii) smart, sustainable and inclusive growth, including economic cohesion, jobs, productivity, competitiveness, research, development, and innovation, and a well-functioning internal market with strong SMEs, (iv) social and territorial cohesion, (v) health, and economic, social, and institutional resilience, with the aim of, *inter alia*, increasing crisis preparedness and crisis response capacity, and (vi)

⁵¹ Baliak et al., 2022.

⁵² To mitigate the impact of high electricity and gas prices negatively affecting undertakings owing to the high energy prices on the basis of the Temporary Crisis Framework for State Aid measures to support the economy following the aggression against Ukraine by Russia, 2022/C 131 I/01, OJ C 131I, 24.3.2022, 1–17.

⁵³ To support the food sector, particularly to improve liquidity and maintain competitiveness, in accordance with section 2.1 of the Temporary Framework; to support storage of primary agricultural products – to improve liquidity, maintain competitiveness, and also to reduce energy consumption by setting a consumption ceiling for the granting of aid, in accordance with section 2.4 of the Temporary Framework; to support primary agricultural production, fisheries, and aquaculture to improve liquidity and maintain competitiveness in accordance with section 2.1 of the Temporary Framework; to support the food and compound feed sector to improve liquidity and maintain competitiveness in accordance with section 2.1 of the Temporary Crisis and Transition Framework for State Aid measures to support the economy following the aggression of Russia against Ukraine.

⁵⁴ Aid to reduce social contributions granted to employers in the agriculture and food industry to reduce the final prices of basic food at retail level in Slovakia.

policies for the next generation, children and youth, in terms of education and skill development.

For an overview of the legislative framework for the implementation of the mechanism (or Facility) in Slovakia, following legal framework is as shown: (i) Regulation (EU) 2021/241, (ii) The Recovery and Resilience Plan for Slovakia, (iii) Commission staff working document – Analysis of the Recovery and Resilience Plan of Slovakia of 21 June 2021, COM(2021) 339 final, SWD(2021) 161 final, (iv) Council implementing decision on the approval of the assessment of the Recovery and Resilience Plan for Slovakia COM(2021) 339 final, 2021/0163 (NLE), SWD(2021) 161 final, of 13 July 2021, (v) Financing agreement between the Commission and the Slovak Republic under the Recovery and Resilience Facility of 1 October 2021 and (vi) Act No. 368/2021 on the mechanism to support recovery and resilience, amending certain acts (effective from 31 December 2021).

Slovakia was allocated approximately EUR 6.3 billion of the total amount of non-repayable financial support (in principle, the maximum financial contribution calculated in accordance with Art. 11 of Regulation (EU) 2021/241). Slovakia's Recovery and Resilience Plan envisages investments in accordance with Art. 3 of Regulation (EU) 2021/241 in the following areas: green economy; education; science, research, and innovation; health and effective public administration; and digitisation.

These areas will be financed in different proportions, and payments can be made by 31 December 2026 at the latest. When comparing the level of investments in individual areas where support should be focused, the highest share of non-repayable financial support is, according to the approved Recovery and Resilience Plan of Slovakia, intended for financing the so-called *green transition* (green economy), up to 43% – EUR 2.73 billion (with a broader assessment of the level of support and including all measures related to climate protection measures).

The financing of specific projects and investments from the Recovery and Resilience Plan from the total amount of allocated non-repayable financial support at the national level is implemented on the basis of Act No. 368/2021 for the mechanism to support recovery and resilience by amending certain acts that came into effect on 31 December 2021.

This Act regulates financial relations in the implementation of the mechanism to support recovery and resilience, including the provision and use of funds of the mechanism, rights and obligations of persons in connection with the implementation of the Recovery and Resilience Plan of the Slovak Republic and liability for breaches of conditions of recovery plan, the powers of public authorities in the implementation of the recovery plan, and some other relationships in the implementation of the recovery plan.

The basic definitions of concepts underlying financing implementation and their peculiarities are as mentioned below: (i) the executor as a central state administration body designated by the government (e.g. the Ministry of the Environment of the Slovak Republic) is responsible for the implementation of the investment or of

the reform in accordance with the recovery plan, including meeting and achieving milestones and objectives; (ii) recipient of funds (the recipient individually identified in the recovery plan, the recipient, whose competence to perform the tasks for which the resources of the mechanism are provided follows from a special regulation, the recipient designated on the basis of the call of the executor, or the recipient designated by a government decision); (iii) individual investments and reforms are in principle financed from the state budget; however, after the implementation of these investments and reforms, the achievement of individual milestones and goals is assessed according to the approved Recovery and Resilience Plan of Slovakia. If the assessment is positive, the funds will be disbursed under non-repayable financial support (exception to this principle – pre-financing under Art. 13 of Regulation (EU) 2021/241); (iv) the Act contains special budgetary rules at national level (Section 9 of the Act); (v) EU – Slovakia relationship (Member State) – there is no co-financing at the level of the Member State for the use of funds from non-repayable financial support to achieve the set milestones and objectives (all funds are allocated from the NextGenerationEU fund⁵⁵); (vi) it is also necessary to state that a successful achievement of the targets and milestones is also conditioned by the political situation in the Member States. If some reforms are not implemented and therefore some milestones or targets are not attained, the Recovery and Resilience Plan may not ultimately provide grants to repay the funds used from the state budget (e.g. in the Slovak Republic, this threat can be observed in connection with the reform of the judiciary).⁵⁶

Regarding the relationship between use of funds from the Recovery and Resilience Plan and the state aid rules, it should be noted that Act No. 368/2021 explicitly states that it is without prejudice to the provisions of the Act on state aid and minimum aid and the Act on public procurement. This implies that the funds are granted in accordance with the state aid and minimum aid rules.

It should be noted, however, that not all the funds provided under the Recovery and Resilience Plan are granted under state aid rules. The key lies in the definition of the recipient, who, as defined in the State Aid Act, is a person carrying out an economic activity, irrespective of its legal form and method of financing, and in who is entitled to receive aid as per the legal act. For the purposes of the Act, an economic activity is any activity consisting of offering goods or services in the market.

This is also typically reflected in individual state aid schemes or calls for applications for funding under the Recovery and Resilience Plan.

55 NextGenerationEU is a temporary instrument designed to help repair the immediate economic and social damage brought about by the coronavirus pandemic.

56 Štrkolec and Popovič, 2022.

As far as state aid schemes are concerned, they are coordinated by the Antimonopoly Office as the state aid coordinator in Slovakia.⁵⁷ When the eligible recipients are economic operators, these schemes are implemented in accordance with the state aid rules. An example is the state aid scheme for decarbonisation of industry under the Recovery and Resilience Plan (Component 4), which aims to support environmental investments in the form of greenhouse gas emission reductions in industrial production sectors.

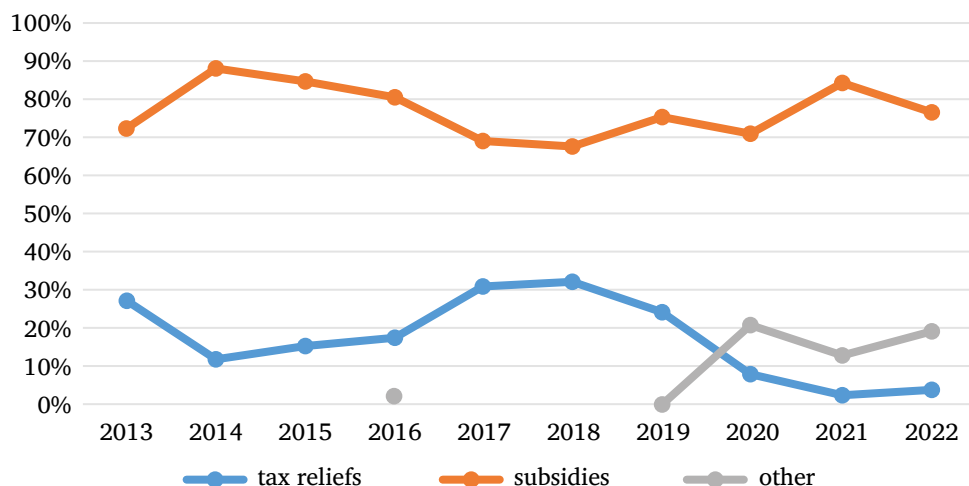
Conversely, state aid rules do not apply to a number of calls for applications. One example is the call for applications for funding from the Recovery and Resilience Facility titled ‘Support for Internationalisation in the Academic Environment’. In this case, the conditions relating to state aid and arising from state aid/*de minimis* aid schemes do not apply. Under this call for applications, funding is provided for fulfilment of the mission of higher education institutions by developing international, particularly European, cooperation through promotion of joint projects with foreign higher education institutions and other foreign institutions, mobility of staff and students of higher education institutions, and mutual recognition of diplomas and qualifications used exclusively for education as a non-economic activity. Only public higher education institutions are eligible for this funding.

3. Fiscal state aid

The majority of state aid in Slovakia is granted in the form of direct cash payments (grants and non-repayable financial contributions), accounting on an average for more than 75% of the total aid over the past 10 years.

Among the indirect forms of state aid, fiscal measures also play an important role. A part of state aid is usually granted through the tax system or the social security system, and these two categories of aid were almost the exclusive means of aid until 2019. Other categories of aid (interest rate subsidies, loan guarantees, venture capital) have appeared only since the Covid-19 pandemic, and after that, the share of state aid through the tax system has been negligible, as can be seen in Figure 2.

⁵⁷ The list of valid and effective notified state aid schemes, including those in the Recovery and Resilience Plan, is published by the Antimonopoly Office. *Platné a účinné notifikované schémy štátnej pomoci* [Online]. Available at: <https://www.antimon.gov.sk/platne-a-ucinne-notifikovane-schemy-statnej-pomoci/?csrt=12574912037303696216> (Accessed: 30 October 2023).

Figure 2: Categories of state aid paid

Data Source: Antimonopoly Office of Slovak Republic

The tax regime in Slovakia contains a number of institutions that should also be considered in the context of (presumed or potential) state aid.⁵⁸

First, individual forms of aid exist as tax relief or remission of tax debt under Art. 70 of the Tax Procedure Code and relief or remission of sanctions under Art. 157 of the Tax Procedure Code. In both cases, relief or remission is possible only in accordance with the State Aid Act. In the first case, relief or remission may be granted to a natural person only if its recovery poses a serious threat to the livelihood of the taxpayer or persons dependent on the taxpayer; it cannot be applied to VAT or excise duties. It is decided by the tax administrator and may be subject to certain conditions, particularly the obligation to pay part of the tax debt within a certain period. The second case applies to both natural and legal persons and is based on three grounds: (i) the same as the above ground of a serious threat to the livelihood of the taxpayer or persons dependent on the taxpayer (the financial administration authority is obliged to approve the relief/remission); (ii) if its payment would lead

⁵⁸ Particularly problematic in the past were the so-called tax holidays, which were granted on the basis of a statutory mandate (to exempt from income tax newly established taxpayers that pay income tax to the state budget), in particular, the exemption under Government Regulation No. 192/1998 on the conditions for exempting newly established taxpayers from corporate income tax, which, based on the definition of the conditions, essentially applied to a single taxpayer – Volkswagen Slovakia (Kicová, 2011), and which, before Slovakia's accession to the EU, was assessed by the Commission as state aid, and to which the Government of the Slovak Republic had to respond. *Návrh postupu pri ďalšom uplatňovaní nariadenia vlády SR č. 192/1998 Z. [...] [Online]. Available at: <https://lrv.rokovania.sk/2091/13/> (Accessed: 30 October 2023).*

to the termination of the taxpayer's activities and, in the case of a legal person, the proceeds from its liquidation would probably be less than the sanction imposed; and (iii) if the sanction is imposed because the taxpayer has declared the tax liability incorrectly or has failed to pay the liability on time as a result of an incorrect application of the law.

In the latter two cases, the decision is left to the discretion of the financial administration authority. The difference also lies in the fact that not only the tax administrators, but also the Financial Directorate and the Ministry of Finance decide on the relief or remission of the sanction (the material competence is determined by the amount of the sanction to be remitted). This regime is subject to notification and subsequent approval by the European Commission. However, a tax advantage may also be granted by inaction, that is, by not collecting the tax debt,⁵⁹ which is an aspect to be seriously considered in view of the amount of tax debt registered for individual taxpayers.⁶⁰

In contrast to these general institutions of the Tax Procedure Code, the Income Tax Act also recognises more specific forms of individual state aid, namely tax relief for recipients of investment aid under Section 30a of the Income Tax Act and tax relief for recipients of incentives under Section 30b of the Income Tax Act.

Tax relief for recipients of investment aid is granted as a form of investment aid pursuant to Act No. 57/2018 on regional investment aid, amending certain acts. Under this scheme, investment aid is granted to support the implementation of an investment project in industrial production, in a technology centre, or in a business service centre. A taxpayer to whom a decision on granting investment aid with tax relief has been issued, may, after fulfilling the conditions (set out both in Act No. 57/2018 and in the Income Tax Act), claim tax relief up to the amount of tax attributable to a proportionate part of the tax base calculated according to a formula considering the eligible investment costs incurred by the taxpayer. The amount of tax relief may not exceed 20% of the value of the total approved investment aid in the form of tax relief, and the taxpayer may claim tax relief for a maximum of ten consecutive tax years. If the conditions are not met, the right to the tax relief lapses, and the taxpayer is obliged to submit a supplementary tax return for all tax periods in which the tax relief was claimed.

Tax relief for recipients of incentives is granted in the form of incentives in accordance with Act No. 185/2009 on incentives for research and development, amending Act No. 595/2003 on income tax, as amended, which constitutes a state aid scheme. A taxpayer to whom a decision on granting incentives has been issued may, for each tax period during the period for which the decision has been issued, claim tax relief up to the amount of the costs reported in the financial statements and paid from its own resources for the purpose of the project for which the incentives have been granted, which *de facto* limits the amount of the approved aid by the

59 Úradník, 2019, p. 350.

60 Their lists are published by the financial administration and by individual municipalities.

Income Tax Act.⁶¹ The main conditions are the establishment of a new R&D facility or the extension of an existing R&D facility. If these conditions are not met, this will result in a reduction or lapse of the tax relief (depending on the extent of the effect on the tax base) and the obligation to file a supplementary tax return. In both cases, the recipient of the investment aid/incentive may be an enterprise, regardless of its size (including a micro-taxpayer).

However, it is necessary to mention three other forms of tax relief or reduction of the tax base.

The first is deduction of R&D expenses (costs) under Section 30c of the Income Tax Act, that is, the so-called super-deduction, which allows enterprises to deduct 100% of the R&D expenses (costs) incurred in the relevant tax period when implementing a specific R&D project, under certain conditions, if they have already not claimed tax relief under Section 30b and the expenses are not expenses for which (even partial) aid has been granted from public sources.

The second is tax relief for registered social enterprises pursuant to Section 30d of the Income Tax Act, under which a taxpayer that is a registered social enterprise in the form of a public utility enterprise pursuant to Act No. 112/2018 may claim a tax relief on economic activity in the amount of the percentage of the obligation to use profits to achieve its main objective for the tax period in which it has been granted the status of a registered social enterprise as of the last day of the tax period, if it has already not claimed tax relief under Section 30a or Section 30b or a deduction of R&D expenses (costs) under Section 30c, and if it is not a recipient of an assignment tax.

The third is deduction of investment expenses (costs) under Section 30e of the Income Tax Act, where the taxpayer-enterprise, when implementing an investment project (investment in a production and logistics system), may deduct a certain percentage of the expenses (costs) from the depreciation of the investment, depending on the planned percentage of realisation of the average value of the investment (ranging from 15% to 55%); however, this scheme cannot be combined with the deduction of R&D expenses (costs) under Section 30c.

A more interesting aspect of fiscal state aid may be various sectoral taxes, where the introduction of a special tax on retail chains by Act No. 385/2018 on a special tax on trade chains, amending Act No. 595/2003 on income tax, as amended, resonated. The tax applied to retail chains as a group of retail establishments using the same or interchangeable trade name and operated by the same entrepreneur or by entrepreneurs related to each other in terms of ownership or personnel, if they are food traders, have establishments in at least 15% of all districts, generate at least 25% of their net turnover from the sale of food to the final consumer, and their establishments have a uniform design, common communication, and common marketing activities.

61 Úradník, 2019, p. 353

The basis for the tax was the net turnover, excluding the turnover of establishments in the least developed districts with a maximum of 10 employees and in municipalities with a maximum of three establishments selling food to consumers. The tax rate was 2.5%. However, the effect of the tax was short-lived, as it was to apply from 2019, but was immediately abolished in April 2019.⁶² This was a result of an in-depth investigation by the Commission into the compatibility of the tax with state aid rules. The Commission concluded that the tax constituted state aid and that the retail turnover tax was selective in that it favoured categories of enterprises that were not subject to the tax according to the established criteria, compared to enterprises that were obliged to pay it, and issued an injunction suspending the state aid.⁶³ Slovakia responded by repealing the relevant part of the Act, and the Commission closed the case.⁶⁴ Thus, in the case of tax advantages in the context of state aid, the main issue is to assess the selectivity of the advantage, since the other three conditions for state aid (aid attributable to the State and financing from the State funds, conferring of an advantage, distortion or threat of distortion of competition and effect on trade between Member States) are already *prima facie* met in many cases. As the Commission pointed out, with regard to this specific tax, according to the settled case law of the Court, the assessment of the condition relating to the selectivity of the advantage concerned requires a determination, in the first place, of whether, under a given legal regime, a national measure is such that it favours ‘certain undertakings or the production of certain types of goods’ over other undertakings, which, in the light of the objective pursued by that legal regime, is in a comparable factual and legal situation and which accordingly suffers differential treatment that can essentially be described as discriminatory;⁶⁵ therefore, it is necessary to identify the ordinary or ‘normal’ tax system applicable in the Member State concerned, that is, the so-called ‘reference system’, and thereafter demonstrate that the tax measure at issue is a derogation from that ordinary system, insofar as it differentiates between operators who, in the light of the objective pursued by that ordinary system, are in a comparable factual and legal situation. In another case, an aid scheme for the reduction of excise duty rates on biofuels was approved in 2017, where the Commission found the measure to be compatible with state aid rules.⁶⁶

As mentioned above in the Frucona case, the write-off of part of tax debt in the context of a restructuring (arrangement) is another case where the state aid rules conflict with the functioning of tax institutions. However, unlike Frucona, similar cases exist with a similar factual basis, such as Konas, where the Commission admittedly

62 For more details, see: Popovič, 2019.

63 State aid SA.52194 (2018/FC) – Slovak Retail Turnover Tax. Invitation to submit comments pursuant to Art. 108 para. (2) of the TFEU, 2019/C 194/03.

64 Commission Decision (EU) 2019/2140 of 21 October 2019 on State aid SA.52194 – 2019/C (ex 2018/FC) – Slovak Republic – Slovak Retail Turnover Tax (notified under document C(2019) 7474).

65 CJEU, 19 December 2018, Case C-374/17, *Finanzamt B v. A-Brauerei*, ECLI:EU:C:2018:1024, para. 35, and case law cited.

66 State Aid SA. 49509 – Slovakia – Preferential taxes for biofuels, C(2017) 9107 final.

considered the write-off of part of the unpaid tax in the context of an arrangement procedure as unlawful state aid in breach of Art. 88 para. (3) of the EC Treaty (as in the previous case, the market economy creditor test was not fulfilled), but at the same time compatible with the common market as restructuring aid (after assessing the comprehensiveness of the restructuring plan), provided that its granting was conditional on implementation of the restructuring plan.⁶⁷

However, other known cases where the Commission did not approve notified proposed investment aid also exist, such as the proposed regional investment aid in the form of tax relief under Section 35a of the former Income Tax Act⁶⁸ in favour of Alas Slovakia, s.r.o., amounting to approximately EUR 2.9 million in 2008, on the grounds that the regional contribution of the proposed aid was not sufficient to outweigh the distortion of competition that would result from granting a selective advantage to one large company.⁶⁹ For similar reasons, the Commission did not approve the same type of tax relief amounting to approximately EUR 1.16 million in 2007 for Glunz & Jensen.⁷⁰ In most cases, however, the Commission does not have any comments on the notified proposed state aid in Slovakia or concludes, after opening an investigation, that no state aid is involved.

4. Conclusion

State aid policy and rules have been gradually developed since 2004, when Slovakia accessed to the EU. The current national legislation therefore reflects not only the implementation of EU legal acts, but also the case law of the Court of Justice of the EU in the two most important cases concerning Slovakia (Frucona, NCHZ). The problems of insufficient reduction of regional disparities and excessive sectoral bias of aid were perceived as major shortcomings in the pre-crisis period, but are no longer perceived as a key problem in times of crisis.

Over the past three years, state aid law has adapted significantly to the demands of times of crisis. Legislators at both European and national level had to react quickly to the impact of the COVID-19 pandemic and the armed conflict in Ukraine. To this

67 2007/204/EC: Commission Decision of 26 September 2006 on State aid C 42/2005 (ex NN 66/2005; ex N 195/2005) implemented by the Slovak Republic for Konas, s.r.o. (notified under document number C(2006) 4205).

68 Act No. 366/1999 on income tax, effective until the end of 2003.

69 2008/734/EC: Commission Decision of 4 June 2008 on State aid C 57/07 (ex N 843/06) which the Slovak Republic is planning to implement for Alas Slovakia, s.r.o. (notified under document number C(2008) 2254).

70 2008/551/EC: Commission Decision of 11 December 2007 on State aid C 12/07 (ex N 799/06) planned by the Slovak Republic for Glunz & Jensen s.r.o. (notified under document number C(2007) 6045).

end, various aid schemes have been used effectively, of which the Recovery and Resilience Plan is prominent. However, it is premature to evaluate this mechanism at this stage, as its disbursement is possible only until 2026.

At this stage, only limited prediction can be made about the future development of state aid rules. However, the logical assumption is that the crisis period will be over and a return to the pre-crisis period and a reduction in the forms of state aid to direct and indirect aid can be expected, as in 2020.

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SLOVENIA: THE SUBSIDY POLICY EMBEDDED IN THE LEGAL ENVIRONMENT OF THE EU – THE CASE OF SLOVENIA



BORUT BRATINA – RADO BOHINC

Abstract

This chapter explores the intricate relationship between state aid regulation and the sovereignty of the European Union (EU) Member States. The study is based on Art. 3 paras. (3) and (4) of the Treaty on the European Union (TEU), emphasising the EU's commitment to establishing an internal market and economic union. While the internal market aims for a highly competitive social market economy, economic and social disparities among Member States necessitate establishing coordinated economic policies. Alongside the discussion on the system governing the protection of competition in the EU's internal market, that is, EU competition law, the chapter also discusses state aid, considered a potential restraint on competition, and other actions like cartel agreements and abuse of dominance. The study argues that state aid, while generally undesirable in a market economy, may be a tool to prevent unwanted outcomes and achieve non-economic objectives. In examining EU competences, the study focuses on the exclusive competence of the EU in determining competition rules for the internal market, as outlined in Art. 3 of the Treaty on the Functioning of the European Union (TFEU). The unique supranational state aid control system significantly constrains Member States in economic, financial, environmental, and regional policy decisions. Notably, the chapter expands its scope to scrutinise Slovenian state aid law, especially in times of crisis. It explores the dynamics of state aid regulations during challenging economic periods (the COVID-19 pandemic and the war on Ukraine), shedding light on how Member States navigate the delicate balance

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between national interests and EU regulations. Using Slovenia as a case study, the chapter highlights the country's constitutional amendments before joining the EU, underscoring how the delegation of the exercise of specific rights to the EU aligns with the principles of EU law.

Keywords: *state aid, sovereignty, EU competition law, internal market, Slovenian state aid law*

1. Introduction

Art. 3 paras. (3) and (4) of the Treaty on the European Union (TEU) are clear in stating that the European Union's (EU) fundamental economic task is to establish an internal market along with an economic and monetary union. An internal market is a precondition for the development of a highly competitive social market economy, which is what the EU wants to be. Nevertheless, the mere establishment of an internal market does not guarantee the achievement of every objective set out in Art. 3 of the TEU. The wide economic and social disparities between Member States necessitate coordinating their economic policies.¹

As early as 1957, Member States committed themselves in the European Coal and Steel Community (ECSC) Treaty to establishing, first, a single market. Only toward the end of 1992 did the EU consider having an internal market, which can be defined as an area without internal frontiers in which free movement of goods, persons, services, and capital is ensured by the provisions of the Treaty on the Functioning of the European Union (TFEU).

EU competition law must function to ensure the establishment and effective functioning of the EU's internal market. EU competition law may simply be defined as the system of legal principles and rules that govern the protection of competition in the internal market of the EU.²

Alongside measures to regulate one or more sectors of the economy or markets with respect to cartel agreements, abuse of a dominant position, and the concentration of undertakings, state aid is considered as a method to restrict competition in the single market. The first three are caused by actions performed by undertakings that restrict free competition in the EU's internal market, while the last two are actions by the state or public authorities, which also require restriction or prohibition. The function of EU competition law (and prior to that of the European Economic Community) has also always been market integration (the creation first of a common market and then of

1 Ferčič, Hojnik and Tratnik, 2011, p. 121.

2 Ferčič, 2011, p. 171.

an internal market), which, in principle, is not a characteristic of national competition law systems that mostly only seek to prevent distortions of market competition.³

Since state aid necessarily interferes with market competition or, more generally, with the market and market relations, granting it is usually not simply a matter concerning the grantor and the recipient of the state aid in question, but also concerns other market players, in particular the recipient's domestic and foreign competitors. Further, state aid may also be a concern of one or more other countries due to its negative cross-border effects, and this may lead to the adoption of international agreements restricting the granting of state aid. In this respect, one may, in principle, conclude that countries with an internationally open market economy are characterised by a more consistent and restrictive state aid policy than are countries with a relatively closed administrative-plan economy.⁴ Although state aid as a form of market intervention in a market economy is in principle not desirable, it is an appropriate means in a given circumstances to prevent unwanted market outcomes and achieve certain desirable non-economic objectives. State aid can be a 'poison or a cure',⁵ depending on the circumstances of a case, which is in line with the existing legal framework that, on the whole, 'rejects' state aid unless well-defined conditions are met.⁶

The sources of EU competition law are found first in EU primary law; namely, the two Treaties TEU and TFEU along with their legal principles and rules. These rules from the main source of EU law are then concretised and elaborated in secondary EU law, represented by regulations, directives, decisions, and judgements, as well as in 'soft' EU law (*sui generis* acts).

To discuss the sovereignty of the EU Member States, first, it is necessary to analyse the provisions of Arts. 2 to 6 of the TFEU, which, regulate in greater detail the types and areas of the EU's competences. These competences can be divided into exclusive competences (Art. 3 of the TFEU), shared competences (Art. 4 of the TFEU), supporting competences (Art. 6 of the TFEU), and 'special' competences (e.g. foreign and security policy).

Art. 3 of the TFEU is clear in stating, *inter alia*, that 'the determination of the competition rules necessary for the functioning of the internal market' is an exclusive competence of the EU.

The system of state aid control established within the EU is unique.⁷ It is a supranational system that significantly constrains EU Member States⁸ in their decisions, especially in the areas of economic, financial, environmental, and regional policy.

3 Weitbrecht, Karenfort and Peck, 2004, p. 32; Ferčič, 2011, p. 173.

4 Ferčič, 2011, p. 9. The administrative planned economy is typically for countries with a socialist-communist legal system and thus also for the former Yugoslavia, which included the Republic of Slovenia.

5 Joaquín Almunia, former EU Competition Commissioner, distinguishes between bad and good state aid. See: European Commission, 2010, p. 4.

6 Ferčič, 2011, p. 35.

7 Ehlermann, 1994.

8 Möschel, 1995, p. 85. The author uses the very graphic term 'country on a chain'.

The direct competition rules are set out in Arts. 101 to 109 of the TFEU. The provisions of Arts. 101 to 106 are aimed at undertakings and, for this discussion, the most relevant are the provisions of Arts. 107 to 109 governing state aid.

This study is guided by three main hypotheses: (i) The definition and regulation of state aid is an exclusive competence of the EU; (ii) While fiscal policy remains the responsibility of Member States, they must respect commonly agreed rules, notably the ‘fiscal rule’; (iii) As state aid is paid out of or charged to the public purse, it is an area of shared competence. States have sovereign fiscal policy discretion, yet they must respect the commonly agreed rules (in particular, the fiscal rule) and may not pay state aid in contravention of the TFEU, secondary legislation (especially regulations issued by the EU Commission), and rulings of the Court of Justice of the EU (CJEU).

EU law goes beyond the rules of international law because the EU or its legislation can make its own rules on (i) the way EU law is passed on to Member States’ legal systems or applied; (ii) its relationship with the law of the Member States; (iii) how it works in Member States’ legal systems.⁹

To become a member of the EU, a country must accept these ‘rules of the game’.¹⁰ This explains why Slovenia had to amend its constitution before joining the EU. The ‘European Article’ 3a was added to the Slovenian Constitution to allow the National Assembly of the Republic of Slovenia, by a two-thirds majority of all its members, to delegate the exercise of part of its sovereign rights to an international organisation (including the EU) in certain conditions.¹¹

It should be stressed that Slovenia has not transferred part of its sovereignty, only the exercise of some of its sovereign rights. Slovenia continues to hold sovereignty as a sovereign state.¹² Any debate on sovereignty must be based on the fundamental principles of EU functioning and EU law as confirmed and consolidated by the EU Court of Justice in its decisions. These fundamental principles are of autonomy, primacy, direct applicability, and of direct effect.

⁹ This follows from the ECJ’s decision in *Costa v. Enel* in 1964. CJEU, 15 July 1964, Case 6/64, *Flaminio Costa v. E.N.E.L.*, ECLI:EU:C:1964:66.

¹⁰ Ferčič, Hojnik and Tratnik, 2011, p. 84.

¹¹ Art. 3a of the Constitution of the Republic of Slovenia reads as follows: ‘(1) Slovenia may, by an international treaty ratified by the National Assembly by a two-thirds majority of the votes of all its members, transfer the exercise of part of its sovereign rights to international organisations based on respect for human rights and fundamental freedoms, democracy, and the rule of law, and enter into defence alliances with countries based on respect for these values; (2) Slovenia may, by an international treaty ratified by the National Assembly by a majority of two-thirds of votes of all its members, transfer the exercise of part of its sovereign rights to international organisations based on respect for human rights and fundamental freedoms, democracy, and the rule of law. (3) Legal acts and decisions adopted within the framework of international organisations to which Slovenia has delegated the exercise of part of its sovereign rights shall be applied in Slovenia in accordance with the legal regime of those organisations’.

¹² Ferčič, Hojnik and Tratnik, 2011, p. 84; Commission Notice on the concept of state aid under Art. 107(1) of the TFEU, 2016/C 262/01, OJ C 262, 19.7.2016, 1–50, point 5.

2. State aid in Slovenian Law

2.1. Law of the Republic of Slovenia concerning state aid

According to the State Aid Monitoring Act¹³ (hereinafter: ZSDrP, or State Aid Act), state aid is the expenditure and reduced receipts of the state or municipality that represents a benefit for the recipient of the aid and thereby provides it with an advantage over competitors and are intended for the financing and co-financing of programmes in organisations engaged in the market production of goods and services with the aim of ensuring a certain competitive advantage, as defined in Art. 107 of the Treaty establishing the European Community.

The State Aid Act and by-laws in the Republic of Slovenia regulate the (i) procedure for notifying state aid, (ii) obligation to report and record state aid, and (iii) assessment of compliance of state aid that need not be notified to the European Commission. The Ministry of Finance performs the following tasks according to the ZSDrP: (i) it considers, evaluates, and forwards the notification of state aid to the European Commission; (ii) it considers, evaluates, and gives its opinion on state aid that constitutes a group exemption and on aid under the *de minimis* rule; (iii) it collects, processes, and monitors data on state aid as well as aid granted under the *de minimis* rule; (iv) it keeps records of this data, prepares an annual report, and advises state aid managers.

The administrator of state aid in Slovenia, which ensures its correct implementation and reporting on its implementation, is the relevant authority that prepares its content and notifies it. All units that, in accordance with statistical regulations, are defined in the state sector and grant state aid must provide data to the Ministry of Finance.

According to the law, the government of the Republic of Slovenia determines by means of a by-law the manner and deadlines for transmission of data to the Ministry of Finance. The government also determines the more precise content and format of the records and the annual report on state aid in a secondary legal act.

By decree, the government of the Republic of Slovenia has established the criteria and conditions for the allocation of regional state aid, considering the policy provisions of this aid in the EU: (i) Regulation on the map of regional aid for the period 2014–2020;¹⁴ (ii) Decree on the allocation of regional state aid and the method of coordination of regional incentives for employment and investment¹⁵ and amendments.¹⁶

13 Official Gazette of the Republic of Slovenia, no. 37/04.

14 Official Gazette of the Republic of Slovenia, no. 113/13.

15 Official Gazette of the Republic of Slovenia, no. 93/14.

16 Official Gazette of the Republic of Slovenia, no. 77/16 and 14/18.

2.2. The concept and meaning of state aid in Slovenia

The concept and meaning of state aid in Slovenia is applied and understood as defined by EU legal sources. It is important to state at the outset that it is difficult to find an area in EU law where the sovereignty of states in economic and fiscal policy is more limited.¹⁷

To monitor state aid more effectively, Slovenia adopted a special law on state aid monitoring, the ZSDrP. According to this law, state aid is

expenditure and reduced receipts of the State or a municipality which confer a benefit on the recipient of the aid and give it an advantage over competitors and are intended to finance and co-finance programmes in institutional units engaged in the marketable production of goods and services with a view to securing a certain competitive advantage as defined in Article 107 TFEU.

In the same sense as in EU law, Art. 2 of the ZSDrP defines the notions of block exemptions and aid under the *de minimis* rule.

The ZSDrP and the by-laws in the Republic of Slovenia regulate the procedure for notifying state aid, the obligation to report and record such aid, and the assessment of the compatibility of state aid that does not have to be notified to the European Commission.

The Ministry of Finance of the Republic of Slovenia is the competent authority under the ZSDrP for: (i) considering, assessing and forwarding notifications of state aid to the European Commission; (ii) examining, assessing, and giving an opinion on state aid that constitutes a block exemption and on aid under the *de minimis* rule; (iii) collecting, processing, monitoring, and maintaining records of state aid and *de minimis* aid; (iv) preparing an annual report; (v) advising state aid administrators.

The Ministry of Finance has established a dedicated State Aid Monitoring Unit. The unit provides advice to state aid donors and checks and assists in the preparation of the legal bases on which state aid is granted. It also issues binding opinions on the compatibility of the implementation of these measures with state aid rules and, where necessary, forwards them to the European Commission for an opinion. It also works with the European Commission to verify and coordinate the compliance of the implementation of measures with EU rules. The unit is also responsible for monitoring and collecting data on state aid. In addition, it regularly provides training for donors and keeps them informed of new developments in this area.

Arts. 4 to 11 of the State Aid Act regulate the content and procedure for monitoring state aid. All institutional units defined in the government sector according to the statistical regulations and the granting of state aid are required to provide the Ministry of Finance with all data further specified in the ZSDrP.

¹⁷ Ferčič, 2011, p. 9.

Based on all the information provided and collected, the Ministry of Finance regularly¹⁸ prepares a State Aid Report. The latest of these reports from December 2022 contains data on state aid disbursed in Slovenia in 2019, 2020, and 2021. The State Aid Report is an analytical overview of state aid disbursed in Slovenia in the last 3 years and an important element ensuring transparency and control over the granting of state aid. The Report is based on data on state aid disbursed by state aid providers (ministries, municipalities, public agencies, funds, other public bodies). Pursuant to Art. 4 para. (2) of the State Aid Act, the government of the Republic of Slovenia has issued a Regulation on the submission of data and reporting on state aid and *de minimis* aid.¹⁹ The Report is adopted by the government and submitted to the National Assembly of the Republic of Slovenia for information within 30 days of its adoption. Slovenia has introduced a Regulation on the submission of information and reporting on state aid and *de minimis* aid.

The Ministry of Finance shall forward the notification of state aid to the European Commission within 45 days of receiving it. The Ministry of Finance must examine the application on its merits and, if it considers that the notified state aid is incompatible with the state aid rules, it must ask the state aid operator to align it with state aid rules. If the operator insists on the content of the notification, it shall make a declaration that the notification with the proposed content should be forwarded to the European Commission. The Ministry then has 5 days to forward the application to the European Commission. Communication in terms of additional questions, explanations, and information regarding the notified state aid between the European Commission and the operator takes place via the Ministry of Finance.

The role of the Ministry of Finance becomes even more substantive in the case of block exemptions and the *de minimis* rule because it is the sole authority dealing with block exemptions and aid under the *de minimis* rule and gives its opinion on their compatibility with the state aid rules. In this respect, the Ministry has a deadline of 45 days for block exemptions and 15 days for the assessment of *de minimis* aid. In the event of any non-compliance, the Ministry shall invite the state aid operator to remedy the non-compliance and set a deadline by which the state aid operator must comply.²⁰ Pending a positive opinion from the Ministry, the implementation of the state aid is suspended and prohibited. The Ministry shall inform the European Commission of the granting of state aid under exemptions.

The Ministry also collects data concerning the effectiveness and efficiency of state aid spending. Based on this, the Ministry maintains a database on state aid and *de minimis* aid granted.

18 This means at least until the end of June of the current year for the previous year.

19 Official Gazette of the Republic of Slovenia, no. 61/04, 22/07 and 50/14.

20 In this area, the European Commission adopted a Commission Notice on the recovery of unlawful and incompatible state aid, 2019/C 247/01, OJ C 247, 2019.7.23, 1–23, which aims to clarify the EU's rules and procedures governing the recovery of state aid and how the European Commission cooperates with Member States.

Art. 9 of the State Aid Act requires the Ministry of Finance to maintain records to ensure transparency in the area of state aid for: (i) all notifications; (ii) notifications sent to the European Commission; (iii) state aid granted; (iv) aid under the *de minimis* rule; (v) other necessary records provided for in the Regulation.

Exceptions to the above rules are state aid to agriculture and fisheries. It is noteworthy that before 2004 the competent authority was the State Aid Control Commission and now the same role is assigned to the Ministry of Finance.

2.3. State aid compatible with the internal market

Energy production and distribution and the construction and management of energy infrastructure require and receive special attention in these topical times. This specific area is covered by sectoral internal market legislation, as reflected in the criteria that ensure the compatibility of aid in these areas with the internal market and the consistency of EU policy on environment and energy. The provisions on regional aid in the Regulation should therefore not apply to measures relating to the production and distribution of energy and energy infrastructure.

The problem of state aid in Slovenia is best illustrated by considering the 22nd State Aid Report adopted by the Slovenian government in December 2022. Under the State Aid Act, the Ministry of Finance must prepare an annual report on state aid granted, which it submits to the government for adoption by the end of June. The report covers data for the previous 3 years to allow proper comparison and analysis. An analytical overview of state aid paid in Slovenia over the preceding 3 years is therefore provided, and the report is an important element of ensuring transparency and control over the granting of state aid. The current report covers the years 2019, 2020, and 2021, which were marked first by the COVID-19 crisis and later by the energy crisis caused by the war in Ukraine.

In 2021, EUR 1.69 billion of state aid was paid in Slovenia,²¹ of which EUR 1.13 billion was to tackle the economic situation created by the outbreak of the virus, representing a large share (66.8%) of all the aid paid that year. The remaining EUR 559.22 million, an increase of EUR 57.37 million over 2020, was allocated to other categories of aid. Aid to deal with the COVID-19 epidemic is discussed separately below.

Over the last 3 years, the structure and proportion of the biggest aid categories in Slovenia have not changed significantly. Aid for environmental protection and energy (EUR 164 million in 2021) still accounts for the largest share, followed by aid for employment (EUR 127.5 million in 2021), research, development, and innovation (EUR 63.56 million in 2021) and transport (EUR 105.3 million in 2021).

State aid was mainly paid out as subsidies, amounting to EUR 422.43 million in 2021, or 75.54% of the total aid paid. In contrast, the volume of repayable forms of

21 Below we summarise and comment on the data and figures published in the 22nd State Aid Report for 2019, 2020 and 2021.

aid (such as soft loans and guarantees) is not significant, representing just 0.35% of the total aid.

A comparison with the EU shows that Slovenia has a similar volume and structure of state aid. Excluding the COVID-19 aid, Slovenia's share of such aid in 2021 was 0.94% of its GDP, ranking Slovenia 15th in the EU.

Another interesting figure comes from the State Aid Performance Assessment Report, which is positive and comprises a summary of the reports submitted by the donors. Unfortunately, this assessment is a lump sum, and the Ministry of Finance concludes that these reports from the donors are deficient and do not follow the Guidelines to the Measurement of the Effectiveness of State Aid Granted.

If we consider the aid granted to mitigate the financial crisis in 2011–2014,²² the share of state aid was highest in 2013 when state aid measures accounted for a good one-tenth of the GDP.

2.4. Structure of state aid in Slovenia

Slovenia spends most of its state aid on 'horizontal' aid²³ aimed at stimulating development and correcting market failures regardless of the sector of the economy. Aid for environmental protection and energy has maintained the largest share over the years. The volume of sector-specific aid, which is less desirable than horizontal aid due to its greater negative impact on competition and trade, is slightly higher in 2020. Aid to specific sectors²⁴ accounted for 18.86% of total state aid (only 13.6% in 2020) or EUR 105.51 million, while the share of aid to agriculture was 3.8%, namely, at the level of the previous 2 years.

Employment aid is the second highest, almost all of which (99.6%) is spent on employing disabled people and adapting the workplace for disabled people. In 2021, this type of aid accounted for EUR 127.56 million, or 12.56% more than that in 2020, and it accounted for over one-fifth of all aid (22.81%).

Research, development, and innovation (R&D&I) accounted for EUR 63.56 million, a significant drop (18% less) compared to the previous year, 2020. It thus represented only 11.37% of the total state aid, which is also below the 2019 level.

Within sectoral aid, most aid was paid as compensation for rail passenger transport. In 2021, EUR 104.66 million, or 18.71% of total aid, was allocated for this purpose, which is surprisingly high. At the same time, the volume of these allowances has been growing steadily over the last 3 years. In the last year, the increase was 55.77%. The Report suggests that this is due to modernisation of the means of

22 This has mainly been in the context of the rehabilitation of state-owned banks, where a commitment was therefore given to the EU Commission that the banks would be privatised at a later stage.

23 State aid by group and category in the Report shows that horizontal aid relates to environmental protection, employment, research and development and innovation, regional aid, culture, broadband development, SMEs, risk capital, training, natural disasters and emergencies, sports and multi-purpose infrastructure, and services of general economic interest.

24 Transport, both land, air and sea, and coal mining, and rescue and restructuring aid.

transport used to operate the public passenger transport service, the higher cost of user charges, and the additional compensation due to the COVID-19 pandemic.

2.4.1. State aid by type of instrument

State aid can be granted in various forms, such as subsidies, soft loans, guarantees, tax or contribution exemptions, and capital injections. The choice of instrument should depend on the objective and the market failure to be addressed and have the least possible negative impact on competition and trade. In Slovenia, the majority of state aid is granted in the form of subsidies. Hence, in 2021, subsidies amounted to EUR 442.43 million, or 75.53% of total aid.

Another option is to pay out state aid in the form of reduced government revenue. In the form of reduced social security contributions, EUR 99.86 million was granted in 2021, representing 17.8% of the total state aid. An upward trend can be noted in this aid instrument during the period under review, mainly in the form of exemptions from employers' contributions for employing disabled persons. Yet, the greatest share of this instrument of reduced public revenue is represented by aid for environmental protection, with 96.6% in 2021 for reducing environmental charges.

The instrument of repayable forms of aid in the form of soft loans was mainly targeted at measures in the field of regional development.

No aid in the form of guarantees was used in the last 3 years under review.

Capital investment accounted for EUR 3.23 million, or 0.57% of the total aid in 2021 and even less in 2020, when it amounted to just 0.4%. However, such aid was earmarked for measures in the fields of risk finance and services of economic interest.

2.4.2. State aid by donor

In Slovenia, the Ministry of Infrastructure granted the most aid (44.72%) in the period 2019–2021. The majority of this aid was allocated to environmental protection and energy saving measures (66.4%), a good one-third to transport (33.12%), 0.45% to coal mining, and only 0.02% to sports and multi-purpose recreational infrastructure.

The Ministry of Labour, Family, Social Affairs and Equal Opportunities is in second place, having granted 22.77% of all aid. The vast majority of this aid (99%) was for the employment of disabled people, with the remainder for training.

The Ministry of Economic Development and Technology granted 14.46% of aid in the period under review chiefly for regional development and for research, development, and innovation.

The Ministry of Education, Science and Sport granted 3.71% of the aid. All of this aid was to promote research, development, and innovation.

The Ministry of Agriculture, Forestry and Food granted 3.84% of the aid (either alone or through municipalities).

This was followed by the Ministry of the Environment and Spatial Planning, which granted EUR 44.77 million, or 2.92% of total aid, all for environmental protection and energy saving.

The Ministry of Culture also allocated a small share of the funds (2.6%), mostly to the audiovisual sector.

Approximately 5% of the remaining aid was granted via other eligible grantors such as ARRS (Slovenian Research and Development Agency), the Slovenian Government Office for Digital Transformation, SID banka, EKO Fund, the Ministry of Finance, the Municipality of Piran.

2.4.3. State aid by type of aid and the procedure for granting it

In Slovenia, the lion's share of aid is granted through aid schemes where the beneficiaries are not known in advance, but the legal basis defines the eligibility criteria and criteria. In the last decade, the share of this type of aid award has varied between 71% and 89%. In 2021, 81.28% of all state aid was disbursed through aid schemes, namely all horizontal aid (environmental protection, regional aid, research, development, and innovation, employment, etc.) granted under the General Block Exemption Regulation, as well as aid for agriculture and rescue and restructuring aid for small- and medium-sized enterprises.

Individual aid targeted at a specific and known beneficiary accounted for 18.72% of all aid. This type of aid received the biggest share (29%) in 2015, mainly due to the large volume of rescue and restructuring aid for specific firms in difficulty. Aid to known recipients was also granted in the transport sector (compensation to Slovenske železnice SŽ – Potniški promet, d.o.o.) and coal sector (aid to Rudnik Trbovlje-Hrastnik, d.o.o.).

Since state aid can be granted only after the compatibility of a measure with state aid rules has been established and confirmed, the Ministry of Finance (for all aid except for agriculture and fisheries) and the Ministry of Agriculture, Forestry and Food are responsible for verifying compliance in Slovenia. Since 2018, more than half (54.1% in 2021) of all state aid has been paid under schemes approved by the Ministry of Finance and the Ministry of Agriculture, Forestry and Food, respectively, without prior notification to the European Commission.

Analysis of the data in the report shows that 74% of the measures or 26 schemes out of a total of 35 schemes for which aid was reported in 2021 were implemented under the General Block Exemption Regulation, that is, without prior notification given to the European Commission. In the EU as a whole, this proportion was 80% in 2020, which implies that competent authorities in the Member States are increasingly taking responsibility for ensuring that state aid complies with EU law. The European Commission is therefore relieved of this administrative work and can therefore carry out more targeted scrutiny of selected 'controversial state aids'.

2.4.4. State aid by region

Slovenia is a small European country with no well-developed regional public authority. After the central public authority at the national level, with its seat in Ljubljana as the capital of Slovenia, the next formal level of public local authority is the municipalities. The debate on the creation of regional public authorities (the proposal envisaged up to 10 provinces) has been underway for several decades with no progress. Consequently, public authorities are subject to much centralisation. Owing to the different levels of development and as part of implementation of the European cohesion policy, Slovenia is divided into two statistical regions: the Eastern Cohesion Region and the Western Cohesion Region, which vary significantly in their economic development. The Western Cohesion Region is one of most developed regions in the EU, exceeding the EU average, while the Eastern Cohesion Region is below the EU average. The division into two regions was requested by the European Commission for a more efficient distribution and use of EU cohesion funds (generally 66.7% to 33.3% in favour of the Eastern Cohesion Region). Although the majority of cohesion and other EU funds are meant to be allocated to the Eastern Cohesion Region, the reality is different, and the majority of these funds are still received by entities from the Western Cohesion Region. The outcome of this wrong and harmful (Slovenian central) policy is that the difference in level of development between the two cohesion regions is further intensified to the detriment of the Eastern Cohesion Region.

The above is also reflected in the data on state aid granted. In 2021, EUR 240.57 million, or 43.02% of total aid, was paid to enterprises established in the Eastern Cohesion Region, which is 5.69% less than the previous year, considering the exemption of crisis measures. The Western Cohesion Region received EUR 319.65 million or 56.98% of total aid in 2021, an increase of EUR 61.23 million over the previous year.²⁵ The average for 2019–2021 is also to the detriment of the Eastern Cohesion Region, which received only 47.24% of the aid provided during the period.

A greater focus of aid on the Eastern Cohesion Region would be fully in line with the rules of the cohesion policy that allocates relatively more resources to less developed regions and, in addition, allows higher aid intensities (such as regional aid) for certain categories of state aid in these areas. However, the analysed data show that Slovenia is not acting in the most coherent way with the European cohesion policy.

2.4.5. State aid in the form of tax measures

State aid in the form of tax measures and privileges in the tax and social contributions system accounts for around 40% of all state aid, according to the EU Commission's estimates.²⁶ EU Member States have the explicit competence to independently

²⁵ It must be reiterated that the majority (66.67%) of the funds should go to the Eastern Cohesion Region.

²⁶ European Commission, State Aid Scoreboard – 2008, COM(2008) 751 final, p. 49.

design their own tax policy and tax system. Therefore, certainly not every case of (unfair) tax competition between EU Member States, which may otherwise harm the functioning of the EU internal market, can be considered as unlawful state aid within the meaning of Art. 107 para. (1) of the TFEU.²⁷ From the outset, EU practice has been dominated by the view that state aid is not only a measure that results in a certain 'inflow' in the sphere of certain undertakings, but also a measure of an 'outflow' or alleviation of normal burdens.²⁸

For this, Slovenia has adopted a special regulation on granting of regional state aid and a method of implementing regional employment incentives and tax incentives for employment and investment.²⁹ This regulation outlines the general and specific conditions for the granting of regional state aid and the method of implementing the regional employment incentive and the tax incentives for employment and investment referred to in Arts. 27 and 28 of the Act on the Promotion of Concerted Regional Development.³⁰

The beneficiaries of the aid provided for in this regulation are legal and natural persons engaged in an economic activity in the territory of the Republic of Slovenia, subject, of course, to the conditions laid down in the law and the regulation.

The objective of aid provided for in this regulation is to promote harmonious regional development in a competitive internal market by reducing costs for businesses, with the benefit of improving the relative position of less developed eligible areas.

Aid under the regulation is not allowed for export-related activities where aid is directly linked to the quantities exported, to the establishment and operation of a distribution network, or to other current expenditure linked to the export activity. Nor is aid allowed in cases where the use of domestic goods would be favoured over the use of imported goods.³¹

Aid is normally granted on the basis of a public call for tenders, an individual application, or the claiming of a tax credit.

Art. 6 of the regulation provides for more detailed rules on the reporting and monitoring of aid granted.

Aid in the form of tax advantages is only one of the forms of aid covered by this regulation.

Aid in the form of tax advantages may be granted where the measure provides for a ceiling that ensures that the applicable threshold for the grant of state aid is not exceeded.³²

27 See: Ferčič, 2011, p. 78.

28 Ferčič, 2011.: For example, radically lower taxation of profits of all legal persons in one EU Member State compared to other Member States, because of the non-selectivity of the tax measure, does not constitute state aid, even if it harms market competition or the internal market. Art. 116 of the TFEU allows for approximation of laws (harmonisation) in this case.

29 Official Gazette of the Republic of Slovenia, no. 93/14, as amended, last edition 47/22.

30 Official Gazette of the Republic of Slovenia, no. 20/11 and 57/12.

31 This is laid down in Art. 4 para. (3) of the Regulation.

32 Art. 11 of the Regulation.

The regional employment incentive takes the form of a reimbursement of compulsory social security contributions paid by the employer for the recruitment of a new worker, at the rate laid down in the rules governing compulsory social security contributions. The worker who qualifies for the relief must meet the conditions laid down in Art. 22 para. (2) of this regulation. The first condition is that the person must be unemployed. The other conditions relate alternatively to the duration of unemployment (6 months), age (15 to 24 years), level of education, disability, membership of an ethnical minority, etc. This tax credit can be used for a maximum of the first 12 months of employment. The maximum amount of state aid allowed for this purpose may be 50% of the wage costs of an individual worker, calculated for the year in question.

The next tax deduction can be used to reduce the tax base by 70% of the amount invested.³³

Taxpayers must repay any unjustified tax relief by increasing their tax liability by the amount of the relief.

3. Impact of the COVID-19 pandemic on the granting of state aid in Slovenia and the EU

The crisis triggered by the COVID-19 pandemic in March 2020 has had a major impact on the Slovenian, European, and global economy. In this report, government expenditure on COVID-19 relief aid is considered in aggregate for both 2020 and 2021. This allows for a more comprehensive overview and better analysis of the data. Of course, not all measures implemented under the intervention laws constituted state aid. The total direct volume of measures related to COVID-19 in 2020 and 2021 totalled EUR 4.5 billion. State aid was paid out to the tune of EUR 2.3 billion, representing just over 51% of the total expenditure for this purpose.

When the first wave of COVID-19 infections swept across Europe, the European Commission, after a rapid consultation with Member States, immediately adopted the ‘Temporary Framework’³⁴ for the granting of state aid in these exceptional circumstances. These temporary measures allowed much needed support to be provided to the economy during the pandemic while maintaining a level playing field in the EU’s single market.

The European Commission was monitoring the course of the pandemic and made adaptations and amendments to the Temporary Framework six times as the crisis evolved and persisted into 2021. The Temporary Framework expired at the end of

³³ Art. 23 of the Regulation.

³⁴ Commission Communication Temporary Framework for state aid measures to support the economy in the event of an outbreak of COVID-19, 2020/C 91 I/01, OJ C 91I., 2020.3.20, 1–9.

June 2022, except for two new tools to support the ongoing recovery of the European economy (investment support and solvency support). In addition to the Temporary Framework, Member States have resorted to granting aid under the rules designed to remedy the consequences of the damage, in accordance with Art. 107 para. (2) point (b) of the TFEU.

On the EU level, EU data³⁵ show that EU-27 Member States spent EUR 320.22 billion in 2020 on state aid for COVID-19 and other measures, excluding aid to railways, which is 2.39% of the EU-27 GDP. This amount is almost 2.5 times the expenditure in 2019 (+ EUR 185.13 billion compared to + EUR 135.09 billion in 2019, corresponding to a nominal rise of around 137% and an increase of 1.58 percentage points of GDP in relative terms).

As for 2020, EU-27 Member States overall increased their provision of ‘non-crisis’ state aid by 1.9% over the last year (EUR 137.59 billion in 2020).

Expenditure on COVID-19 measures (EU-27 Member States plus the UK³⁶) amounts to EUR 227.97 billion, covering around 59% of the total spending.

Significant differences appear between EU Member States in both the volume and structure of state aid. State aid as a share of GDP was highest in Malta (4.83% of the GDP) and lowest in Ireland (only 0.6% of the GDP). Slovenia ranks fifth with 3.44% of state aid, mainly due to the large volume of COVID-19 expenditure, which accounts for 73% of all state aid provided in 2020.

Germany paid out the most state aid in absolute terms (EUR 114.94 billion), accounting for around 30% of total state aid expenditure in the EU-27 plus the UK. Germany also granted the most state aid for COVID-19 (EUR 63.66 billion or 28% of total aid).

The general trend over the last decade shows a steady increase in state aid expenditure, with a big jump in 2020 due to the COVID-19 crisis.

In Slovenia, crisis measures were adopted on the basis of 10 national intervention laws,³⁷ which previously had to be aligned with the statutory conditions of the Temporary Framework and the conditions of Art. 107 point (2) point (b) of the TFEU in order to deal with the consequences of the damage caused by the COVID-19 pandemic.

Of course, not all measures implemented under the intervention laws constituted state aid. The total direct volume of COVID-19-related measures in 2020 and 2021 amounted to EUR 4.5 billion, while state aid accounted for EUR 2.3 billion, representing just over 51% of the total expenditure for this purpose.

Measures that did not constitute state aid were mainly those aimed at all entities in Slovenia under the same conditions (non-selective measures), measures aimed

35 Aggregate information on state aid expenditure on the EU and national levels is provided by Scoreboard, an analytical database produced annually by the European Commission.

36 The agreement on the UK's withdrawal from the EU came into force on 1 February 2020.

37 The act on intervention measures to contain the COVID-19 epidemic and mitigate its consequences for citizens and the economy, Official Gazette of the Republic of Slovenia, no. 49/20, and subsequent amendments, and about 10 other laws regulating intervention measures for citizens and businesses.

at natural persons not engaged in economic activity (e.g. vouchers and social assistance) and measures aimed at public services (health and education).

Slovenia applied the following points of the Temporary Framework to implement the state aid measures: 3.1. Aid in the form of direct grants, repayable advances or tax incentives (ceiling of EUR 800,000 per company, increased to EUR 1.8 million on 28 January 2021 and to EUR 2.3 million on 8 November 2021); 3.2. Aid in the form of loan guarantees; 3.3. Aid in the form of subsidised interest rates on loans; 3.4. Aid in the form of guarantees and loans channelled through credit or other financial institutions; 3.6. Aid for research and development in the field of COVID-19; 3.8. Investment aid for the manufacture of products related to COVID-19; 3.10. Aid in the form of paid subsidies to employees to prevent redundancies during the COVID-19 outbreak (aid limited to the reimbursement of 80% of an individual worker's salary); 3.12. Aid in the form of support for non-covered fixed costs (limited to an aid amount of up to EUR 3 million per undertaking, on 28 January 2021 the aid amount was revised to EUR 10 million per undertaking, and on 18 November 2021 the limit was increased to EUR 12 million).

Most funds were allocated under Action 3.1 of the Temporary Framework as they were also the easiest to allocate. A significant part of the funding was allocated under point 3.10, which allowed for assistance to reimburse wage compensation of up to 80% of labour costs for workers on waiting time. Under this point, aid for part-time work was also granted.

Data published in the State Aid Report 2019–2021 show that the greatest amount of state aid in Slovenia was granted to companies to reimburse 100% of the wage compensation for workers put on furlough. The aid was thus granted under the first, sixth, and eighth intervention laws. These aids were granted to the tune of EUR 558.13 million and benefited 47.575 market operators. This measure has clearly been effective as Slovenia today has the lowest unemployment rate since the pandemic ended and, at the same time, many companies have been able to retain key personnel for their activities thanks to this measure, noting that economic growth in Slovenia since the end of the pandemic has also been above the EU average.

In second place in terms of the volume of aid is aid granted in the form of a monthly basic income of EUR 411.69 million, as granted to 57.235 market operators.

Among the larger and more important aid measures is one contained in the first intervention law aimed at exempting workers who were working during the pandemic from the need to pay contributions. This type of aid amounted to EUR 360.54 million as was received by 57.679 market operators.

Aid in the form of the partial reimbursement of uncovered fixed costs was granted in the amount of EUR 316.72 million to 16,073 market operators.

Further, 14,811 companies benefited from aid to reimburse wage compensation for workers put on furlough by companies, receiving up to 80% of the compensation totalling a value of EUR 108.43 million.

Other measures were granted aid of less than EUR 100 million.

In Slovenia, the most widely used aid instrument was the grant (i.e. subsidy), representing 63.5% of all aid granted. Together with the instrument for reduction in social security contributions, this accounts for 87.6% of all aid granted to remedy the effects of COVID-19.

Aid granted in the form of soft loans and guarantees accounted for just 5.2% and tax exemptions, exemptions, and reliefs for a mere 0.11% of aid, and they are mainly measures involving reducing the payment of rent for publicly owned premises.

In terms of the size of the market operators receiving aid, by far the largest share of aid was received by micro enterprises. These are enterprises employing up to 10 people. Micro enterprises received EUR 945.28 million in aid.

Small enterprises employing between 10 and 49 people received almost half as much aid (EUR 528.78 million). Medium-sized enterprises (50–249 employees) were given EUR 270.86 million in aid and large enterprises (more than 250 employees) EUR 426.32 million, which is 19.63% of all the COVID-19 aid.

Aid toward the end of the COVID-19 pandemic was scaled back and refocused on measures targeting recovery from the COVID-19 crisis and stimulating investment in green and digital transitions. The latter has become even more relevant since the energy crisis erupted in the wake of the war in Ukraine.

The European Commission is committed to updating the collection and monitoring of information on the use of COVID-19-related measures. The aim is for countries to recover as quickly as possible from the effects of the COVID-19 pandemic and accelerate the double green and digital transitions, while ensuring that crisis support measures are phased out in line with economic developments. It is important that Member States and the European Commission take the right measures to allow economic operators to recover quickly from the crisis of the COVID-19 crisis and to be prepared to face a new energy crisis, this time caused by the military invasion of Ukraine, an important country in Europe.

It is vital to actively monitor and measure the performance of state aid to ensure that public funds are used efficiently and channelled toward actions with clear and measurable results that best contribute to achieving policy objectives. In Slovenia, assessing the performance of state aid is the responsibility of line ministries and other donors that design measures and channel public funds to selected policies and projects. The regulation on data transmission and reporting on state aid and *de minimis* aid³⁸ was adopted, which requires the responsible government department to notify the aid and then submit a report assessing the performance of the state aid granted. In so doing, it must follow the specific guidelines adopted in 2004 for measuring the effectiveness of state aid granted.

The mentioned report states that the Ministry of Finance's examination of these performance reports reveals that not all donors fully comply with the provisions and deadlines of the Regulation and the Instruction. The reports are hence often deficient, with an opaque structure of objectives and indicators, making it difficult to

38 Official Gazette of the Republic of Slovenia, no. 61/04, 22/07 and 50/14.

determine whether the results are in line with the objectives of the scheme and the actual performance of the measure. The Ministry is therefore part of a cooperation project under the Structural Reform Facility being prepared and implemented by the European Commission. The goal of this project is to identify, with the help of relevant experts, a suitable set of targets and indicators for specific areas that would allow donors to monitor the performance of public spending on state aid and target resources to measures that have a positive impact.

4. Selected cases of controversial state aid and case law in the EU and Slovenia

Since 2012, the European Commission has been implementing a roadmap to modernise the area of state aid. The legislative package has noticeably strengthened Member States' accountability and boosted cooperation between the Commission and Member States on the enforcement of state aid law. As a result, Member States are granting more aid without prior control by the European Commission. The European Commission has thus had to boost its follow-up measures to ensure that Member States correct distortions of competition by recovering aid paid in breach of the state aid rules. In order to further clarify the European Commission's rules and procedures governing the recovery of state aid and how the European Commission works with Member States to assure that they are complying with their obligations under EU law, the European Commission published a Commission Notice on the recovery of unlawful and incompatible state aid.³⁹ The Notice is addressed to the authorities in the Member States responsible for implementing the decision in which the Commission ordered the recovery of state aid (the recovery decision).

Art. 4 para. (3) of the TEU provides that Member States are to support the EU in the performance of its tasks. The EU and the Member States must, following the principle of sincere cooperation, assist each other in the performance of these tasks to achieve the EU's objectives. The European Commission and the Member States must cooperate in good faith in all stages of the state aid procedure, especially during the investigation pursuant to Art. 108 para. (2) of the TFEU. Since cooperation is smooth during the investigation, implementing the recovery decision becomes quicker and easier.

The recovery of state aid is not a penalty, but the logical consequence of a finding that the aid was unlawful. Irrespective of whether the source of the recovery obligation is a recovery order or a recovery decision, the Member State concerned must effectively and immediately implement the recovery in accordance with the

³⁹ Commission Notice on the recovery of unlawful and incompatible state aid, 2019/C 247/01, OJ C 247, 23.7.2019, 1–23.

Procedural Regulation. The measures taken by Member States must not only consider effective implementation of the recovery decision as their objective, but also achieve it in practice.

4.1. Examples of state aid litigation in Slovenia

In Slovenia, state aid is usually granted under the rules of administrative procedures, which is why dissatisfied parties can appeal to the Administrative Court of Slovenia that provides judicial protection of the rights and legal interests of the parties against the decisions of public authorities. However, a decision of the Administrative Court can be appealed to the Supreme Court of Slovenia. A few ‘sample’ litigation cases are listed below.

Case U-3/2005 of 21.03.2008 concerned an error of substantive law in the application of state aid to post-earthquake reconstruction. The regulation governing state aid under the *de minimis* exemption does not apply to the transport sector, which is subject to special rules. National law does not distinguish between the beneficiaries of the state aid in question by virtue of the activity in which they are engaged. It is for the administrative authority to take a decision that is in harmony with EU law. In its decision, the Slovenian government’s Office for Structural Policy and Regional Development unjustifiably rejected the applicant’s application to register business damage caused by the earthquake of 12 July 2004. On 11 November 2004, the Slovenian government decided that the state aid in question should be granted under the *de minimis* rule in respect of the business damage. However, undertakings in the transport sector are ineligible for *de minimis aid* under the EU Regulation. The competent authority responsible for granting that aid therefore considered that the grant of state aid to the undertaking as infringement of the rules on the grant of state aid under the *de minimis* rule. The applicant submitted that the *de minimis* rules do not apply to the present case as the matter concerns compensation for damage caused by natural disasters, as is expressly authorised by Art. 107 para. (2) of the TFEU. The Court of First Instance annulled the order on the grounds that the competent authority had not applied the relevant rule.

The Minister of Labour, Family and Social Affairs issued a call for tenders to promote the development of social entrepreneurship II under the 4th development priority ‘Equality of Opportunities and Promotion of Social Inclusion’ and ‘Social Inclusion’ of the Operational Programme for the Development of Human Resources for the period 2007–2013 and granted the applicant funding of up to EUR 292.910. The Minister also explained in his statement that the earmarked EU funding represented 85% of the total eligible public expenditure for the eligible project costs. The dedicated funds of the Slovenian participation represented 15% of the total eligible public expenditure for the eligible costs of the project. The applications were evaluated by an expert panel. One applicant complained that it was not selected because it was ranked lower than the project selected for co-financing. The complainant stated the project selected for co-financing had already been financed from other public

sources, meaning that it was no longer eligible for new public funding. This anomaly was identified by the relevant department at the Ministry, but not considered by the expert panel, which nevertheless ranked this controversial application high on the list. As the selected project had already been financed and was unlawfully included on the list, the Appellate Body annulled the award of state aid and referred the case back to the Court of First Instance for reconsideration.

In UPRS Judgment I-U-183/2019-8, the Court ruled on the eligibility of direct payments in agriculture under Commission Regulation (EU) No. 702/2014 of 25 June 2014 declaring certain categories of aid in the agriculture, forestry, and rural areas compatible with the internal market in the application of Arts. 107 and 108 of the TFEU. This EU Regulation provides for exceptions to the general prohibition on state aid. Member States are not allowed to adopt a state aid scheme that would allow the granting of aid to an extent exceeding that allowed by the Regulation. The addressee of the Regulation is hence the Member State and the claimant could not therefore claim any rights under it. The applicant could not therefore succeed on the grounds that the scheme (adopted by Slovenia) is stricter than the Commission Regulation and that the decision to refuse state aid was thus unlawful. A Member State would infringe the Commission Regulation only if the aid scheme provided for in the programme exceeded the criteria found in the Regulation.

In the more recent case UPRS Judgment I-U-635/2022-7, on 19 October 2022, the Administrative Court of the Republic of Slovenia decided on the compatibility of the state aid for COVID-19 under the intervening Slovenian law (ZIUOPDVE)⁴⁰ in relation to the EU's rules (specifically Commission Regulation (EU) No. 651). The company seeking aid for COVID-19 had, as of 31 December 2019, accumulated losses owing to which more than half of its subscribed capital had disappeared, making it a 'company in difficulty' under Art. 18 para. (2) point (a) of Regulation 651/2014 and as such not eligible for the partial reimbursement of uncovered fixed costs. The company, as the claimant in the dispute, stated in its submission that when assessing the condition of the 'undertaking in difficulty' the competent authority must also consider the exceptions stated in point 3.12 of the fourth amendment to the Temporary Framework⁴¹ and that it, as a micro enterprise not involved in insolvency proceedings and not subject to operating restrictions as part of the state aid received, met the conditions found in point 3.12 of the fourth amendment to the Temporary Framework. In the proceedings, the competent authority noted that the application of the Commission Communication – Temporary Framework on state aid measures to support the economy following the outbreak of COVID-19 – was not binding on

40 Law on intervention measures to mitigate the consequences of the second wave of the COVID-19 epidemic, Official Gazette of the Republic of Slovenia, no. 175/2020.

41 Fourth amendment of the Temporary Framework for state aid measures to support the economy in the event of an outbreak of COVID-19, 2020/C 91 I/01, OJ C 91I., 2020.3.20, 1–9, and amendment of the Annex to the Communication from the Commission to the Member States on the application of Art. 107 and 108 of the TFEU to short-term export-credit insurance, 2021/C 497/02, OJ C 497, 10.12.2021, 5–13.

Member States by its very content since this document merely sets out the types and amounts of aid that a Member State may apply. It also follows from Art. 288 of the TFEU that the Temporary Framework is not a binding act, but merely constitutes guidelines or an external framework within which the content of specific aid measures is defined by each Member State in its own legal order. I fully agree with and support this view of the Administrative Court. While the Temporary Framework allows for the provisions on ‘undertakings in difficulty’ not to apply to micro and small enterprises (like with the case of the specific company complaining), that exception has not been transposed into Slovenian law, and therefore micro and small enterprises requesting aid could not be ‘undertakings in difficulty’ as of 31 December 2019. The case clearly shows how the shared competence between the EU and the Member State works in practice.

5. Conclusion

Finally, from the above-mentioned cases, the following conclusions regarding the validity of the three hypotheses, partially or fully, may be drawn.

Hypothesis 1 is fully supported. The definition and regulation of state aid is an exclusive competence of the EU and Member States have as much autonomy in this respect as the EU decides to leave to them. Recent events have made it clear that the EU Commission has been setting general exemptions from prohibited state aid, leaving it up to the Member States to define more precisely the criteria for granting state aid considering the framework established by the EU Commission.

Hypothesis 2 is also fully supported as the COVID-19 crisis has shown how important it has been for countries to be able to intervene independently with public funds to mitigate the adverse effects of the COVID-19 pandemic. At the same time, the EU has even temporarily waived its strict fiscal rule, although countries will certainly have to comply with it in the years to come.

Hypothesis 3 is also supported in view of the fact that this ‘shared competence’ varies in practice and depends on both the EU Commission and, in particular, the case law of the CJEU, which is the sole interpreter of EU law that overrides national law.

One may conclude that the area of state aid is a complex legal and economic domain that continues to evolve and change depending on the objectives set by the EU and actual world circumstances, presently considering two particular crises: the energy crisis and the security crisis, which were both triggered by the war in Ukraine.

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PART III

TAX POLICY

THE RELEVANCE OF PRIMARY EU LAW ON DIRECT TAX MATTERS: LESSONS FROM TRANSFER PRICING CASES



BALÁZS KÁROLYI

Abstract

This chapter deals with the relationship of EU law and tax sovereignty of the Member States and serves as an introduction to the national chapters. Given its introductory character, it will provide a general overview of the relevant EU legislation that affects the most the tax sovereignty of the Member States. The main focus of the chapter will be put on primary EU law (leaving the specific issues of harmonization to the national chapters) with particular regard to the recent transfer pricing cases in the light of the EU State aid rules. These cases can demonstrate very well the interdependent relationship between primary EU law and the delicate concept of tax sovereignty of the Member States and that of tax competition in a multilayered legal environment.

Keywords: *tax sovereignty, fundamental freedoms, fiscal state aid, transfer pricing, tax rulings, tax competition, tax harmonization, profit shifting, tax avoidance, discrimination*

1. Introduction

The present contribution constitutes a foundational element of an extended research project entitled *Economic Governance*, which revolves around the balance and

Balázs Károlyi (2024) 'The Relevance of Primary EU Law on Direct Tax Matters: Lessons From Transfer Pricing Cases'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 429–455. Miskolc–Budapest, Central European Academic Publishing.

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extent of sovereignty that European Union (EU) Member States retain in the context of the EU's economic integration process. This research scrutinises four key areas: public finance, State aid, taxation, and monetary policy. While the research generally focuses on the perspectives of Central European countries, the introductory chapter, which consists of four subchapters, aims to provide a basic understanding of the relevant EU law rules in all four fields of economic policy mentioned above and to present how EU institutions interpret the economic sovereignty of Member States.

Against this backdrop, this contribution is meant to provide an overview of EU rules that affect the sovereignty of Member States in the field of direct taxation with a focus on primary EU law. The rationale for this structure is to allow the present chapter to work as an integrated part of the research output and the country chapters to address tax sovereignty issues arising from the coexistence of national tax systems and EU law. Furthermore, although secondary EU law clearly affects the tax sovereignty of Member States, it is a product of harmonising measures that, according to the current rules, require the unanimity of Member States. Consequently, no tax-related secondary EU laws can be adopted against the will of any member state. Considering the requirement of unanimity, it is not surprising that secondary EU legislation in the area of direct taxation is sporadic.¹ However, in the last decade, two important directives have been adopted for corporate taxation: the anti-tax avoidance directive (ATAD)² and, most recently, the directive on the global minimum tax for corporations (GloBE Directive).³ These achievements are remarkable. Although their detailed analysis would stretch the boundaries of this subchapter, the relationship between harmonization and the constraints of primary EU law on fiscal sovereignty will be shortly addressed to shed light on the dynamic of such a supranational legal environment like the EU that is based on the foundations of constitutional pluralism.⁴

1 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast) OJ L 345, 29.12.2011, 8–16 (Parent-Subsidiary Directive); Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States OJ L 157, 26.6.2003, 49–54 (Interest-Royalty Directive) and Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States (Codified version) OJ L 310, 25.11.2009, 34–46 (Tax Merger Directive); Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64, 11.3.2011, 1–12 (DAC).

2 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market OJ L 193, 19.7.2016, 1–14 (ATAD 1); Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries OJ L 144, 7.6.2017, 1–11 (ATAD 2).

3 Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union ST/8778/2022/INIT, OJ L 328, 22.12.2022, 1–58 (GloBE Directive).

4 Lanearts and Gutiérrez-Fons, 2013.

This contribution is structured as follows. Following this introductory section (Section 1), Section 2 will shed some light on the interrelationship between positive (harmonization in the form of secondary EU law measures) and negative integration (prohibition of certain domestic tax measures due to the infringement of primary EU law) developments. Subsequently, Section 3 will present the most important primary EU legal rules that shaped the direct tax systems of Member States and thus their fiscal sovereignty – namely, the state aid rules and fundamental freedoms – and very briefly summarise the evolution of their application. Section 4, the core of the chapter, will outline recent trends in the application and interpretation of state aid rules in transfer pricing cases as well as those crystallised in the case law of the Court of Justice of the European Union (CJEU or Court) and in the approach of the Commission. Obviously, an in-depth analysis of the relevant cases cannot and will not be carried out within the framework of the present contribution. Nevertheless, it is still worth attempting to capture the tendencies and impacts that these EU rules exert on the direct tax systems of Member States. The author found two relevant trends that could be further elaborated: the intense investigation of the Commission regarding tax rulings issued by the national tax authorities with respect to the transfer pricing of intra-group transactions and the challenges around the conformity of (progressive) turnover-based taxes with state aid rules and fundamental freedoms.⁵ However, it cannot be ignored that the present contribution is part of a research project, and turnover-based business taxes and their legal implications in the context of EU law will be addressed in other chapters. Therefore, to avoid repetition and overlap, this chapter omits these cases and focuses solely on transfer pricing cases. Finally, Section 5 will present the concluding remarks.

2. The concepts of tax sovereignty and tax competition

Tax sovereignty in the field of direct taxation is considered as one of the sacrosanct of sovereignty for the Member States as it constitutes an essential aspect of collecting revenues.⁶ Furthermore, direct taxation remains a very important macroeconomic policy tool for Member States, especially for those which introduced the euro and joined the monetary union and relinquished their sovereign monetary

⁵ Although the choice of these two aspects of the recent trends in the field of direct taxation is necessarily arbitrary, it can somewhat be justified by their outstanding importance in influencing national tax systems and academic discussions as well as in raising media attention. Nevertheless, it is also worth noting that the focus on taxpayer's rights is also gaining increasing momentum in the jurisprudence of the CJEU, with this trend expected to continue. In this respect, the relevant cases revolve around the interpretation of the Charter on the Fundamental Rights of the European Union in tax procedures. Similarly, see: van Thiel, Pistone and Wathelet, 2021.

⁶ Kingston, 2007, p. 287.

policy.⁷ Thus, tax sovereignty establishes an important instrument in the hand of the Member States to fund public services and achieve their economic goals.

Such economic goals might encompass the attraction of foreign direct investment (FDI) in the country by means of tax incentives. This phenomenon is entitled as tax competition. On the one hand, tax competition can be useful. It was also the original standpoint of the CJEU according to which regulatory (including tax) competition can be beneficial for the internal market whereby Member States compete for foreign investments, which could lead to a regulatory (tax) sandpit, ideally resulting in finding the best regulatory (tax) system.

On the other hand, tax competition can be perceived as a collective-action problem. Although Member States might individually benefit from attracting FDI, tax competition can result in the decrease of the collective EU welfare due to unlimited competition ‘race to the bottom’.⁸ Such an outcome is harmful as either no funds will be available anymore for financing public goods and services through taxes or Member States must shift on the tax burden towards immobile factors, typically on labor and consumption⁹. It would be likely to lead to a decline of Pareto efficiency in the form of below-the-ideal tax rates, furthermore to an unfair allocation of the tax burden as large companies would get more beneficial treatment and less mobile actors would receive less favorable treatment.¹⁰

Tax sovereignty is also reflected in the unanimous voting rule in the special legislative procedure in the field of taxation. This de facto veto for the Member States means an important bargaining tool.¹¹ It could be seen in the course of the adoption of the global minimum tax directive where Hungary was the last Member State to give consent to the directive in exchange for certain concessions related to both the directive and other areas.¹²

The power resulting from the veto indeed ensures higher level of tax sovereignty but – as certain authors note – it also prevents higher level of fairness within the EU that could be achieved by means of harmonization.¹³ Furthermore, a seemingly paradox phenomenon can be observed: cooperation or harmonization in the field of direct taxation might result in the preservation of a higher level of tax sovereignty because the lack of any harmonization or cooperation between the Member States could entail pressure to participate in (extreme) tax competition,¹⁴ which may result in involuntary reductions to tax sovereignty.

7 de la Feria, 2023, p. 4.

8 Mason, 2023, p. 22.

9 Mason, 2023, p. 22.

10 de la Feria, 2023, p. 10.

11 de la Feria, 2023, p. 5.

12 *EU Member States unanimously adopt Directive implementing Pillar Two Global Minimum Tax rules*, 2022.

13 de la Feria, 2023, p. 2.

14 de la Feria, 2023, p. 2.

Nevertheless, tax sovereignty has limitations. It is restricted by the obligation of Member States to devise their tax systems in conformity with EU law, particularly with fundamental freedoms and State aid rules. Such negative integration – the prohibition of domestic tax measures that fall foul of primary EU law – is dominant in the field of taxation and is carried out by the CJEU.¹⁵ Furthermore, positive integration also restricts the tax sovereignty of Member States: once a certain area of taxation has been harmonised at the EU level, Member States must transpose the EU rules into their national tax systems and cannot regulate the given field anymore at their wish.

3. Primary EU law and direct taxation

3.1. Preliminary remarks

If one looks into the main sources of primary EU law, the texts of the Treaties, i.e., that of the Treaty of the European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU), they can come across hardly any explicit tax provisions. The few tax related rules encompass the prohibition of fiscal measures levied at the event of goods crossing the borders within the Union, i.e., the prohibition of customs duties and measures having an equivalent effect necessary for the establishment of a customs union,¹⁶ the prohibition of discriminatory taxation of products of a foreign origin,¹⁷ the general legal basis for the harmonization of rules (including direct tax rules) that affect the internal market¹⁸ and indirect taxation.¹⁹

Then, the question might be raised how primary EU law plays a crucial role in the negative integration process of national direct tax measures in the jurisprudence of the CJEU. The roots of it lie in the internal market idea. As Art. 26 paras. (1)–(2) of the TFEU states, the primary economic aim of the EU integration is to establish and ensure the functioning of the internal market, which is defined as an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties. In other words, the idea of an internal market entails that the Member States do not apply internal rules that restricts the free movement of production factors (labor and capital) and production outputs (goods and services). The CJEU recognized that direct tax measures could

¹⁵ Kingston, 2007, p. 290.

¹⁶ Arts. 28–30 of the Consolidated version of the Treaty on the Functioning of the European Union, OJ C 326, 26.10.2012, 47–390 (TFEU).

¹⁷ Art. 110 of the TFEU.

¹⁸ Art. 115 of the TFEU.

¹⁹ Art. 113 of the TFEU.

also be susceptible to cause such an undesirable restriction.²⁰ Yet another primary EU law instrument that is meant to ensure that the internal market functions without distortion is the EU State aid rules that is currently enshrined in Arts. 107–109 of the TFEU. As a main rule, it prohibits measures that involve ‘any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.’²¹ The CJEU pointed out already in an early stage of the EU integration that such an unlawful aid could also be granted by the Member States via tax measures by means of mitigating the tax burden of certain undertakings that they normally must bear.²²

These two sets of rules, that is the fundamental freedoms and the State aid rules have become the cornerstone of the negative integration of the national direct tax systems of the Member States. Although by interpreting these provisions, the CJEU did not prescribe what provisions the national tax systems should contain, it ruled on which provisions were incompatible with primary EU law and should be changed. Such a negative integration process is especially a delicate exercise because very vaguely and generally phrased EU law provisions must be applied to often very technical and nuanced tax measures. In the next section, a brief history of the evolution of these rules will be presented.

3.2. Evolution of the application of fundamental freedoms and State aid rules to direct tax measures

3.2.1. Fundamental freedoms and direct tax measures

As noted, the fundamental freedom provisions of the TFEU do not explicitly address tax rules other than customs duties. However, the direct tax measures have not been carved out from their scope either, which solution can be observed in various international trade agreements.²³ Consequently, the CJEU started to apply the fundamental freedoms to direct tax measures as early as 1986. The first case was revolving around the discriminatory treatment of a permanent establishment of foreign companies by France in the *Avoir Fiscal* case.²⁴ From this point up to now, we can distinguish three eras in the CJEU’s jurisprudence²⁵. In the evolution of its case law, it can be observed that the language of the judgments varied, swinging

20 CJEU, 28 January 1986, C-270/83, *Avoir Fiscal*, ECLI:EU:C:1986:37.

21 Art. 107 para. (1) of the TFEU.

22 For more details, see Section 3.2.2.

23 To some extent, this is the case for certain WTO agreements. For instance, an exception from the national treatment and most favored nation treatment provisions applies to direct tax measures in the GATS agreement.

24 C-270/83.

25 Kingston, 2007, pp. 289–303.

from a discrimination approach towards a restriction-based approach and back.²⁶ Originally, the compatibility assessment was clearly based on a discrimination test. The second generation of tax cases starting from the 1997 with the *Futura* judgment, the CJEU adopted a restriction-based language that was also applied to non-tax fundamental freedom cases and subsequently, a return to discrimination test can be experienced starting from 2005.²⁷ However, it was argued by several scholars that the CJEU, even when it used its restriction-based terminology in substantive tax measures, in effect, it checked whether the measure concerned created a difference in treatment between comparable domestic and cross-border situations.²⁸ Consequently, the application of the free movement provisions to direct tax measures boils down to a discrimination test in most of the cases. Such discrimination test entails three steps. First, a disadvantage test is carried out, assessing whether cross-border situations suffer from an unfavorable treatment compared to domestic situations. Then, closely related to the first step, the comparability of the domestic and cross-border situations is examined. This is decided in the light of the objective of the tax measure. If an unfavorable treatment is identified for a cross-border situation that is comparable to the domestic situation, then the *prima facie* discriminatory measure can still be justified by an overriding public interest under the third step, provided that it fulfils the requirement of proportionality.²⁹

In the Court's case law, the following justifications have been accepted for a discriminatory direct tax measure: the need for effective fiscal supervision,³⁰ the need to maintain a balanced allocation of power to tax,³¹ the need to maintain the coherence of the tax system,³² and the prevention of abuse (tax evasion and avoidance).³³ As Wattel and Brokelind convincingly argue, all of these justification grounds boil down to one single concept: the protection of tax base integrity.³⁴ It entails the right of the Member States to tax the economic activity that is carried out within their territory and thus to tax the value increase in the given jurisdiction.³⁵

In the case law of the Court, the effective fiscal supervision constitutes the procedural side of tax base integrity, while the fiscal cohesion and balanced allocation of

26 Cordewener, 2006, pp. 1–2.

27 For an overview of the three generations of tax cases, see: Bammens, 2012, pp. 534–542.

28 Zalasinski, 2009, p. 288. and cases referred to therein; Snell, 2007, p. 349.

29 In detail, see: Károlyi, 2022.

30 See, for example: CJEU, 20 February 1979, C-120/78, *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)*, ECLI:EU:C:1979:42, para. 8; CJEU, 15 May 1997, C-250/95, *Futura Participations SA and Singer v Administration des contributions*, ECLI:EU:C:1997:239, para. 31.

31 See, for example: CJEU, 12 September 2006, C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, ECLI:EU:C:2006:544, para. 56; CJEU, 20 January 2021, C-484/19, *Lexel AB v. Skatteverket*, ECLI:EU:C:2021:34, para. 59.

32 See, for example: CJEU, 30 June 2016, C-123/15, *Max-Heinz Feilen*, ECLI:EU:C:2016:496, para. 30; CJEU, 12 June 2018, C-650/16, *Bevola*, ECLI:EU:C:2018:424, para. 45.

33 See, for example: CJEU, 12 September 2006, C-196/04, *Cadbury Schweppes*, ECLI:EU:C:2006:544, para. 55; CJEU, 20 January 2021, C-484/19, *Lexel AB v. Skatteverket*, ECLI:EU:C:2021:34, para. 49.

34 Brokelind and Wattel, 2018, p. 689.

35 Wattel, 2018, p. 631.

taxing power justifications, often complemented with the principle of territoriality, have basically identical meaning.³⁶

What these concepts mean is that taxpayers should not be able to choose freely where they want their income to be taxed and expenses/losses to be deducted and these elements of the tax base cannot be disconnected from the territory where the corresponding economic activity is performed.³⁷

The question of tax base integrity is therefore closely related to the question of whether a certain item of income/transaction is taxed in a given jurisdiction. The latter issue, i.e. the issue of being subject to tax is also used by the Court to determine the comparability of internal and cross-border situations. Consequently, there is no sharp distinction between the comparability and the justification phase. As Advocate General Kokott noted, these two phases are often conflated by the Court.³⁸ This opinion is also shared by Wattel who states that there are plenty of cases where the Court found the differential treatment of domestic and cross-border situations justified by the overriding public interest of balanced allocation of taxing rights, however, the situations should not have been considered comparable (i.e. no discrimination) at the first place because one of them – the cross border situation – was not subject to tax, while the given Member State taxed the domestic situation.³⁹ Advocate General Bobek is also of the view that when a Member State delineates the boundaries of its tax jurisdiction on non-resident taxpayers in accordance with the territoriality principle, it does not amount to a discriminatory measure, therefore the justification phase should not be reached.⁴⁰

Seemingly, it is immaterial whether the substantive comparability test / tax base integrity test is conducted in the comparability or justification phase. However, besides the potential procedural implication of the burden of proof, there is a very important, substantive difference: to reach the justification phase, Member States' measures must pass the proportionality requirement.⁴¹ Thus, finding the measure *prima facie* discriminative is the gateway to the proportionality test.⁴²

36 Brokelind and Wattel, 2018, p. 680.

37 CJEU, 18 July 2007, C-231/05, *Oy AA*, ECLI:EU:C:2007:439, paras. 53–56.

38 Opinion of Advocate General Kokott, C-48/13, *Nordea Bank Danmark A/S v Skatteministeriet*, paras. 21–28.

39 Wattel, 2018, pp. 640–641 with particular reference to the *Oy AA* case in which the Court held that the Finnish regime on intra-group financial transfers entailing the deduction of an intra-group financial transfer from the taxable income of the transferor and the assimilation of that transfer to income in the hands of the transferee was discriminatory as foreign group companies (not taxed by Finland whatsoever) were excluded from the benefit of the regime. Nevertheless, the Court found this 'discrimination' of comparable situations justifiable based on the need for a balanced allocation of taxing rights. See: C-231/05, paras. 51–56.

40 Opinion of Advocate General Bobek of 14 December 2017, C-382/16, *Hornbach Baumarkt AG*, ECLI:EU:C:2017:974, para. 133.

41 Opinion of Advocate General Kokott, C-48/13, *Nordea Bank Danmark A/S v Skatteministeriet*, paras. 27–28.

42 Wattel, 2018, p. 627.

3.2.2. State aid and direct tax measures

3.2.2.1. The definition of State aid

Art. 107 of the TFEU contains the definition of State aid, which states, ‘save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market’. It was already enshrined in the Treaty of Paris of 1951 establishing the European Coal and Steel Community (ECSC).⁴³

It is formulated in a rather vague way and consequently its meaning and application has been crystallized in the jurisprudence of the CJEU throughout the years. The CJEU clarified that four cumulative criteria must be met in order to conclude that a measure constitutes State aid.

First, it must be granted by the State or through State resources. Second, it must confer a benefit, an advantage of an economic nature to the recipients compared to their situation in the absence of the measure.⁴⁴ It also entails that the measure granting the benefit must be selective, i.e., it must benefit only certain undertakings or the production of certain goods discriminating to the detriment of other, comparable undertakings or productions.⁴⁵ Third, the domestic measure must distort or threaten to distort competition. This criterion is given very limited weight in the State aid analysis of the Court,⁴⁶ which is surprising in the light of the competition law character of the State aid rules.

The fourth criterion involves that the domestic measure must be liable to affect trade between Member States. It often overlaps with the criterion of distortion of competition⁴⁷ as it also entails a change in competitive positions. However, it is also easily satisfied because it only requires that the products or activities affected by the measure are subject to trade between Member States⁴⁸ and there is no minimum threshold or percentage under which it is presumed that trade is not affected.⁴⁹

43 Micheau, 2014, p. 55.

44 Quigley, 2015, p. 6.

45 Opinion of Advocate General Wahl, C-524/14 P, *Commission v. Hansestadt Lübeck*, para. 74.

46 Lang, 2012, p. 411. Quigley also states that this criterion is easily fulfilled because any effect (or the mere threat of an effect) on production cost is sufficient. This standard renders this criterion synonymous with having an effect on competition. See: Quigley, 2015, pp. 8, 76 and cases referred therein.

47 Nicolaidis and Metaxas, 2014, p. 56; Quigley, 2015, p. 83.

48 Quigley, 2015, p. 8. For a critical view on neglecting this criterion in case law, see: Englisch, 2019, p. 24.

49 CJEU, 21 March 1990, C-142/87, *Belgium v. Commission*, ECLI:EU:C:1990:125, para. 43; CJEU, 21 July 2005, C-71/04, *Xunta de Galicia*, ECLI:EU:C:2005:493, para. 41; CJEU, 17 July 2008, C-206/06, *Essent Netwerk Noord and Others*, ECLI:EU:C:2008:413, para. 76.

3.2.2.2. State aid rules in the context of direct tax measures

The Court maintained the four criteria developed in its non-tax-related case law. However, the crucial aspect of the State aid analysis in tax matters became the selectivity criterion, which is often examined together with the existence of an advantage; that is, a selective advantage often creates a single criterion in the tax related case law of the CJEU.⁵⁰ The central position of the selectivity test can be explained by the fact that the other criteria are easily met in the field of taxation.

The original application of the selectivity test can be named as the derogation approach and it involves a three-step analysis.⁵¹ Under the first step, the CJEU determines the relevant reference framework or normal system of taxation. In the second step, it examines whether the measure at issue derogates from the reference system in a way that it discriminates between economic operators that are in a comparable factual and legal situation, having regard to the objective pursued by the tax system. If this is the case, the Member State concerned has the possibility under the third step to justify the *prima facie* selective measure by proving that the differentiation flows from the nature and general structure of the reference system.⁵²

Thus, the selectivity test of the State aid analysis can be regarded as a sort of discrimination test, which has been explicitly confirmed by the CJEU itself.⁵³ Another proof that selectivity boils down to a discrimination test is the CJEU's judgment in the *Gibraltar* case, where it did not even require the finding of a derogation and found the general tax system to be selective in itself in so far as it resulted in a discriminatory treatment between comparable undertakings (*de facto* selectivity).⁵⁴ In other words, *de facto* selectivity exists when the tax system does not grant a selective advantage at face value but factually does so by setting the requirements to enjoy the benefit in a manner that it can be fulfilled in practice only by certain enterprises or sectors.⁵⁵ In the underlying case, Gibraltar planned to repeal its existing

50 Miladinovic, 2021, pp. 39–41; Miladinovic and Szudoczky, 2019, p. 519; Lang draws attention to AG Jääskinen's opinion that the *Gibraltar* case described advantage and selectivity as key but separate terms (although Jääskinen failed to clearly distinguish them). See: Lang, (2012), p. 413; I note that similar observation can be made regarding the opinion of Advocate General Wahl in the *Hansestadt Lübeck* case in which he plead for the distinction between the criterion of advantage and that of selectivity but did not clearly separate them in his analysis. See: Opinion of Advocate General Wahl, C-524/14 P, *Commission v. Hansestadt Lübeck*. Schön also questions whether separate tests regarding the advantage and selectivity make sense. See: Schön, 2016, p. 17. Quigley also uses the notion of selective advantage based on the application of the general principle of equal treatment. See: Quigley, 2015, pp. 7, 64.

51 Szudoczky, 2014.

52 CJEU, 8 September 2011, C-78/08 to C-80/08, *Paint Graphos and Others*, ECLI:EU:C:2011:550, para. 49.

53 CJEU, 21 December 2016, C-524/14 P, *Commission v. Hansestadt Lübeck*, ECLI:EU:C:2016:971, para. 53; CJEU, 6 October 2021, C-51/19 P and C-64/19 P, *World Duty Free Group SA and Kingdom of Spain v. Commission*, ECLI:EU:C:2021:793, para. 33.

54 CJEU, 15 November 2011, C-106/09 P and C-107/09 P, *Commission v Government of Gibraltar and United Kingdom*, ECLI:EU:C:2011:732.

55 Schön, 2016, p. 21.

corporate tax system and to introduce a new corporate tax regime for all companies in Gibraltar.⁵⁶ The proposed system comprised a payroll tax, a business property occupation tax (BPOT) and a lump-sum registration fee.⁵⁷ The aggregated tax liability of the payroll tax and the BPOT was capped at 15% of the corporate profits and it followed from this rule that without profit no tax liability arose for the purposes of these two taxes.⁵⁸ Thus, the proposed new rules seemingly applied to all undertakings without any derogation. Yet, the Court concluded that the system constituted a selective advantage for offshore companies (which were de facto exonerated from corporation tax due to the lack of business property and employees onshore) because a selective advantage can be granted not only by way of derogating tax measures but also by way of ‘adjusting and combining the tax rules in such a way that their very application results in a different tax burden for different undertakings’.⁵⁹ The mere existence of the different level of taxation would not have been sufficient for de facto selectivity, it was also necessary as to the CJEU that the design of such system characterized the recipient undertakings by virtue of their specific properties (i.e. being offshore) as a privileged category.⁶⁰

3.2.2.3. The evolution of the application of State aid rules to direct tax measures

The theoretical possibility to apply State aid rules to tax measures was recognized by the CJEU as early as in 1961 when it already ruled in its judgment in *De Gezamenlijke Steenkolenmijnen* that interventions that mitigate the charges which are normally included in the budget of an undertaking are similar in character and have the same effect as subsidies.⁶¹

Nevertheless, the number of direct tax cases in the context of EU State aid rules remained relatively few until the mid-2000 years.⁶²

The change could be attributed to the Commission’s intent to use the State aid instrument to national direct tax measures more intensely. It was first signaled by the issuance of a Commission Notice in 1998 on the application of the State aid rules to measures relating to direct business taxation, in which the Commission explicitly recognized that a strict application of State aid rules to direct tax measures is necessary in order to effectively contribute to the tackling of harmful tax competition.⁶³

⁵⁶ C-106/09 P and C-107/09 P, para. 8.

⁵⁷ C-106/09 P and C-107/09 P, para. 12.

⁵⁸ C-106/09 P and C-107/09 P, para. 12.

⁵⁹ C-106/09 P and C-107/09 P, para. 93.

⁶⁰ C-106/09 P and C-107/09 P, paras. 103–104.

⁶¹ CJEU, 23 February 1961, C-30/59, *De Gezamenlijke Steenkolenmijnen v. High Authority of the European Coal and Steel Community*, ECLI:EU:C:1961:2., p. 19.

⁶² Lang, 2021, p. 516.

⁶³ Commission notice on the application of the State Aid rules to measures relating to direct business taxation, 98/C 384/03, OJ C 384, 10.12.1998, 3–9 (hereinafter: Comm. Notice, 1998), para. 1. Report of the Code of Conduct Group of 28 November 1999, Council Doc. SN 4901/99 (hereinafter: ‘Report of the Code of Conduct Group, 1999’).

Thus, the enhanced activity of the Commission in investigating direct tax measures in the light of the State aid rules connected to a parallel project at Community level, namely the fight against harmful tax competition, the distortive effects of which have been seen as a threat on the internal market objective.

Pursuant to the work of the Code of Conduct Group, the ECOFIN Council managed to reach a non-binding political commitment to dismantle harmful tax regimes in 1997. The Code of Conduct for Business Taxation⁶⁴ was created to monitor and reduce harmful tax competition within the Community. The Code of Conduct sets certain criteria for identifying harmful tax regimes. A peer review process among the Member States was meant to ensure that tax regimes that are considered harmful would not be introduced (the standstill clause) and that existing ones would be repealed (the rollback).

It became obvious that an overlap between State aid rules and provisions of the Code of Conduct could exist, as certain tax measures could fall foul of both. This created uncertainty regarding how State aid rules should be applied to tax measures, and the Commission attempted to provide for a remedy by the issuance of its 1998 Notice.⁶⁵ Although the Commission issued the Notice with the explicit objective of supporting the fight against harmful tax competition that the Code of Conduct Group carried out, it also emphasized the independent nature of State aid analysis from that of the Code of Conduct.⁶⁶

In this Notice, the Commission provided guidance on how to interpret the criteria of State aid in the context of business tax measures. It put forward that measures that are generally open to all operators on an equal access basis, i.e., are not *de facto* reduced in scope, do not constitute State aid.⁶⁷ Furthermore, it already pointed out that the condition of selectivity could be fulfilled by means of administrative practices, including tax rulings.⁶⁸ The Commission acknowledged that tax rulings can serve as a legitimate tool to provide legal certainty for taxpayers, however, it raised the attention that they must constitute a mere confirmation of the general rules rather than discretionary practices.⁶⁹ It also cautioned against the lack of transparency of tax rulings.⁷⁰

The Code of Conduct Report of 1999 identified 66 tax measures with harmful features. Some of them granted benefits to certain taxpayers on a discretionary basis by means of advance rulings issued by the national tax authorities. In that regard, the Group found some regimes harmful on account of the fact that albeit

64 Code of Conduct for Business Taxation, (1997). Resolution of the Council and the Representatives of the Governments of the Member States, Meeting within the Council of 1 December 1997, on the code of conduct for business taxation (hereinafter: Code of Conduct, 1997).

65 van Thiel, Pistone and Wathelet, 2021, p. 238.

66 Comm. Notice, 1998, para. 30.

67 Comm. Notice, 1998, point 13.

68 Comm. Notice, 1998, para. 22.

69 Comm. Notice, 1998, para. 22.

70 Traversa and Sabbadini, 2017, §6.04 [C].

the domestic legislation incorporated the arm's length principle (ALP) for profit allocation, the rulings under certain circumstances allowed for a formulaic apportionment between the head office and a branch⁷¹ or the application of fixed margins for headquarters and logistic centres,⁷² resulting in lower tax level than under the normal rules.⁷³

Several of these identified tax regimes have also been tackled by the Commission as State aid and even confirmed by the CJEU (*Belgium and Forum 187 v. Commission*) that tax regimes that accept an intra-group pricing which does not reflect a market-based outcome (provided that in the given Member State such a requirement exist as a general rule but not to all undertakings) could be selective under certain circumstances.⁷⁴

Nevertheless, a new wave of investigations related to transfer pricing treatment of intra-group transactions provided in tax rulings has emerged starting in 2014⁷⁵ as the aftermath of the LuxLeaks scandal. When the sweetheart deals granted by the national tax authorities in their rulings to certain multinational groups became known to the wide public, the Commission took advantage of the momentum and started to extensively investigate their potentially selective nature. Although the Commission emphasized in these cases –similarly to its Notice – that rulings were not inherently problematic, it found in most of the cases that the tax treatment provided by these rulings deviated from the ordinary rules of taxation to the benefit of the taxpayers concerned.⁷⁶

Apart from the more intense investigation of tax rulings, one can also observe an increase in the number of recent direct tax case law of the CJEU, where the Member States' tax systems are challenged by the Commission on the grounds that they allegedly constitute State aid incompatible with the internal market.⁷⁷ Within this trend, besides the transfer pricing cases, the challenge of turnover-based taxes stands out for several reasons. First, the challenges affected several taxes of various Member States within a short period of time. Second, they were new in nature in the sense that the proliferation of turnover-based taxes is a new phenomenon and their compatibility with EU law has not been subject to the Commission's and the CJEU's scrutiny up until the mid-2010s. As it was indicated in the introduction, the challenge of turnover-based business taxes in the light of the State aid rules is the topic of a different chapter. Therefore, the core topic of the present contribution is the challenge of tax rulings concerning transfer pricing treatment of intra-group transactions.

71 Report of the Code of Conduct Group, 1999, pp. 12, 38.

72 Report of the Code of Conduct Group, 1999, p. 36.

73 Report of the Code of Conduct Group, 1999, p. 12.

74 CJEU, 22 June 2006, C-182/03 and C-217/03, *Belgium and Forum 187 v Commission*, ECLI:EU:C:2006:416.

75 van Thiel, Pistone and Wathelet, 2021, p. 242.

76 Lopez, 2022.

77 Kofler et al., 2021; Kofler et al., 2022.

4. Transfer pricing cases through the prism of state aid rules

4.1. Preliminary remarks

As shown in the previous section, few hard-law tools are available at the EU level to curb harmful tax competition within the internal market. Although the Code of Conduct proved to be an effective instrument for dismantling several tax regimes that were considered harmful, its soft-law character and peer review monitoring made it less efficient when significant budgetary consequences or cornerstones of national tax policies were at stake. Consequently, the Commission expressed its intention to tackle regimes constituting harmful tax competition through hard law, State aid rules.⁷⁸ A new impetus has emerged in the new era starting in 2014, when the LuxLeaks scandal was aired.⁷⁹ The Commission began to review the tax rulings of many multinational enterprises obtained from tax authorities in Luxembourg, Ireland, Belgium, and the Netherlands. These rulings typically addressed transfer pricing; that is, the pricing of intra-group transactions. In many cases, the formal investigation of the Commission ended in a negative decision, holding that the tax treatment granted to multinationals in the rulings constituted a selective advantage and, thus unlawful State aid. Although these cases are similar with respect to the subject matter (transfer pricing), they can be classified into various subgroups. The Fiat, Starbucks and Amazon cases can be regarded as transfer pricing cases in the strict sense as they concern the attribution of profits between associated enterprises and the correct pricing of their intra-group transactions. The Apple case dealt primarily with the attribution of intellectual property assets between the head office and branches. Additionally, the Belgian Excess Profit Exemption case (*Magnetrol*) revolved around the primary question whether the practice of the Belgian tax authorities could be qualified as an aid scheme rather than individual aids.

Following the Commission's negative decisions, the Member States at issue lodged appeals against the decisions, and in many cases, the General Court had already ruled on the issue, mostly in favour of the Member States. The only case in which the CJEU has already delivered its final say is the Fiat case whereby the CJEU annulled the Commission decision. AS the cases show similarities, it can be expected that the future judgments will follow suit.

In this section, the three branches of cases (*Apple*; *Amazon-Starbucks-Fiat*; and *Magnetrol*) will be shortly demonstrated with a primary focus on the Fiat case being the only one that is final and that is indicative to the prospective outcome of the other, still pending cases.

⁷⁸ Comm. Notice, 1998.

⁷⁹ Brundsen, 2017.

4.2. The allocation of profits in intragroup transactions: The cases of Fiat and Amazon

4.2.1. Preliminary remarks

The Amazon, Starbucks and Fiat cases – albeit based on different fact patterns – all dealt with the correct application of transfer pricing (TP) rules in the light of the State aid rules.⁸⁰ In this section, the Amazon and Fiat cases will be dealt in some more detail.

4.2.2. The Fiat Chrysler case

4.2.2.1. Commission Decision

The *Fiat Chrysler* case is the first in the line of the transfer pricing ruling cases where the CJEU delivered its final judgment and it can be expected that the outcome will be indicative for the result of the other cases as well.

Here, the fact patterns also concerned the pricing of intra-group transactions namely intra-group financing. In the rulings, the determination of the profit allocable to the Luxembourgish financing entity was carried out with reference to an estimated level of remuneration of a hypothetical, regulatory capital,⁸¹ which according to the Commission, did not result in a reliable approximation of a market-based outcome. The Commission applied a *sui generis* ALP standard and held that multinational enterprises must adopt a single particular income –allocation rule on the basis of the OECD TP Guidelines.⁸²

In examining the selectivity test, the Commission was of the view that the Luxembourgish corporate tax system constituted the reference framework, whose objective was to tax the profits of all companies.⁸³ In the light of this reference framework, it considered that group companies and standalone companies were in a comparable legal and factual situation.⁸⁴

In the second step, the Commission held that the tax treatment laid down in the rulings deviated from the ALP and thus from the normal level of taxation because the agreed pricing did not approximate a market-based outcome, resulting in a reduction of the tax base.⁸⁵

Consequently, the Commission pointed out that if it was proven that the chosen methodology departed from a reliable approximation of a market-based outcome,

⁸⁰ Haslehner and Pantazatou, 2022, p. 98.

⁸¹ Opinion of AG Pikamäe, Case C-885/19 P, *Fiat Chrysler*, paras. 20–24.

⁸² Mason, 2017, p. 947.

⁸³ CJEU, 8 November 2022, C-885/19 P and C-898/19 P, *Fiat Chrysler*, ECLI:EU:C:2022:859, para. 16.

⁸⁴ C-885/19 P and C-898/19 P, para. 16.

⁸⁵ C-885/19 P and C-898/19 P, paras. 17–18.

the measure amounts to State aid.⁸⁶ It is noteworthy that the Commission came to that conclusion irrespective of whether the Member State itself had incorporated the ALP principle or not because it regarded the ALP as being inherent in Art. 107 of the TFEU.⁸⁷ It only examined the tax treatment granted by the rulings in the light of the ALP as enshrined in the domestic law as an alternative line of reasoning.⁸⁸

As the Commission has indeed found such a deviation from the ALP without proper justification, it concluded that the rulings constituted unlawful State aid, the beneficiary of which was the group as a whole.⁸⁹

4.2.2.2. General Court judgment

Following an appeal against the Commission decision, the General Court upheld the Commission decision. Actually, that was the only case where the General Court ruled in favor of the Commission (apart from the *Magnetrol* case that forms a different class of ruling cases). The General Court acknowledged that the ALP could be used as a tool to verify whether intra-group pricing accepted by the tax authority corresponded to the market conditions and whether an advantage was received.⁹⁰ Consequently, the Commission was entitled to compare the taxable profit of the Luxembourgish Fiat group company with the taxable profit that would have been under the normal Luxembourgish rules applicable to standalone companies.⁹¹ The General Court dismissed the argument that the ALP was extraneous to the Luxembourgish tax law on the grounds that the use of this principle was permitted by the fact that the Luxembourgish tax rules provided that integrated companies are to be taxed on the same terms as stand-alone companies.⁹²

4.2.2.3. Court of Justice judgment

However, after the appeal against the judgment of the General Court, Advocate General Pikamäe disagreed with such a stance in his opinion on the grounds that the reference framework could only consist of rules and principles intrinsic to the national legal system and these rules cannot be replaced by extraneous, fictitious reference framework.⁹³

The CJEU annulled the Commission decision and – confirming the opinion of Advocate General Pikamäe – has not found unlawful State aid to exist.⁹⁴

⁸⁶ C-885/19 P and C-898/19 P, para. 18.

⁸⁷ C-885/19 P and C-898/19 P, para. 19.

⁸⁸ C-885/19 P and C-898/19 P, para. 21.

⁸⁹ C-885/19 P and C-898/19 P, para. 23.

⁹⁰ C-885/19 P and C-898/19 P, para. 31.

⁹¹ C-885/19 P and C-898/19 P, para. 32.

⁹² C-885/19 P and C-898/19 P, para. 35.

⁹³ Opinion of AG Pikamäe, in Case C-885/19 P, *Fiat Chrysler*, para. 64.

⁹⁴ C-885/19 P and C-898/19 P, para. 113.

As a preliminary remark, the CJEU stated that the selective advantage test under the State aid scrutiny essentially boils down to a discrimination test.⁹⁵

In order to decide whether discrimination occurs between comparable taxpayers, it is essential to correctly delineate the reference framework which must be carried out following an exchange with the Member State concerned and requires an objective examination of the content, the structure and the specific effects of the applicable rules.⁹⁶

The CJEU pointed out that, as a main rule, in the absence of harmonisation, it is for the Member State to determine the characteristics of its tax system (basis of assessment and taxable event), creating the reference framework.⁹⁷ Consequently, only the national law applicable in the given Member State could be taken into account⁹⁸ and only national transfer pricing rules should have been examined without reference to an abstract ALP.⁹⁹ By accepting that the Commission may rely on rules which were not part of Luxembourg law, it would be tantamount to infringing the autonomy of the Member States in the field of direct taxation.¹⁰⁰

Consequently, the Commission was not entitled to autonomously define the normal taxation of an integrated group company.¹⁰¹ Such a finding can also be derived from the principle of legality.¹⁰² Instead, the determination of the reference framework must be judged based on the actual national rules.

Regarding the status of the OECD TP Guidelines, the Court emphasised that it does not bind the Member States, and even if it incorporates some sort of international consensus on the taxation of associated enterprises, the given transactions could only be examined in light of national provisions.¹⁰³ Such a statement can be underpinned by the fact that there are significant differences between the detailed rules in the application of the ALP even among OECD countries.¹⁰⁴

The CJEU dismissed the Commission's interpretation of previous case law (in particular the *Belgium and Forum 187 v Commission*¹⁰⁵) that the CJEU meant to establish an autonomous ALP inherent in Art. 107 of the TFEU.¹⁰⁶

As a conclusion, the CJEU ruled that the Commission erred when it did not take into account the national ALP of Luxemburg tax law in the course of determining the reference framework and such an omission was not properly rectified in

95 C-885/19 P and C-898/19 P, para. 67.

96 C-885/19 P and C-898/19 P, para. 72.

97 C-885/19 P and C-898/19 P, para. 73.

98 C-885/19 P and C-898/19 P, para. 74.

99 C-885/19 P and C-898/19 P, para. 93.

100 C-885/19 P and C-898/19 P, para. 94.

101 C-885/19 P and C-898/19 P, para. 94.

102 C-885/19 P and C-898/19 P, para. 97.

103 C-885/19 P and C-898/19 P, para. 96.

104 C-885/19 P and C-898/19 P, para. 95.

105 C-182/03 and C-217/03.

106 C-885/19 P and C-898/19 P, para. 104.

its alternative line of reasoning either. Consequently, the Commission failed to prove that the rulings constituted a selective advantage.

However, the CJEU left alive its Gibraltar judgment, according to which finding a derogation is not a prerequisite for the existence of State aid ECJ if the reference system in itself, in practice, discriminates between comparable undertakings.¹⁰⁷

Such a persistence of the findings of the Gibraltar judgment raises the question whether it means that the State aid rules can also apply to tackle tax competition or merely to ensure that free trade is not violated. The author agrees with Prof. Mason when she comes to the conclusion that the Gibraltar case involved discrimination, i.e. unequal treatment, rather than mere tax competition.¹⁰⁸

4.2.3. *The Amazon case*

4.2.3.1. Commission Decision

The Amazon case revolves around the tax structure that Amazon set up in Luxembourg. It consisted of a tax-transparent Luxembourgish entity, which was entitled to exploit the intellectual property (IP) relevant to EU business operations and sublicense it to another operating Luxembourgish entity (Lux OpCo). The royalty paid by Lux OpCo to the transparent Luxembourgish entity was regarded as attributable to the latter because of its cost-sharing agreement with the US parent company.

Similar to the Apple case, when Amazon obtained a tax ruling from the Luxembourgish tax authorities, only marginal taxable profits were allocated to Lux OpCo. This was achieved by pricing of the intra-group royalty payment that has been determined as the difference between the EU-level group profits and a pre-defined return of the operating entity as a markup on its operating expenses, while capping it at 0.55% of EU revenue.¹⁰⁹

The Commission challenged this methodology on the ground that it was not in line with the ALP. First, it argued that the tested party should have been the transparent entity since it was the less complex party under the chosen transactional net margin method (TNMM) given that it did not perform the development, enhancement, maintenance, protection, and exploitation (DEMPE) functions related to the IPs.¹¹⁰ Second, the Commission held that the profit-split method would have been a more appropriate transfer pricing method, furthermore, choosing the operating expense as a profit level indicator was wrong and adding a ceiling to the markup was incompatible with the ALP.¹¹¹

107 C-885/19 P and C-898/19 P, para. 70.

108 Mason, 2023, p. 21.

109 CJEU, 12 May 2021, T-816/17 and T-318/18, *Amazon*, ECLI:EU:T:2021:252, para. 9.

110 Commission Decision (Amazon case) C(2017) 6740 final of 4 October 2017 on State Aid SA.38944 (2014/C) (hereinafter: Commission Decision, *Amazon*), paras. 407–429.

111 Commission Decision, *Amazon*, paras. 519–558.

4.2.3.2. Judgment of the General Court¹¹²

The General Court accepted the comparability of standalone and integrated companies on the grounds that the underlying corporation tax system did not distinguish them regarding their tax liability and intended to tax the profit arising from the economic activity of such an integrated undertaking as though it had arisen from transactions carried out at market prices.¹¹³

The General Court ruled that the Commission could use the ALP together with related international documents, such as the OECD TP Guidelines, to compare the tax burdens of standalone and integrated companies. Thus, the analysis could be carried out in the context of a not purely national reference framework because it was not strictly examined to what extent Luxemburgish law and practice incorporated the principles set out in the TP Guidelines.¹¹⁴ However, the Commission was obligated to prove that deviations between market-based outcomes and the agreed pricing of the transaction go beyond the inaccuracies inherent in the TP methodology¹¹⁵ and, consequently, a certain margin of appreciation must be given to the authorities of a Member State.¹¹⁶

The status of the OECD TP Guidelines has also been addressed by the General Court. It ruled that – despite their non-binding character – they were relevant to interpret the ALP but only to the extent that these guidelines existed at the time of the issuance of the tax rulings or the later versions only provided for useful clarification of already existing guidelines.¹¹⁷ Against the background, the General Court easily excluded the relevance of the DEMPE functional analysis carried out by the Commission because it was set out only in the 2017 version of the OECD TP Guidelines.¹¹⁸ The acceptance of explicit reliance on the OECD TP Guidelines even bearing in mind the temporal limitations set by the General Court could be criticized based on the facts that first, these guidelines constitute soft law instruments, second, they are external to EU law, so that the interpretation of the latter should not depend on those guidelines.¹¹⁹

112 It must be noted that at the time of the submission of the manuscript, no CJEU judgment has been yet delivered; however, on 14 December 2023, the CJEU ruled that the Commission failed to prove that Luxembourg granted unlawful State aid to Amazon. The CJEU's reasoning resonates with its former position formulated in the Fiat case. See: CJEU, 14 December 2023, Case C-457/21 P, *Amazon*, ECLI:EU:C:2023:985.

113 T-816/17 and T-318/18, para. 118.

114 Haslehner, and Pantazatou, 2022, p. 99.

115 T-816/17 and T-318/18, paras. 121, 123.

116 T-816/17 and T-318/18, para. 126.

117 T-816/17 and T-318/18, para. 154.

118 T-816/17 and T-318/18, para. 155.

119 Haslehner and Pantazatou, 2022, p. 106.

4.3. *The allocation of intellectual property: The Apple case*

4.3.1. *Background of the case*

The first case in which the Commission made its decision¹²⁰ was Apple, which revolved around correct profit attribution to the Irish permanent establishments (PE) of Apple's subsidiaries. Two group companies – Apple Sales International (ASI) and Apple Operations Europe (AOE) – were incorporated in Ireland; however, they were not considered tax residents¹²¹ as they were effectively managed by the US. Meanwhile, owing to the US incorporation rule, these companies were also not considered tax residents in the US. Thus, they became stateless entities.

These two companies entered into a cost-sharing agreement with Apple US to share the costs and risks of the R&D activities necessary to develop IP related to technology for Apple's products. In exchange, although Apple Inc. remained the legal owner of the IPs, these companies received royalty-free licences, enabling the manufacture and sale of Apple products worldwide (except in North and South America).¹²² Further, ASI and AOE set up Irish branches to manage the procurement, sales, distribution, and manufacturing of Apple products.¹²³ Against this background, Apple sought for an advanced ruling whereby the profit attributable to the Irish branches has been determined so as to correspond to a *confidential* percentage of their operating costs, (excluding costs such as sums invoiced from affiliated companies within the Apple Group and material costs) and a confidential percentage of the branch' turnover.¹²⁴

4.3.2. *Commission decision*

The Commission concluded that the tax treatment of the Irish branches constituted a State aid in the form of renounced tax revenue by Ireland in the amount of EUR 13 billion.

The Commission based its decision on two grounds: on a primary line of reasoning and a secondary line of reasoning. In the primary line of reasoning, the Commission argued that the Apple IP licenses should have been allocated to the Irish branches instead of their artificial allocation to non-resident Irish subsidiaries as no relevant functions were performed by the head offices.¹²⁵ This is what Kofler labels as 'exclusion approach': if the IP licenses could not be attributed to anywhere else, they should be allocated to the Irish branches.¹²⁶

120 Commission Decision (Apple case) C(2016) 5605 final of 30 August 2016 on State aid SA.38373 (2014/C) (hereinafter: Commission Decision, Apple, 2016).

121 CJEU, 15 July 2020, T-778/16 and T-892/16, *Apple*, ECLI:EU:T:2020:338, para. 3.

122 T-778/16 and T-892/16, para. 6.

123 T-778/16 and T-892/16, paras. 9–10.

124 T-778/16 and T-892/16, paras. 17–19.

125 Commission Decision, Apple, 2016, para. 264 and seq.

126 Kofler, 2022, p. 184.

The secondary line of reasoning of the Commission states that even if one accepts that the IP licenses could not be allocated to the Irish branches, still the wrong transfer pricing method was chosen and, additionally it was applied in an incorrect manner. According to the Commission, the one-sided transfer pricing method, the transactional net margin method (TNMM) did not enable to come to a market-based outcome of profit allocation, especially because the choice of operating expenses as a profit-level indicator was wrong and the profit margin applied to that indicator was too low.¹²⁷

4.3.3. *Judgment of the General Court*

Upon appeal against the Commission's decision, the General Court annulled the decision and the recovery of unlawful aid on the grounds that the Commission failed to prove that a selective advantage was granted via the examined rulings. The General Court determined the reference framework as being constituted by the ordinary rules of taxing corporations' profits in Ireland, including the taxation of profits of both standalone and integrated companies as well as resident and non-resident companies¹²⁸, the latter category of taxpayers only to the extent that they carry out trade in Ireland via a permanent establishment (PE).¹²⁹

Regarding the taxation of the profits of Irish branches (PEs), the General Court pointed out that the Commission was right to place resident companies and Irish branches of non-resident companies in a comparable situation and assume them to be taxed as if they were operating under market conditions.¹³⁰ Consequently, the Commission was entitled to apply the ALP as a tool in its State aid analysis under Art. 107 of the TFEU¹³¹ even if the ALP was not explicitly incorporated into Irish law at the time of the issuance of certain rulings.¹³² Thus, the General Court accepted that – due to the actual application of the ALP by Irish tax authorities – the ALP could be used by the Commission as a tool together with the corresponding guidance provided by the current OECD TP Guidelines and the Authorised OECD Approach.¹³³ This dynamic interpretation of the related OECD documents can be seen as problematic as it goes against the principle of legal certainty, even if the General Court regards them as an international consensus, which is rather questionable.¹³⁴

However, it also clarified that the application of the ALP is not a freestanding obligation of the Member States inherent in Art. 107 of the TFEU.¹³⁵ Instead, the

127 Commission Decision, Apple, 2016, paras. 328–359.

128 T-778/16 and T-892/16, paras. 140–165.

129 T-778/16 and T-892/16, para. 161.

130 T-778/16 and T-892/16, paras. 212–214.

131 T-778/16 and T-892/16, para. 214.

132 T-778/16 and T-892/16, paras. 217–220.

133 T-778/16 and T-892/16, paras. 212–220.

134 Kofler, 2022, p. 191.

135 T-778/16 and T-892/16, para. 221.

ALP principle gained relevance with reference to Irish law and practice, which showed that it required the existence of a domestic law proxy.¹³⁶ Thus, the General Court did not refuse the Commission's approach in theory. Nevertheless, it rejected its findings because they were not compatible with neither the domestic Irish rules, nor the ALP and AOA approach in respect of the exclusion line of arguments and consequently, the Commission erred in attributing functions and activities to the Irish branches that would have justified allocating the IP licenses to them.¹³⁷

Regarding the subsidiary line of argument, the General Court highlighted that mere inaccuracies and methodological inconsistencies in the applied transfer pricing method were not sufficient to prove the existence of State aid.¹³⁸

It is worth noting that the case also stirred a transatlantic debate as the US was triggered by the Commission's allegedly new State aid interpretation. Not only had it repercussions on the European profits of important US companies with a retroactive effect,¹³⁹ but the State aid decision also had an impact on the financial interest of the US itself, as the theoretical recovery of the taxes in Ireland could have raised an obligation of the US to credit them as foreign income taxes upon repatriation.¹⁴⁰ However, as things stand now, the Commission's approach will likely be stricken down by the CJEU.

4.4. The selectivity of an aid scheme: The Belgian excess profit regime

The fact pattern of the *Magnetrol*¹⁴¹ case (also known as the Belgian excess profit exemption regime) is slightly different from that of other tax ruling cases. The first issue was whether an aid scheme¹⁴² existed. After confirming the existence of the aid scheme implemented through a consistent administrative ruling practice, the CJEU referred the case back to the General Court and did not rule on the compatibility of the scheme itself.¹⁴³

136 Kofler, 2022, pp. 189–190.

137 T-778/16 and T-892/16, paras. 251–295.

138 T-778/16 and T-892/16, paras. 352–481.

139 *Treasury Department White Paper on The European Commission's Recent State Aid Investigations of transfer Pricing Rulings* [Online]. Available at: <https://home.treasury.gov/system/files/131/WhitePaper-EU-State-Aid-8-24-2016.pdf> (Accessed: 3 November 2023). See also: Kofler, 2022, p. 182.

140 Kofler, 2022, p. 192.

141 CJEU, 16 September 2021, C-337/19 P, *Belgium v. Commission (Magnetrol)*, ECLI:EU:C:2021:741.

142 An aid scheme is defined under Art. 1 point (d) of Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the TFEU, OJ L 248, 24.9.2015, 9–29, in the following way: an 'aid scheme' means any act on the basis of which, without further implementing measures being required, individual aid awards may be made to undertakings defined within the act in a general and abstract manner and any act on the basis of which aid which is not linked to a specific project may be awarded to one or several undertakings for an indefinite period of time and/or for an indefinite amount.

143 C-337/19 P, para. 172.

The excess profit exemption scheme was not implemented under Belgian law. Instead, it was de facto applied by the Belgian tax authorities¹⁴⁴ in a way that differed from the ordinary transfer pricing rules of the Belgian corporate income tax system. The excess profit was calculated on a hypothetical basis as a percentage of the average profit using a profit level indicator of standalone companies. Thus, the starting point of the profit calculation was not the actual recorded profit of the Belgian group company, but a hypothetical one.¹⁴⁵ The Commission concluded that the excess profit exemption scheme was not part of the ordinary Belgian profit taxation system because the Belgian transfer pricing rules, which formed part of the reference framework, only allowed for a downward adjustment given a corresponding adjustment in the counterparty's profit in a different jurisdiction.¹⁴⁶

Such standpoint was confirmed by the General Court. It ruled that in the light of the objective of the Belgian corporation tax system, which was to tax the actual profits of the companies¹⁴⁷, the excess profit exemption scheme did not take part of the reference framework.¹⁴⁸ The General Court emphasised that the said reference framework could only be determined with reference to the applicable national law.¹⁴⁹ Based on the national law, the calculated excess profit would have been taxed in the absence of the administrative practice of the tax authorities as reflected in the tax rulings.¹⁵⁰ The General Court ruled that the administrative practice created a derogation from ordinary Belgian transfer pricing rules as the excess profit exemption practice did not require any corresponding adjustment or inclusion of profit in order to apply.¹⁵¹

As the identified objective of the tax system was to tax all the profits of Belgian companies and PEs,¹⁵² the General Court found that companies that benefited from the excess profit exemption regime were comparable with both other group entities and standalone entities that did not benefit from the regime.¹⁵³ Furthermore, the regime was only available for companies forming part of large or at least medium-size groups,¹⁵⁴ that made investment, created jobs, and centralised activities in Belgium and could only be obtained in the form of an advance ruling.¹⁵⁵

144 CJEU, 20 September 2023, T-263/16 RENV, T-265/16, T-311/16, T-319/16, T-321/16, T-343/16, T-350/16, T-444/16, T-800/16 and T-832/16, *Magnetrol*, ECLI:EU:T:2023:565 (hereinafter: *GC Magnetrol*), para. 64.

145 *GC Magnetrol*, para. 77.

146 *GC Magnetrol*, para. 45.

147 *GC Magnetrol*, para. 46.

148 *GC Magnetrol*, para. 80.

149 *GC Magnetrol*, para. 40.

150 *GC Magnetrol*, para. 30.

151 *GC Magnetrol*, para. 115.

152 *GC Magnetrol*, para. 121.

153 *GC Magnetrol*, para. 123.

154 *GC Magnetrol*, para. 133.

155 *GC Magnetrol*, para. 125.

The General Court refused Belgium's assertion that the objective of the excess profit exemption scheme was to avoid double taxation in the absence of any corresponding adjustment. Therefore, it could not be justified by such an aim.¹⁵⁶

Following the conclusion that the ruling practice constituted an aid scheme, it was relatively straightforward that such practice constituted unlawful aid. In contrast to the other transfer pricing cases, the treatment did not reflect the domestic ALP, resulting in a derogation from general national rules.

4.5. Some observations regarding tax sovereignty in light of the transfer pricing cases

Section 2 pointed out that positive integration (i.e. the challenges of Member States' tax systems in light of primary EU law) and negative integration (adopting harmonising measures) are not two separate worlds. Rather, there is an interaction between them, and their dynamics affect the tax sovereignty of Member States. Such an interrelationship is worth examining in light of the transfer pricing cases.

In the last decade, two very important directives have been adopted at EU level: the ATAD and the GloBE Directives. The former introduced mandatory measures for the Member States to tackle tax avoidance practices, while the latter goes even further: it established a floor to tax competition even in the absence of abusive situations. Although the Commission lost or seems to lose the State aid cases both in the field of TP cases, yet, the fact that it managed to draw the attention of wide public of harmful tax competition can be perceived as incentivizing the harmonization processes.¹⁵⁷ The connection between the lost cases (where the Commission attempted to use a sort of EU arm's length principle instead of national rules) and positive integration is even clearer in the case of the Transfer Pricing Directive Proposal¹⁵⁸ in the framework of the Business in Europe: Framework for Income Taxation (BEFIT) package. Although the Member States did not violate the State aid rules by way of their lenient transfer pricing rules according to the CJEU, the Commission was successful at highlighting the problematic nature of the application of national arm's length principles within the internal market, the recognition of which might result in the adoption of harmonized rules in this field.

It is more desirable also from the perspective of legal certainty: the use of State aid rules to curb tax competition is problematic as the concept of tax sovereignty prevents the Commission from deciding of what is an appropriate national tax because this decision at EU level can only be taken by means of harmonization.¹⁵⁹ Thus, harmonization, which can only occur by the consent of all the Member States is the

¹⁵⁶ GC *Magnetrol*, para. 147.

¹⁵⁷ Bacon, 2017.

¹⁵⁸ European Commission, Proposal for a Council Directive on transfer pricing, SWD(2023) 308–309 final.

¹⁵⁹ Recent trends, CJEU – Recent Developments in Direct Taxation 2020, p. 232.

right alternative to the excessive use of primary EU law beyond their scope to rectify phenomena that are harmful to the internal market, yet there is no available hard law at EU level to eliminate them.¹⁶⁰

5. Conclusions

The negative integration of the CJEU shaped the area of direct taxation to a large extent, particularly by applying fundamental freedom provisions and State aid rules to national direct tax measures. The convergence of both tests can be observed and they essentially boil down to a discrimination test. Indeed, they were successful and correct tools to dismantle discriminatory tax regimes. However, they have their limitations: they should not be used as a tool to tackle non-discriminatory tax competition among the Member States. This intention could be seen on the side of the Commission in particular when it carried out its State aid investigations regarding the transfer pricing treatment of multinational group companies obtained in tax rulings.

The Commission seems to lose in these cases, as in the Fiat case, the CJEU annulled the Commission's decision. The CJEU is certainly right to rely on its analysis of the applicable domestic rules of a given Member States and to exclude external principles or rules from the reference framework. This is what the principle of legal certainty and a consistent application of law require.

Nevertheless, the Commission successfully raised awareness of how little tax multinationals may pay in certain jurisdictions (even if legally) and the perceived unfairness might be assumed to urged the Member States to take coordinated measures against it. Consequently, Member States could agree on a variety sets of rules on tackling tax avoidance and, even more surprisingly, on the introduction of a global minimum tax that would require multinationals to pay an effective tax rate of 15% in each jurisdiction in which they operate. Eliminating harmful tax competition via harmonisation is the best way forward, as it improves the functioning of the internal market without restricting the tax sovereignty of Member States to a larger extent, as would follow from the Treaties.

¹⁶⁰ de la Feria, 2023, p. 6.

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CROATIA: GLOBAL AND EUROPEAN INFLUENCE ON PROCEDURAL TAX PROVISIONS



NATAŠA ŽUNIĆ KOVAČEVIĆ

Abstract

After short introduction on the impact of European and global recent changes on the development of Croatian tax law it is given a survey on the issue of the concept of tax sovereignty in Croatia. Special part of the paper is the section that confirms influence and the importance of the tax harmonization at the EU level for national legislative amendments and reforms. The obvious field of such influence is revised in section on anti-tax avoidance framework with examined national tax policy in the area of tackling tax avoidance and fraud. Special focus is given on the implementation and evaluation of Union measures in the field of anti-tax-avoidance in Croatia, since the EU policing tax avoidance has special dimension for MS. Information exchange and mandatory disclosure rules as tools for fighting tax avoidance and fraud are fields that are shown as example of the influence of tax policy approach addressing the issues of tax transparency and fighting tax evasion. Peculiarities in the domestic legislation as rules that apply in addition to EU law are in a brief analysed in paper, such as the introduced piercing the corporate veil for tax purposes. It was an instrument for preventing tax avoidance. It is concluded that Croatian tax legislation landscape would undeniably benefit from further improvements, especially regarding tax procedure, and improvements from the European and international level. Croatian tax system in the last decades have been linked with the inputs and advice of foreign experts so it is underlined that Croatian, as any tax system, should be adapted to country's socio-economic specificities.

Nataša Žunić Kovačević (2024) 'Croatia: Global and European Influence on Procedural Tax Provisions'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 457–475. Miskolc–Budapest, Central European Academic Publishing.

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1. Introduction

European tax law, which reflects the fundamental legal principles of European law, directly influences Croatian tax law, as exemplified by the implementation of the anti-avoidance rule on which this chapter focuses. The fight against tax evasion and abuse at the global and European Union (EU) levels has been particularly remarkable in the last decade – this is evident, for example, in intense legislative efforts to prevent tax evasion and the simultaneous development of legal transparency. Notably, such efforts have influenced the development of an increasingly complex framework for information exchange and administrative co-operation. This chapter discusses the impact of these developments on Croatian tax law with reference to taxpayers' rights (especially in terms of resolving tax disputes) to explore relevant issues in European law and its practical impact on national tax law.

2. The concept of tax sovereignty in Croatia

During the transitional era of the 1990s, Croatia created a new tax system suitable for a market-oriented economy, initiating an intensive legislative shift. This is where the development of the material and procedural tax frameworks differs. The dynamics of changes in the procedural legal framework of taxation are not particularly intensive; however, they are accelerating in a positive direction under the influence of European legislation. A more dynamic substantive tax law is the result of the social and economic environment in Croatia and is not due to the greater influence of EU legislation.

The Croatian tax system is the most important source of national public revenue. It is¹ regulated at the central level, as taxes are introduced only by the state parliament. Even when local units are entitled to regulate tax rates, this is done within the set framework, as all elements are set out in the tax acts. The Croatian Constitution² includes a universal obligation to pay taxes in accordance with individual

1 Accounting to 55.6% of budget revenues in 2020.

2 The Constitution of the Republic of Croatia, Consolidated text, Official Gazette ('Narodne novine') No. 56/1990, 135/1997, 113/2000, 28/2001, 76/2010, 5/2014 (hereinafter: the Constitution).

economic capacity, thereby mandating the ability to pay principle in the Croatian tax system. The Constitution also sets out the principles of equality and equity as the fundamental principles of the tax system. The normative framework of taxation includes the systemic legal source – that is, the law on tax procedure; namely: the General Tax Act (GTA).³ The importance of legislative instruments in this area should be emphasised, as Croatia has both a civil law legal system that strongly adheres to the constitutional principle of legality and a long tradition of literal interpretations of the law by the courts.⁴

2.1. Development of Croatian tax law

From a tax policy perspective, it is interesting that some of the most controversial changes in tax legislation, including the new framework of anti-tax avoidance rules and rules in the field of information exchange, took place without special discussions with legal practitioners or tax scholars. It should be emphasised that no single theory underlying the anti-avoidance approach in tax legislation could be identified during the amendments of the respective legal framework. At the same time, it should also be noted that, in the context of information exchanges, the theory of the protection of taxpayers' rights has increasingly been emphasised. The abuse of law doctrine, which is deeply rooted in Croatian civil law, was used to justify the GTA amendments of 2012, laying down a special procedure for 'piercing the corporate veil' in tax matters.⁵ The amendments caused a stir in the business community because they allowed tax authorities to declare a company's shareholders, board members, and executive directors (as well as individuals connected to them) liable for the company's tax debt, provided that it could be proven that the company's inability to pay its tax debt was caused by an abuse of rights or power.

On the contrary, one distinctive targeted anti-avoidance rule (TAAR) was included in the 2012 Profit Tax Act (PTA) amendments, which introduced a tax benefit for reinvested company profits. Specifically, the corporate income tax base can be reduced by increasing the company's capital for investment and development. From the outset, policy-makers recognised the tax avoidance potential of this benefit and introduced a TAAR, which stipulates that entitlement to reduce corporate income tax will not be granted if it is obvious that the intention of the company's capital increase was tax evasion or tax avoidance. Examination of the taxpayer's purpose as a condition for the application of the anti-avoidance rule is what makes this specific TAAR similar to the general anti-avoidance rules (GAARs) found in other tax systems. The wording of the above-mentioned TAAR is comparable to that of TAARs applicable in the context of the three EU direct tax directives. The provisions of the

3 General Tax Act, Official Gazette No. 115/16, 106/18, 121/19, 32/20, 42/20, 114/22.

4 Gadžo and Klemenčić, 2014, p. 290.

5 See: Žunić, Kovačević and Kovač, 2023, pp. 59–86.

Merger Directive (MD),⁶ Parent–Subsidiary Directive (PSD),⁷ and Interest-Royalties Directive (IRD)⁸ were implemented in Croatian legislation – mostly in the PTA and the accompanying Ordinance on Corporate Income Taxation⁹ – during accession to the EU. It appears that the Croatian legislature opted for a uniform anti-avoidance approach in the context of tax directives, even though the wording of the different TAARs is not identical. Consequently, the benefits of the MD, PSD, and IRD are denied if the principal purpose or one of the principal purposes of the pertinent transaction/arrangement is tax evasion or tax avoidance. Ultimately, it can be concluded that the harmonisation of Croatian tax law with EU law requirements brought important changes to the design of anti-avoidance legislation. Specifically, the taxpayer's purpose as a subjective element of the transaction, which was previously not acknowledged in the delimitation of tax avoidance, is now recognised as a constitutive element of tax avoidance, albeit in a limited number of TAARs. The tax community found that the positive influence of EU law on Croatian anti-avoidance law provided an important point of departure for future policy choices in this area.¹⁰ The preceding overview of Croatian anti-avoidance legislation may lead to the conclusion that policy-makers considered a GAAR unnecessary and chose instead to rely on TAARs as key anti-avoidance tools. However, a more detailed analysis of the legislative dynamics in this area reveals that Croatian tax policy-makers have not adopted a coherent anti-avoidance approach. What is particularly worrying is the absence of uniform criteria to delimit tax avoidance. In practice, taxpayer abuse of laws or rights are a defining element of tax avoidance. Examples include cases related to the application of the GTA provisions on scam transactions and cases related to 'piercing the corporate veil', where the purpose of the taxpayer's transaction or arrangement is rendered unimportant.¹¹ In other cases, such as those related to the application of a TAAR concerned with a tax benefit for reinvested profits or the implementation of the provisions of EU direct tax directives, the taxpayer's purpose is essential. As described in case law, the CJEU considers both objective and subjective

6 Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States (Codified version), OJ L 310, 25.11.2009, 34–46.

7 Directive 2011/96/EU of the Council of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), OJ L 345, 29.12.2011, 8–16.

8 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, 49–54.

9 Ordinance on profit tax, Official Gazette No. 95/05, 133/07, 156/08, 146/09, 123/10, 137/11, 61/12, 146/12, 160/1, 12/14, 157/14, 137/15, 115/16, 1/17, 2/18, 1/19, 1/20, 59/20, 138/20, 1/21, 156/22.

10 Gadžo and Klemenčić, 2014, p. 293.

11 Gadžo and Klemencic, 2014, p. 293.

criteria constitutive elements of tax avoidance.¹² Therefore, the reconciliation of differing criteria in delimiting tax avoidance in Croatia is possible if viewed in light of EU legal requirements. Croatian tax authorities and courts are obliged to adhere to the CJEU's notion of tax avoidance when applying national anti-avoidance rules to transactions and arrangements covered by the provisions of EU law. More flexibility is allowed only with regard to national and third countries or non-EU member states.

2.2. Role of stakeholders in the development of Croatian tax policy

In the context described above, there is no debate between stakeholders, including tax authorities, as the Ministry of Finance is the key player in the development of Croatian tax policy. From the perspective of tax legitimacy, the tax administration and the Ministry of Finance play a more dominant role in the creation of tax law than Parliament.¹³ This is supported by the fact that most tax bills drafted by the Ministry of Finance have become laws with minimal, if any, revisions during enactment procedures. In this respect, one may question whether certain provisions have been introduced as a consequence of lobbying by various pressure groups or as part of the implementation of European legislation.

The Croatian tax system provides an example of how the introduction of a European rule on the GAAR can enhance legal certainty, although the standard argument is that the GAAR overthrows this important principle. Frequent changes in anti-avoidance legislation, with the introduction of new TAARs, reflect the general problem of the Croatian tax system since its reform in 1994; namely: the unpredictability of the legislative framework.¹⁴

Accordingly, the main advantage of introducing EU tax law provisions may be legal certainty.¹⁵ Moreover, legal certainty could be enhanced via instruments accompanying the fight against tax evasion at the global and European levels. This struggle also takes place through information exchanges between international and European legislative sources, which are detailed below.

Since the outbreak of the latest economic crisis, tax reforms in Croatia have been driven mostly by the ensuing pressures of fiscal consolidation.¹⁶ Due to a failure to comply with the fiscal targets set out in EU legislation, Croatia entered the excessive deficit procedure (EDP) immediately after its EU accession, meaning that its public finances were monitored by EU institutions.¹⁷ Although the tax community

12 See more: CJEU, 21 February 2006, C-255/02, *Halifax and Others*, ECLI:EU:C:2006:121; CJEU, 12 September 2006, C-196/04, *Cadbury Schweppes and Cadbury Schweppes Overseas*, ECLI:EU:C:2006:544; etc., detailed in: Gadžo and Klemenčić, 2014, p. 286.

13 See: Arbutina et al., 2016, pp. 281–284.

14 Gadžo and Klemenčić, 2014, p. 294.

15 Gadžo and Klemenčić, 2014, p. 294.

16 Perić, Kordić and Mesarić, 2014, p. 115; see also: Čičin-Šain, 2013, pp. 297–301.

17 See: Šimović and Deskar-Škrbić, 2019, pp. 169–186.

still seems to agree that there is no space for a further increase in the overall tax burden, the potential fiscal effects of policies aimed at enhancing tax compliance have been largely overlooked. The experiences of other crisis-stricken EU member states confirm that one of the conditions for EU financial assistance is the development of a strategic approach to fixing the structural deficiencies of national tax systems, including approaches to tax compliance.¹⁸ In this context, the improvement of tax legislation through European initiatives and similar legislative changes by other Member States has given rise to a set of tax guidelines that mostly align with CJEU case law. Notably, the development of a coherent framework for tax law can have significant effects on revenue.

The GTA, a systemic tax law, regulates the relationship between taxpayers and tax authorities by controlling taxation and other public dues (if they are not otherwise regulated by special acts on certain types of taxes and other public charges) and represents the basis of the joint tax system. In addition to this so-called ‘systemic regulation’, numerous acts regulate specific taxes as *leges speciales*. All tax acts are accompanied by one or more ordinances. As set out in Art. 2, the GTA relates to ‘taxes and other public dues’, with ‘taxes’ signifying financial dues and area budget revenue used to settle public expenditure determined in the budget.

3. The harmonization of Croatian tax law

While in some EU Member States there are hot debates over the perceived loss of tax sovereignty,¹⁹ with national legislators having to abide by the ever more complex framework of EU tax law, this discourse is largely absent in Croatia. This was previously explained in the Croatian tax community by the fact that accession to the EU was one of the rare strategic goals agreed upon by an overwhelming majority of domestic political actors since the 2000s.²⁰ Accordingly, the harmonisation of the domestic legal system with EU tax law was traditionally perceived as a purely technocratic goal necessary to meet the accession criteria. Furthermore, a general lack of awareness of the implications that primary and secondary EU laws may have on Member States’ tax systems probably also played a role. Finally, it has to be noted that Croatia never used its tax system to become a financial centre or the ‘tax haven of the Balkans’, making conflicts with EU law relatively unlikely from the start. In the Croatian tax community, there is an awareness of European tax law as a facilitator of important and inevitable movement in the global direction founded in BEPS and post-BEPS legislative activities.

18 See: Kassim and Lyons, 2013, pp. 1–21.

19 See: Van Apeldoorn, 2016, pp. 215–230.

20 Gadžo, 2019, pp. 116–146.

Amendments to the Croatian tax legislature have mostly been initiated by proposed novelties at the EU and global levels; these include amendments to the GTA as well as to substantial laws, such as those related to corporate income tax.²¹ These amendments also recognise that some proposals from the EDP regarding property taxation, such as those proposed by the World Bank, have not been accepted or implemented.²² The jurisprudence of the CJEU on tax matters has caused even less debate – at least outside academic circles.²³ Notably, some critical observations of the Croatian courts do not refer to preliminary rulings before the CJEU.²⁴

Broadly, the national tax community does not recognise Croatian tax sovereignty as something to protect from non-Croatian or supranational influence. It is generally accepted that Croatian legislators at least ‘tacitly approved the direction of EU tax policy, diligently transposing the rules of tax directives in domestic law’.²⁵ The plea for greater fiscal and taxation autonomy does not play a part, even within the sporadically heard Eurosceptic narrative.²⁶ This may be linked to the expenditure side of the European budget, as Croatia is becoming aware of its position as a growing receiver of EU funds.

3.1. Croatia’s anti-tax avoidance framework

3.1.1. Croatian tax policy for tax avoidance and fraud

The Croatian anti-avoidance legislative framework has changed due to strong European and global effects. Several GTA and PTA amendments drafted based on EU Directives introduced a new general and targeted anti-avoidance rule. A notable example is the amendment of the PTA in 2016 with the transposition of the Parent-Subsidiary Directive. This amendment prescribes that taxpayers should not be granted any benefits envisaged in corporate tax legislation if they make use of an arrangement or a series of arrangements classified as non-genuine. The article defines ‘non-genuine arrangements’ as any business transaction, scheme, action, operation, understanding, promise, or event, comprising one or more steps or parts, which has been put into place to obtain a tax advantage in light of all relevant facts and circumstances. In addition, such arrangements may be considered non-genuine only to the extent that they are not implemented for valid commercial reasons that reflect the economic reality – that is, if they are implemented for the purposes of tax evasion or fraud. Further directions for the application of such a GAAR are listed in the prescribed GTAs. Assessments of an

21 Profit Tax Act, Official Gazette No. 177/04, 90/05, 57/06, 80/10, 22/12, 146/08, 148/13, 143/14, 50/16, 115/16, 106/18, 121/19, 32/20, 138/20, 114/22, 114/23 (hereinafter: PTA).

22 See: Bartlett, 2018, pp. 149–162.

23 Dujmović, 2020, p. 353; Žunić Kovačević and Gadžo, 2018; Čičin-Šain, 2016.

24 See: Duić and Petrašević, 2019, pp. 65–95; Materljan, 2019, p. 211.

25 See: Essers, 2022.

26 Compare also the discussion by Čular and Grbeša, 2020, pp. 39–60.

arrangement's genuineness must establish whether the arrangement, regardless of the taxpayer's subjective intention, defeats the object, spirit, and purpose of the pertinent tax provision.

Accordingly, Croatian tax authorities have started to vigorously assess the economic substance of mergers and acquisitions (M&As), often denying the acquirer different tax benefits, which makes the entire restructuring more costly. In doing so, Croatian tax authorities rely on a myriad of domestic anti-tax-avoidance rules, according to which M&A operations may be characterised as abusive. Accordingly, Croatian anti-tax-avoidance legislation has hindered M&A activities. The application of the anti-abuse rule stems from the implementation of the Merger Directive. In transposing the requirements of the Merger Directive into its national legislation, Croatia opted to exercise the option envisaged in Art. 15 para. (1) point (a) of the directive and adopted an explicit anti-tax-abuse provision on the domestic legal plane. Accordingly, tax benefits are denied if it is evident that the principal objective or one of the principal objectives of the transaction at hand is tax evasion or avoidance. Given that taxpayers may engage in abusive behaviour in many different circumstances (i.e., a lack of a valid business or commercial motive amounts to only one example of tax avoidance) revenue bodies presume tax avoidance, as explicitly provided in the Merger Directive itself. The manner in which tax authorities apply these provisions in practice is even more important for M&A participants. It is standard to fully shift the burden of proof to the taxpayer; thus, it is up to the taxpayer to prove that tax avoidance or tax evasion is not the primary goal of the reorganisation. Administrative practice shows that Croatian tax authorities start with the presumption that the intended transaction involves tax avoidance as one of its main purposes even if no evidentiary substratum supports this position. In the second step, the onus is on the taxpayer to rebut this presumption by presenting evidence that the reorganisation is being completed for a valid commercial purpose.²⁷

3.1.2. Global and European influences on combating tax avoidance

Tax avoidance currently ranks high in global tax policy, as evidenced by the base erosion and profit shifting plan (BEPS)²⁸ and other developments at the regional and international levels. EU institutions have also taken an active role and initiative in this area, stressing the need for a uniform anti-avoidance approach across all Member States. The EU has responded to the BEPS with directives against tax avoidance practices that directly affect the functioning of the internal market

²⁷ Žunić Kovačević and Gadžo, 2018.

²⁸ The base erosion and profit shifting (BEPS) initiative of the Organisation for Economic Co-operation and Development (OECD) and G20 countries marked an important development in the reform of the international taxation regime. The plan, which was adopted in 2015, was designed to close tax avoidance loopholes in the patchwork of domestic fiscal laws and bilateral tax treaties and to correct the impact of unfair tax competition.

(ATAD),²⁹ with the aim of ensuring fair and effective taxation and collection of tax revenue based on new international rules. This confirms the importance of implementing BEPS measures at the Member-State level to achieve fair, efficient, and coordinated taxation at the EU level.

This European response was possible because it involved an instrument that removes obstacles to the functioning of the internal market. Specifically, the ATAD prescribes *de minimis* protection; that is, it does not exclude the application of provisions with a higher degree of protection of domestic or national tax bases of corporate income tax. In other words, it is a minimum harmonisation directive because Member States may apply higher standards than those provided in the directive. In particular, the ATAD introduced four specific rules against tax evasion: three specific anti-tax avoidance rules and one general anti-tax avoidance rule. Member States were obliged to harmonise national legislation with the ATAD by 2018, with some exceptions.³⁰ Croatia has implemented GAAR and TAARs, mostly by amending corporate taxation legislation and some GTA provisions. As a rule, there has been no debate about these novelties in tax practices.

3.1.3 The implementation and evaluation of European Union measures in Member States' anti-tax-avoidance strategies

The EU's policing of tax avoidance is notable for Member States³¹ as the requirements of EU law confirm that there is no genuine EU tax policy.³² However, the principle of the supremacy of EU law over Member States' national legislation significantly restricts national tax policy and brings additional complexity to anti-avoidance strategies. Ultimately, tax avoidance approaches are unique to each country.³³ The requirements of EU law have a harmonising effect: national anti-avoidance rules must align with EU limitations if a transaction or arrangement is carried out in the EU. In numerous cases, the CJEU decided on the compatibility of national anti-avoidance rules with EU law,³⁴ resulting in the development of an implicit concept of tax avoidance in the EU. The CJEU's reasoning in 'tax avoidance cases' is derived from the prohibition of the abuse of law as a general principle of EU law.³⁵ From the tax policy perspective, it is essential to note that the CJEU's approach to tax avoidance cases is remarkably similar

29 Directive (EU) 2016/1164 of 12 July 2016 laid down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, 1–14.

30 Žunić Kovačević, 2020.

31 Prebble, 2017.

32 Gadžo and Klemenčić, 2014, p. 285; Wattel, Marresand and Vermeulen, 2018, p. 478

33 Edgar, 2007, p. 833.

34 Gadžo and Klemenčić are mentioning many cases, starting with e.g., Halifax case and Cadbury Schweppes decision. See also: Gadžo and Klemenčić, 2014, pp. 286–287.

35 Many international authors have explored this subject; see, for example: de la Feria and Vogenauer, 2011; Kuźniacki, 2019.

to those found in statutory GAARs in national contexts, including in Croatian judicial practices.³⁶ Many administrative instances of case law and substantial tax disputes confirm the positive influence of European legislation. Further, European legislation has also introduced important procedural instruments to prevent tax disputes, such as preliminary rulings and horizontal monitoring. There is also legislation on dispute settlement mechanisms at the EU level, which may be an important instrument for determining general standards for a national tax dispute settlement framework.

The standards for the resolution of tax disputes at a comparative level are not the subject of this paper; however, it remains notable that the Directive on tax dispute resolution mechanisms serves as an indicator of trends at the European level. Thus, although data point to the shortening of the duration of tax disputes in national frameworks before first-instance courts based on the Directive on Tax Dispute Resolution Mechanisms,³⁷ the standards at the European level are clear.³⁸

Croatia implemented this directive by adopting the Tax Dispute Resolution Mechanism Act.³⁹ The working documents of the Croatian Parliament state the goal of the Directive and the law itself, which lies in the need to ensure the efficient and effective resolution of disputes in cases of double taxation, with the complete elimination of double taxation.

To improve the tax dispute settlement mechanisms between Member States, a uniform and harmonised implementation of the rules on tax dispute settlement mechanisms is necessary. While this is essential in the global fight against tax evasion and avoidance, this shift also has implications at the national level, where there is a need for new or alternative mechanisms for tax dispute settlement, including adjustments at the levels of tax authorities and at the judicial level. New tax dispute settlement mechanisms in Europe are equally important or required for purely domestic national tax disputes. European tax dispute resolution standards can also become requirements for national tax practices. The Croatian tax community emphasises the importance of the equal interpretation and application of European legislation in all Member States. According to existing research,⁴⁰ the main issue with the taxation system in Croatia is legal security.⁴¹

36 See: Gadžo and Žunić Kovačević, 2019, p. 345.

37 Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union, OJ L 265, 14.10.2017, 1–14.

38 See: Groen, 2022.

39 Tax Dispute Resolution Mechanisms Act (cro. Zakon o mehanizmima rješavanja poreznih sporova u Europskoj uniji), Official Gazette No. 98/19.

40 Bejaković and Bezeredi, 2019; Žunić Kovačević, 2016.

41 Koharić, 2018.

4. Information exchange and mandatory disclosure rules as tools for fighting tax avoidance and fraud

Following developments in the field of global administrative cooperation, which began in 2009 with the acceptance of the automatic exchange of information as the global standard of tax transparency,⁴² efforts have been made within the Croatian tax system to enable exchanges of information. The tax policy approach to addressing issues of tax transparency and fighting tax evasion confirms an awareness of the benefits of higher tax transparency. Information exchange has undergone a complex transformation from a secondary instrument to the most important globally accepted instrument for fighting tax evasion. Further, it also plays an important role in providing countries with information on the income their residents earn and the property they hold in other countries; that is, with information useful for the revenue side of fiscal policy.

The EU started harmonising administrative cooperation through the provisions of the Directive on Mutual Assistance in Direct Tax Matters in 1977.⁴³ This work continued with the adoption of the Savings Directive in 2003,⁴⁴ which enabled the automatic exchange of information. However, these efforts did not provide a sufficient legal basis for the global exchange of information; thus, a new directive on administrative cooperation in tax matters (the DAC) was adopted in 2011. The DAC and its amendments included elements of the BEPS initiatives. The DAC did not stop at the exchange of information on direct taxes, but ensured fiscal transparency by expanding the scope and requirements of amendments related to automatic exchanges of information (DAC 2), automatic exchanges of tax rulings and advance pricing agreements (DAC 3), automatic exchanges of country-by-country reports (DAC 4), access to beneficial ownership information collected pursuant to anti-money-laundering legislation (DAC 5), and automatic exchanges of reportable cross-border arrangements (DAC 6), with tax transparency rules for reporting by digital platforms (DAC 7). Globally, the exchange of information on tax matters is mostly related to direct taxes; however, there is a similar procedure for indirect taxes, such as value-added tax (VAT). The exchange of information on VAT is prescribed by Council Regulation (EU) No 904/2010 of 7 October 2010 on administrative cooperation and combating fraud in the field of VAT with current amendments.

As of 2014, financial intermediaries had assumed increased importance and EU institutions decided to take legislative action. First, they enacted the Savings

42 For more examples, see: Gadžo and Klemenčić, 2017.

43 Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ L 336, 27.12.1977, 15–20.

44 Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ L 157, 26.6.2003, 38–48.

Directive⁴⁵ to ensure the effective taxation of the taxable savings income of residents in all Member States in the form of cross-border interest payments. Subsequently, the DAC 2 was introduced, amending the directive regarding the mandatory automatic exchange of information in the field of taxation. The latter instrument focuses on the role of financial intermediaries, laying down a series of duties which must be strictly followed and correctly carried out to grant the transmission of taxpayer data to competent authorities. Finally, Directive 2015/2376/EU was adopted to ensure the mandatory automatic exchange of advance cross-border rulings and pricing arrangements. Moreover, the focus was on the role of financial intermediaries; in particular, attention was paid to analysing their duties and approaches to balancing taxpayers' privacy rights with the state's taxing power.

It should be mentioned that the adoption of advanced rulings, as an instrument of harmonisation in the tax field, played an important role in achieving additional benefits for taxpayers as well as tax security (one of the basic general principles of the rule of law). Notably, the judicial treatment (which generally served as a public rule) of the public opinions of the tax authorities in Croatia's tax community were seriously criticised. These criticisms were well-justified; accordingly, there were demands to adopt and apply a *bona fide* principle of taxation to introduce advance rulings.⁴⁶ European legislation enhanced and accelerated the achievement of legal certainty and acted in good faith in the tax procedure; that is, harmonisation in the introduction of the advanced ruling institute prompted the Croatian legislature to accept and implement this important instrument for achieving taxpayer tax security. Thus, the status of public and general opinion has also been improved in such a way that it was, as a consequence of harmonisation, implemented in GTA provisions and the accompanying Ordinance on *bona fide* tax procedures.⁴⁷

Numerous other institutes based on European legislation were also introduced by the Croatian tax system to secure a more favourable or safer position for taxpayers. Debate on the eventual justification of such changes among Croatian academics and

45 Directive 2014/48/EU of 24 March 2014 amending Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ L 111, 15.4.2014, 50–78.

46 See: Arbutina, Žunić Kovačević and Gadžo, 2022. '[...] those opinions is clear – they are not, and cannot be, the source of law. They are, however, broadly published in specialized professional journals and widely read by taxpayers as hints of the course the Croatian tax administration will direct its actions in some particular category of cases [...] Such a situation cannot, by and standard legal criterion, be justified. It induces legal uncertainty, since, on the one hand, opinions cannot be legal argument, and, on the other, they cannot be ignored either [...] it turns out that they are an informal (de facto) legal source, albeit with an unclear status'.

47 Ordinance on the implementation of the General Tax Law, Official Gazette No. 45/19, 35/20, 43/20, 50/20, 70/20, 74/20, 103/20, 114/20, 144/20, 2/21, 26/21, 43/21, 106/21, 144/21, 156/22, replaced the Ordinance on acting in good faith of participants in the tax-legal relationship, the economic entity and the forms for reporting facts for which there is an obligation to report and declarations about the sources of acquisition of property, Official Gazette No. 59/09, 115/16, 30/17.

professionals was absent because such changes were considered necessary and were realised thanks to the implementation of EU legislation. Admittedly, the practice of concluding advance rulings and advance pricing agreements is not very comprehensive; however, it is comparable to practices in countries that were simultaneously reconstituting their tax systems in the same way to adapt to and harmonise with EU law, as evidenced by Slovenia's changes to tax legislation and advanced rulings.⁴⁸

Croatia actively supports international efforts to tackle tax evasion and is one of the 'early adopters' of tax transparency initiatives regarding the automatic exchange of information. This was confirmed by analysing the implementation of the exchange of information included in tax treaties.⁴⁹ The Multilateral Convention on Mutual Administrative Assistance in Tax Matters,⁵⁰ a multilateral instrument developed by the OECD and the Council of Europe for exchanges of information, was signed in 2013. The Convention provisions served as the legal basis for the implementation of the US Foreign Account Tax Compliance Act, FATCA and OECD/DAC Automatic Exchange of Information Instruments.⁵¹ Notably, given that Croatia did not have a tax treaty in force with the US, the Convention served as the legal basis for Croatia's automatic exchanges of information.⁵²

The provisions of the DAC and its amendments have been transposed in the form of a separate piece of legislation: The Act on Administrative Cooperation in Tax Matters. The provisions for administrative cooperation were previously part of the GTA. With the adoption of the FATCA and the increase in DAC provisions, the legislature decided to include all international exchanges of information provisions within a single act. The Ministry of Finance, Tax, and Customs Administration has the authority to implement administrative cooperation. This Act sets out the rules for administrative cooperation in the field of taxation between the Croatia and EU Member States, automatic exchanges of information on financial accounts between Croatia and other jurisdictions, automatic exchanges of information for country-by-country reporting between Croatia and non-EU jurisdictions, and the implementation of the FATCA agreement between Croatia and the US.

Powerful anti-avoidance and anti-tax evasion tools, which positively influence the revenues of participating governments, may be caught up in administrative constraints and the absence of resources for revenue bodies that have to effectively implement the aforementioned global and European standards. Taxpayers' duties have increased domestically and internationally with the global development of information exchanges; therefore, the positions of taxpayers and the protection of

⁴⁸ See: Kovač, 2019.

⁴⁹ See: Klemenčić and Klun, 2022.

⁵⁰ Law on Confirmation of the Convention on Mutual Administrative Assistance in Tax Matters, as amended and supplemented by the Protocol Amending and Amending the Convention on Mutual Administrative Assistance in Tax Matters, Official Gazette – International Contracts No. 1–6/14.

⁵¹ Seer and Kargitta, 2020.

⁵² See: Gadžo and Klemenčić, 2017.

their rights should remain the focus of all tax law amendments. Taxpayer rights, including the right to fair process, privacy protection, and procedural rights, should be preserved. All these rights are well defined in domestic national law, with equally effective national protection. Any additional instrument with the same purpose – global or European – is desirable. However, global and European benefits and exchanges of information simultaneously bring the risk of breaches of the minimum standard of taxpayers' fundamental rights: the right to be informed and heard, the right to appeal, the right to pay an exact amount of tax, the right to certainty, the right to privacy, and the right to confidentiality and secrecy. Exchanges of information are designed to prevent double taxation, which is useful not only for taxpayers, but also for states seeking to combat tax evasion and avoidance. Protecting taxpayers' interests is crucial because the exchange of information is related to personal and potentially confidential information. Therefore, governments must consider taxpayer interests when fulfilling their obligations to exchange information.⁵³

4.1. Peculiarities in domestic legislation: Applicable rules in addition to EU law

While general efforts have been made to tackle tax avoidance, it should be noted that Croatia's tax legislature follows global and European proposals. This was the case with the previously mentioned introduction of GAAR and TAARs (as well as special anti-avoidance rules [SAARs]) in the Croatian tax system and global or European standards for administrative cooperation and exchanges of information. Further, even before the global or European standards, the Croatian tax system already prescribed a general anti-avoidance rule through a provision on fictitious legal transactions in the GTA; specifically, this provision stipulated, if another legal transaction is concealed by a fictitious legal transaction, the basis for determining the tax liability is then the concealed legal transaction. This implies that the Croatian tax system was aware of the 'principle of preventing the abuse of legal norms' as a general anti-avoidance rule. This provision was examined under case law and confirmed by the decisions of the High Administrative Court of the Republic of Croatia. Moreover, after the global financial crisis of 2012 and before the EU accession, Croatian tax authorities focused on financial discipline and proposed piercing the corporate veil for tax purposes, thereby highlighting another instrument for preventing tax avoidance.

⁵³ Oberson, 2015, pp. 4–13.

5. Concluding remarks

The introduction of EU tax law provisions into the Croatian tax system has both advantages and challenges. On the one hand, it enhances legal certainty and helps combat tax evasion. However, it requires careful consideration of the differences between the Croatian and EU tax systems, as well as the potential conflicts and inconsistencies that may arise. Overall, the harmonisation of Croatian tax law with EU law provides a framework for the continued development and improvement of the tax system.

As in other countries, the obligation to pay taxes in Croatia stems from the constitutional principle of the ability to pay. Art. 51 of the Constitution states that every person should participate in the defrayment of public expenses in accordance with his/her economic capacity. The Constitution also stipulates that the tax system should be based on the principles of equality and equity, establishing the paramount objectives of Croatian tax policy. These constitutional principles are reflected in diverse statutory provisions. For example, provisions of the GTA oblige parties in a tax relationship to act in good faith; that is, to conduct themselves conscientiously and fairly in accordance with the law. Recent global and European efforts to stop tax avoidance are especially important when reviewing tax systems. Notably, tax avoidance undermines both dimensions of equity: horizontal equity is endangered because the share of the tax burden borne by two taxpayers with equal economic faculties differs depending on their tax planning schemes; meanwhile, vertical equity is endangered because tax avoidance schemes are largely a privilege for high-income earners, limiting the tax system's progressiveness.⁵⁴ Consequently, this constitutional principle justifies anti-avoidance legislative instruments in Croatia.

In conclusion, the above review suggests that the introduction of EU tax law provisions in the Croatian tax system has involved many benefits and challenges. Although Croatian tax legislation did not contain a rule defined as a GAAR, certain provisions which follow the same underlying objectives can be found in the first stages of Croatia's tax system. The GTA effectively codified the 'Substance Over Form' principle in the process of determining tax facts. Additionally, the GTA provides, '(I) f the revenue, income, profit or other assessable benefit was acquired without a legal basis, the tax authority shall determine the tax liability in accordance with a special law regulating certain types of taxes'. The implementation of this principle allows the tax administration to tax profit acquired even by a criminal act with the basic idea of taxing the underlying economic substance – the general legal character of the action or transaction that led to the profit is irrelevant. The implementation of European legislation created a more complex legislative framework to combat tax avoidance. The judicial control of taxation in individual tax decisions confirms the importance of tax security, fundamental principles, and the need for the effective protection of taxpayers' rights. Compared with other countries, the Croatian

⁵⁴ Gadžo and Klemenčić, 2014, pp. 277–302.

approach to the implementation of European and global fiscal and tax standards seems to be underdeveloped or fragmented.

A brief look *de lege lata* and *de lege ferenda* suggests that the Croatian tax legislation landscape would undeniably benefit from further improvements, especially regarding the acceptance and transfer of tax procedures and improvements at the European and international level into the Croatian national legal framework. Regarding the relationship between the government and taxpayers, Croatia seems to be a novice to democracy. While some tax measures introduced in the Croatian tax system in the last decades have been linked with the inputs and advice of foreign experts as well as EU institutions and other international organisations, it seems that domestic legislators have gradually come to terms with the prescient words of the late Professor Jelčić, who insisted that any tax system should be adapted to a country's socioeconomic specificities and that European solutions cannot be copied in Croatian tax law.⁵⁵

⁵⁵ Gadžo, 2017, pp. 179, 182–188.

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CZECH REPUBLIC: INDEPENDENT TAX POLICY AS A PART OF CZECH FISCAL POLICY



MICHAL RADVAN

Abstract

Tax issues are often considered crucial to public financing. Many state policies depend on tax revenue. The state sets its tax policy to collect adequate income in order to ensure the management of the state and local self-government units.¹ The position of tax law within the system of law is perceived in a variety of ways in the world and in European Union (EU) Member States. For example, in Western European countries (the old EU Member States), tax law and tax law science have long-standing traditions. Tax law is an independent branch of European law. In the new EU Member States (Central and Eastern Europe), tax law is (still) a sub-branch of financial law according to the local legal sciences; specifically, it pertains to the fiscal part of financial law, which deals with the legal relationships created, implemented, and terminated in the process of creating, distributing, and using public monetary funds. The fiscal part of financial law includes, in addition to tax law (public budget revenues), budgetary law, and public subsidy law (public budget expenditures).² This chapter addresses the position and role of tax laws in the Czech legal system. The following sections identify the pros and cons of tax sovereignty and tax harmonisation in tax law regulations and reviews notable efforts in the tax avoidance field. The last section presents the conclusions and *de lege ferenda* recommendations.

1 For this subchapter, several parts from Radvan, 2020; and Hulkó and Radvan, 2022, pp. 63–73, are used.

2 Mrkývka, 2012; Boháč, 2006, pp. 6–10.

Michal Radvan (2024) 'Czech Republic: Independent Tax Policy as a Part of Czech Fiscal Policy'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 477–501. Miskolc–Budapest, Central European Academic Publishing.

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1. Tax law in general and the specifics of Czech tax law

In the Czech Republic, tax law is defined as a system of legal norms regulating the social relationships created, implemented, and expired in the process of creating public monetary funds. In fact, taxes *sensu lato* (in the broader sense) are social relationships regulated by tax law. These relationships are defined by their subjects, objects, and content. The subjects can be divided into two parties as well as third parties. The weaker party in the relationship is the taxpayer or paying agent, who has fewer rights and more obligations. The stronger party is the tax administrator, who has decision-making powers. In tax proceedings, there are also third parties, such as experts, interpreters, and witnesses. The object of the tax law relationship is tax in the economic sense – public payments into public funds (e.g. the state budget, local self-government budgets, state funds). It is possible to talk about taxes *sensu stricto* and *sensu lato*. While taxes *sensu stricto* are public payments called ‘taxes’, taxes *sensu lato* also include charges, customs duties, and similar levies. From a legal perspective, the tax and the tax relationship can be defined as a power relationship of an economic nature, monetary, irrecoverable, usually regular, with no equivalent and no direct counter-performance by the public monetary fund to the entity fulfilling its tax law obligation (e.g. paying taxes). Charges (fees) are characterised in the same way, except that they are usually irregular, with direct counterperformance to the person paying them. For both taxes and charges, *nullum tributum sine lege* is crucial: the condition *sine qua non* for every tax *sensu lato* is the act imposing a tax. The legislator can create different titles for taxes *sensu lato* (e.g. customs, contributions, levies, tolls, excises, tariffs, insurance, including many other varieties in national languages). However, each payment to a public fund will always, theoretically, be classified as either a tax or a charge (fee).³ According to the structure of all Czech legal acts dealing with taxes and charges, tax relationships share the same basic structural components (e.g. the object of taxation, tax subject, tax base, tax rate, correction components, payment conditions, tax administrator, budget destination).

Specific to tax law is its regulatory method, which is a modified version of the administrative law method. Generally, the administrative law regulation method is based on the effect that public authorities have on their subjects, especially by means of the norms that they can enforce and that are contained in normative administrative acts – that is, the bylaws and ordinances issued by public authorities, authorised in and for the implementation of the law and within limits stipulated by law

3 Hukl and Radvan, 2022, p. 63.

(sub-statutory regulations) – as well as individual administrative acts – that is, the decisions of the public authorities authorised by law to make such decisions in a specific administrative matter. The modification may be demonstrated, for example, by: (i) The relatively limited application of sub-statutory regulations (only in the local tax area); (ii) Public administrative authorities applying a wide range of economic instruments that affect recipients (e.g. tax credits, tax holidays); (iii) The use of elements of private law (e.g. options to negotiate or postpone taxes, payment calendars); (iv) The delegation of certain administrative activities to private law entities (e.g. in a labor law relationship, the employer is obliged to deduct a personal income tax advance payment as well as social security and health contributions and other levies stipulated by law from the employee's wages and the employee is obliged to permit this; a bank withholds tax on accrued interest, a joint stock company withholds tax on dividends, a seller collects value-added tax (VAT) from a buyer along with the sale price); (v) The application of the principle of self-application (the taxpayer applies tax law norms to itself by determining the tax base using its knowledge, uses the relevant tax rate for itself, applies the corrective elements, and subsequently delivers the completed tax return to the tax administrator, which assesses the tax tacitly – that is, implicitly – provided that it has no reservations regarding the correctness and completeness of the return); the self-application principle means that, in most cases, there is no interaction between the tax administrator and the taxpayer; (vi) The introduction of elements of choice to moderate the mandatory nature of tax law relationships (e.g. voluntary VAT payments, different methods of calculating depreciation, lump-sum taxes, lump-sum expenditures for income taxes).⁴

Similar to many other branches of law and tax law in other countries, Czech tax law has both general and specific parts. The general part comprises information regarding tax law and its object, norms, and relationships. This part contains certain institutes of a general nature and general principles applied to tax law as a whole. This part is not codified; however, general issues could appear, for example, in existing regulations of a more procedural nature (e.g. the Tax Code⁵) as well as in entirely new legislation (e.g. the Public Finance Act). The specific part contains legislation regarding individual tax law relationships, which are regulated across many different legal regulations. However, it is possible to define two sub-branches of tax law – tax law and charge law – with regard to the above statement that each public payment to a public fund is always theoretically classified as either a tax or a charge (fee). As customs duties have charge characteristics, they could be part of a charge law, even if customs law sometimes creates a specific part of a financial law or tax law. The same may be stated for social security contributions (e.g. pension insurance premiums, contributions to the state employment policy, sickness insurance premiums) and health contributions – based on their characteristics, they might belong

⁴ Hulkó and Radvan, 2022, pp. 59–60.

⁵ Act no. 280/2009 Sb., Tax Code, as amended.

to tax law; however, in the Czech Republic, they are now part of social security law.⁶

Tax law has a substantive component (substantive tax law) and a procedural component (procedural tax law). The norms of the substantive component determine the structural elements of the tax: persons burdened with tax liability (taxpayers and payers/paying agents); the object, base, and rate of the relevant tax; and other structural elements of the tax. The procedural part (procedural tax law) is a set of procedural law norms that regulate the position of entities in proceedings on rights, legally protected interests, and obligations resulting from substantive tax laws. The procedural part also deals with procedural law practices in decision-making processes before tax administration authorities and legal and natural persons – whether entrusted by law or based on the law – on the rights, legally protected interests, and obligations of other entities resulting from substantive tax law norms. The procedural component also covers the practices of subordinate entities when implementing substantive tax law – this does not involve proceedings before public authorities but does include procedures that the subject of taxation (e.g. taxpayer, payor) applies or that the payor sets as a legal obligation for the taxpayer based on substantive tax law (e.g. tax liability) using the prescribed tax technique and declares in the prescribed manner to the superior authority (which has the same legal effect as a judgment in legal proceedings) and carries out. Finally, the legislative process of creating, passing, and monitoring the fulfilment of public budgets pursuant to financial (tax) documents is part of the procedural component.⁷

In addition to its substantive and procedural components, the financial law system also includes other elements. Judicial tax law regulates decision-making processes in matters of substantive tax law in court, particularly in administrative justice and the judicial enforcement of tax administration decisions. Administrative (organisational) tax law deals with tax administration (and customs) authorities in public revenues from taxes, charges, and customs. Criminal tax law defines the foundations and consequences of the liability for breaches of tax law norms. Legal regulations are contained in the Tax Code and Criminal Code and, to a lesser extent, in individual, predominantly substantive tax regulations (e.g. the Act on Local Charges⁸).⁹

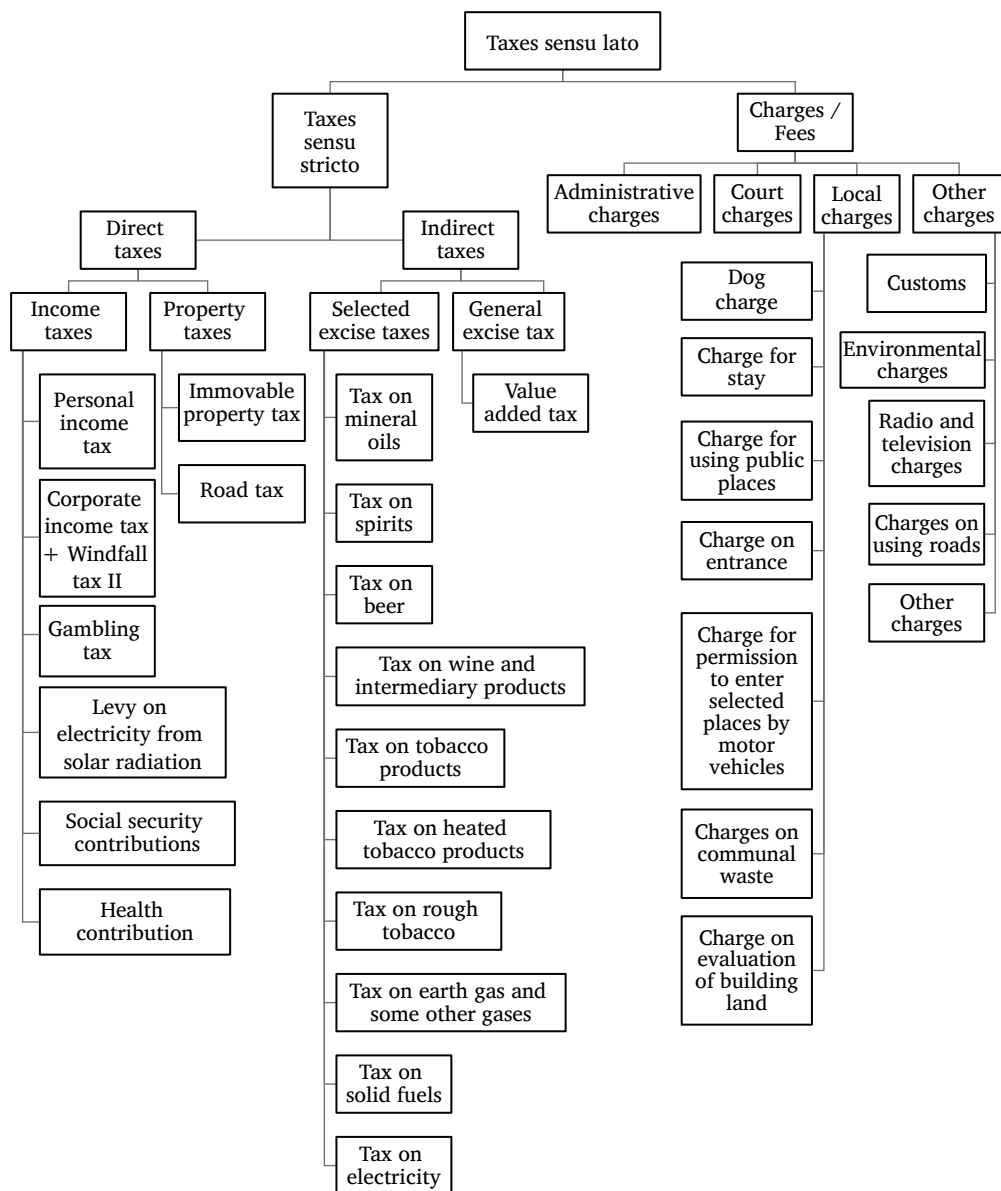
Taxes *sensu lato* create a tax system. The most common system divides taxes and charges (fees). Broadly, the most traditional classification of taxes is based on their impact. Direct taxes are assessed according to the taxpayer's income or property. In contrast, indirect taxes are paid and collected in the prices of goods and services, without respect to the taxpayer's personal situation.

6 Hulkó and Radvan, 2022, pp. 63–64.

7 Hulkó and Radvan, 2022, p. 64.

8 Act no. 565/1990 Sb., Local Charges Act, as amended.

9 Hulkó and Radvan, 2022, pp. 64–65.

Figure 1: The Czech tax system as of 2023¹⁰

Compared with other European tax systems, the Czech Republic lacks traditional property transfer taxes. Inheritance and gift taxes were abolished in 2014. However, in practice, inheritances and gifts are taxed through income tax. The tax on the

¹⁰ Hulkó and Radvan, 2022, p. 66.

acquisition of immovable property was cancelled in 2020 for all properties transferred in the cadastre as of 1 December 2019.¹¹

According to the Council Directive (EU) 2022/2523 on 14 December 2022, to ensure a global minimum level of taxation for multinational enterprises and large-scale domestic groups in the EU, from 2024, the GloBE rules will be applied in the Czech Republic, and an additional amount of tax (a top-up tax) should be collected.

2. Elements of tax sovereignty in Czech tax law

The power to levy taxes is an essential part of every EU Member State's sovereignty; accordingly, the EU has limited competencies in this area. Officially, tax harmonisation is implemented to smooth the operations of the single market. Harmonisation efforts are primarily focused on indirect taxes. To secure fair competition and limit shortfalls in tax revenue, the EU is actively fighting tax evasion and avoidance.

The importance of tax sovereignty is evident in the Treaty on the Functioning of the European Union (TFEU), which states that the Council must act unanimously (in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee) when adopting provisions for the harmonisation of legislation concerning turnover taxes, excise duties, and other forms of indirect taxation. In other words, Member States must unanimously adopt tax measures. Moreover, harmonisation is necessary to ensure the establishment and functioning of the internal market and prevent competition from being distorted.¹² Other important provisions in the TFEU are included in the chapters on tax provisions¹³ and the approximation of laws.¹⁴ Meanwhile, other provisions relevant to the tax policy are hidden in articles related to the free movement of persons, services, capital, environment, and competition. Enhanced cooperation¹⁵ can also apply to tax matters.¹⁶ The role of the Court of Justice of the European Union (CJEU) as a negative legislator is also crucial.

It is also necessary to highlight the differences between the definitions of direct and indirect taxes. In step with the typical division of taxes stated above, traditional Czech tax law science defines direct taxes as taxes assessed by the taxpayer according to income or property and indirect taxes as taxes paid and collected in the prices of goods and services. In contrast, according to EU law, direct taxes are levied on income, wealth, and capital, while indirect taxes comprise all other taxes (e.g.

11 Hulkó and Radvan, 2022, p. 66; Kozieł, 2021, p. 28.

12 Art. 115 of the TFEU.

13 Arts. 110–113 of the TFEU.

14 Arts. 114–118 of the TFEU.

15 Arts. 326–334 of the TFEU.

16 Paternoster, 2016, p. 1.

VAT, excise tax), including energy and other environmental taxes. A good example of a different approach is the taxation of motor vehicles, which is considered a direct tax according to Czech tax science; however, it is an environmental and thus indirect tax according to the EU.

As stated above, tax policy and tax sovereignty have always been considered symbols of national sovereignty.¹⁷ Tax sovereignty expresses the power of the state to impose, collect, and subsequently enforce taxes while autonomously redistributing the proceeds of these taxes at its own discretion and need.¹⁸ Tax sovereignty is essential for every state because it is primarily political – states must make decisions on state revenues to finance public goods and services according to their goals. Along these lines, every government must use tax rates as an instrument of domestic economic policy. In addition, many states argue over the historical consequences of national tax systems. From an economic perspective, every state has a different economy and economic background, which is reflected in taxation issues. However, it is also important to highlight issues related to competitiveness: states with lower taxes can attract workers, businesspeople, and companies as tax residents. This can be illustrated by trends in national corporate income tax rates. Germany's tax rate on corporate income, including corporate taxes, solidarity surcharges, and local trade taxes, decreased from 27% in 1995 to 30% in 2008.¹⁹ In addition, Czech corporate income tax fell from 45% in 1993 to 19% in 2010.²⁰ Similar trends are visible in almost all countries worldwide, including all EU Member States. While for several countries (especially Germany and France), low corporate income taxes may be troubling and tend to harmonise, for economically weaker states (mainly Central and Eastern European countries), tax competition may be a tool for catching up with more economically developed Western European countries (old EU Member States) – a car cannot catch a car with the same engine already driving in front of it.²¹

Tax sovereignty is apparent in the regulation of direct taxes in the Czech Republic. From the revenue perspective, income tax is the most important factor. Both personal and corporate income taxes are regulated by the Income Taxes Act.²² While personal income tax is paid by natural persons, all other entities are liable for corporate income tax; therefore, all legal subjects pay at least one income tax.

Personal income tax²³ includes five possible objects of taxation (regardless of whether income is monetary or non-monetary or acquired by exchange): income from dependent activity (employment), independent (business) activity, capital property

17 Šíroký, 2018, p. 21.

18 Mrkývka, 2015, p. 111.

19 *German tax rate on corporate income 1995-2009* [Online]. Available at: https://upload.wikimedia.org/wikipedia/commons/3/39/German_tax_rate_on_corporate_income_1995-2009.png (Accessed: 7 August 2023).

20 Dias and Zamazalová, 2022.

21 Macháček, 2019.

22 Act no. 586/1992 Sb., Income Taxes Act, as amended.

23 More in: Radvan, 2020, pp. 31–42.

income, rental (lease) income, and other income. The sovereignty of personal income taxation is evident in several provisions. The most important aspects are as follows: (i) Different levels of taxation for employees and self-employed persons are designed to support business creation: even though employees and entrepreneurs are taxed at the same rate, employees pay more taxes than entrepreneurs. This is primarily because small businessmen with incomes of up to CZK 2,000,000 can pay a lump-sum tax; that is, they can consolidate their personal income tax and social and health contributions into one payment and do not need to file tax returns and contribution statements. The monthly lump-sum tax small businessmen have to pay depends on their incomes.²⁴ Second, this difference is also because employed persons have no right to deduct any expenses from their incomes to obtain a partial tax base, while businesspeople can deduct real expenses or, even better, lump-sum expenses.²⁵ The differences in taxation are so significant that some taxpayers are formally entrepreneurs even if they technically obey someone else's commands while executing their work. This practice is called the Svarcsystem, and it offers benefits to the commissioning party, which has no duty to pay social security and health contributions to the worker. (ii) A relatively low tax rate, especially for high-income subjects: the tax rate is a progressive percentage of 15%, resp. 23% for income higher than the average wage, multiplied by 48; (iii) Tax benefits for low-income subjects in the form of basic tax relief;²⁶ (iv) No taxation of inheritance; (v) No taxation of gifts from relatives; (vi) Many 'social' exemptions from taxation, including no taxation of retirement and other pensions, alimony payments, social benefits, scholarships, incomes from the sale of an immovable property (with the time-test: only if the seller lived in the family house for at least two years immediately before the sale or if the seller owned the property for at least ten years); (vii) Tax allowances to encourage charitable gifts, pension insurance, life insurance, living in an apartment or house (housing loan interest can be deducted from the tax base); (viii) Deductibility of tax loss in the five previous taxable periods and costs of research and development from the tax base; (ix) Tax relief reflecting the social status of the taxpayer (e.g. spouse with limited income, disability, student, child in kindergarten, number of children); (x) Tax relief to stimulate the employment of disabled employees.

As with personal income taxation, in the area of social and health contributions, self-employed persons enjoy more benefits than employees. For employees, the contribution base is gross wages; for businesspeople, it is 50% of their personal income tax base (regardless of whether they use real or lump-sum expenses).

24 There are three bands. For example, in 2023, in the first band for incomes up to CZK 1,000,000, the amount is CZK 6,208 per month, including a personal income tax of CZK 100, a social contribution of CZK 3,386, and a health contribution of CZK 2,722.

25 Compared to other countries, the lump-sum expenses are very high (e.g. 80% of income from agricultural production or handicrafts, 60% from other industries and trades, 40% from other businesses such as those of lawyers and doctors, and 30% from business rents). Lump-sum expenses are limited in practice to an annual income of CZK 2,000,000.

26 Tyniewicz and Koziel, 2021, p. 67.

Corporate income tax²⁷ is paid by entities such as companies, civil corporations, political parties, state corporations, banks, insurance companies, investment corporations, state funds, pension funds, and churches. The tax base is generally economic income from bookkeeping – that is, income from all activities and the management of all types of property – reduced by the expenses incurred to generate, assure, and maintain that income. In addition, several aspects of state sovereignty are evident in the legal regulations on corporate taxation, which primarily follows a linear tax percentage rate of 19%. The impulse for R&D activities is hidden in the items deductible from the tax base; in fact, R&D costs for research and development can be deducted twice. The other item deductible from the tax base is the tax loss in the previous five taxable periods. Similar to personal income tax, taxpayers can use tax relief for employees with disabilities. Czech legislators also respect the liabilities of company partners. For example, if owners are situated as responsible for the loss of a company (general partnership partners and general partners in limited partnerships), then shared profits are not subject to corporate income tax but only personal income tax. In the case of limited partners' shares in the profits of limited partnerships and limited liability companies, joint stock companies, and cooperatives, both corporate income tax and (withholding) personal income tax are to be paid – this is, in fact, an example of interstate double taxation.

Tax sovereignty in the Czech Republic is also obvious in the two windfall taxes (however, the gambling tax may also qualify as such and therefore there may actually be three windfall taxes). A windfall tax usually implies a higher tax rate on profits that result from a sudden windfall gain for a particular company or industry. This is a special tax on profits or a surcharge on the existing (corporate) income tax. The first windfall tax in the Czech Republic was adopted in 2012 as a levy on electricity generated from solar radiation.²⁸ The levy was adopted due to the highly guaranteed amount of support for electricity generated from renewable resources in power plants using solar radiation, which were placed in service in 2010 when construction costs were lower. These legal and economic consequences led to high profits; therefore, the levy was collected for the first time in 2014. The object of the levy is electricity generated in power plants from solar energy, from 1 January 2014, using solar radiation, and placed in service from 1 January 2010 to 31 December 2010, as long as the right to support electricity generation from renewable resources continues. The taxpayer is a producer of electricity from solar energy. The tax payor (paying agent) supplies electricity to the final consumer. The tax base is the amount (without VAT) paid by the electricity supplier to the electricity producer for electricity generated from solar energy. The tax rate is 10% (11% for green bonuses).²⁹

27 For more detail, see: Radvan, 2020, pp. 45–48.

28 Act no. 165/2012 Sb., on Supported Energy Sources and on Amendments to Certain Acts, as amended.

29 For more detail, see: Radvan, 2020, p. 67.

The second windfall tax is closely related to the global energy crisis from 2021–2023 and Russian aggression in Ukraine, and follows the International Monetary Fund’s recommendations to institute windfall profit taxes targeted at economic rents in the energy sector, excluding renewable energy, to prevent further development. In the Czech Republic, this tax is called the extraordinary tax on unexpected profits and is regulated by the Income Taxes Act.³⁰ This tax should be temporary – valid from 1 January 2023 until the end of 2025. It is applied to electricity and gas producers and traders, fossil fuel miners, fuel wholesalers, and refineries with annual sales of more than CZK 2 billion. The other group of taxpayers comprises banks with annual interest yields exceeding CZK 6 billion. The windfall tax rate is 60% and is applied to excess profit, which is specified as the difference between the tax base from 2023–2025 and the average tax base from 2018–2021 times 20%.³¹

As suggested above, the gambling tax³² can also be considered a (corporate) income tax surcharge.³³ This tax covers both on-site and online hazards, regardless of whether they are legal or illegal. The tax base is the difference between the deposits received and the winnings paid. The tax rate is higher for the partial tax base on lotteries and technical games (35%) and lower for odds betting, totalizator games, bingo, live games, raffles, and small-sized tournaments (23%). For technical games, a minimum tax (CZK 9,200 per calendar quarter) was set for every game point.

Property taxes, as local taxes, fall under the exclusive competence of EU Member States. According to an international comparison, the Czech immovable property tax³⁴ is one of the lowest recurrent property taxes worldwide. Officially, immovable property taxes include land and building taxes. Practically, the building tax includes not only buildings, but also flats and non-residential premises owed by general taxpayers. The cadastre is used to identify properties and the taxpayers that own them. A unit-based system prevails in constructing the tax base. The tax rates are mostly fixed. As the revenue belongs to municipalities, they hold some authority in adjusting these taxes. Typically, several options for additional exemptions, coefficients to influence the tax rates, and the local coefficient multiplying the final tax between 1.1 and 5.

All transfer taxes in the Czech Republic were abolished over the last decade. Inheritance and gift taxes were cancelled at the end of 2013 due to civil law reform. Inheritances and gifts are now liable for income taxes. Nevertheless, all inheritances, gifts from relatives, and other small gifts, up to a specific limit, are exempt from taxation. The immovable property transfer tax was abolished in September 2020 with retroactive effects officially extending back to 31 March 2020 for all property

30 Arts. 17c, 20ba–20be, 21 para. (5) of the Income Taxes Act.

31 *Tax Changes in 2023: The Windfall Tax, the End of EET and a Higher VAT Limit* [Online]. Available at: <https://shorturl.at/vrxIU> (Accessed: 7 August 2023).

32 Act no. 187/2016 Sb., Gambling Tax Act, as amended.

33 Radvan, 2017; Boháč and Krasulová, 2017.

34 Act no. 338/1992 Sb., Immovable Property Tax Act, as amended. For more details, see: Radvan, 2020, pp. 49–58.

transfer tax obligations, given that entry to the cadaster was made in December 2019 or later.³⁵ It should also be noted that no wealth tax is collected in the Czech Republic.

Local charges, together with immovable property tax, belong to a group of local taxes in the Czech Republic. Every Czech municipality has the right to adopt local bylaws by levying local charges (fees). The generally binding municipal ordinance may be within the conditions defined by the Local Charges Act (e.g. varieties of charges or the absolute charge rate). The list of local charges is relatively broad, including a dog charge, a charge for stay (a tourist charge), a charge for using public places, a charge on entrance (to cultural, sport, sale or advertisement action), one of two possible charges on communal waste (a charge for the municipal waste management system, or a charge for the disposal of municipal waste from the immovable property), a charge for permission to enter selected places by motor vehicle, and a charge on evaluation of building land. Unlike immovable property taxes administered by tax offices, municipal offices are responsible for administering and collecting local charges.

As stated above, the EU's harmonisation efforts are primarily focused on indirect taxes. However, following the principles of the free movement of persons, services, and capital, EU Member States can adopt additional indirect taxes (excise taxes) within their sovereignty. The Czech Republic added two additional excises to the list of harmonised excise taxes: tax on rough tobacco in 2015 and tax on heated tobacco products in 2019.³⁶

Since the beginning of 2013, there has been a new trend in the sale of tobacco products in the form of untaxed rough tobacco leaves offered for sale by weight as tobacco, allegedly for decorative purposes, garden work, or other declared purposes (e.g. litter for birds). However, rough tobacco does not fall within the definition of the object of excise tax on tobacco products under EU or national law. Therefore, rough tobacco is traded on the Czech market without control or registration. Considering the almost uncontrolled access to this raw material, the availability of relatively simple and inexpensive equipment for the production of tobacco products (tobacco cutting machines) and the very low cost of selling this commodity, tax fraud or tax evasion related to the handling of rough tobacco is very easy, and control by state bodies is difficult or even impossible. The new rough tobacco taxation legislation introduced approximately the same conditions as those for the (harmonised) taxation of other tobacco products. In addition, it eliminated tax evasion and simplified control activities in this area.

Heated tobacco products were introduced to the Czech market in the second half of 2017. The main reason for the taxation of heated tobacco products was to ensure that they did not enjoy a tax advantage over other tobacco products liable to excise taxes. The legal regulation of the taxation of heated tobacco products is based on the

35 Boháč, 2022; Radvan, 2022; Radvan and Svobodová, 2021.

36 Act no. 353/2003 Sb., Excise Taxes Act, as amended.

provisions of the Excise Taxes Act concerning ‘traditional’ tobacco products. The tax is applied on a weight basis, with the tax rate the same as that for smoking tobacco, such that the resulting level of taxation is lower than, for example, for cigarettes, owing to the low weight of tobacco contained in heated tobacco products. Such regulations also indicate that heated tobacco products are less harmful to human health than traditional tobacco products.

3. How is tax harmonisation reflected in Czech tax law?

With the development in the volume of international trade, globalisation, growth in the number and importance of multinational companies and their subsidiaries, the transfer of capital and persons (residents of a country who work in another country), and uniform rules of taxation (tax harmonisation) are needed.³⁷ Additionally, governments must cooperate to fight tax avoidance and share information about taxpayers and their tax duties.

In Czech tax science, tax harmonisation at the EU level represents the process of approximating Member States’ tax systems based on common rules.³⁸ Tax harmonisation is a mechanism used to eliminate tax provisions that either create obstacles to the functioning of a single internal market or distort competition. Tax harmonisation is certainly not aimed at achieving a single tax system but rather at the approximation and synchronisation of individual tax systems.³⁹

The first stage in the process of tax systems harmonisation is tax coordination, which includes concluding agreements or recommendations for limiting harmful tax competition. The objective is to set a minimum standard for transparency and exchanges of information in tax administration⁴⁰ rather than uniformity of tax systems. Bilateral agreements, especially those for the avoidance of double taxation and agreements on the cooperation of tax administrations (e.g. exchange of information, tax distrains), are examples of tax coordination. Tax coordination may be unilateral or spontaneous. A good example is the tax competition between EU Member States in decreasing corporate income tax rates. The second stage is tax approximation, which involves the approximation of tax systems but not their harmonisation. The third stage is tax harmonisation.

The tax harmonisation process comprises three stages. First, identifying the taxes to be harmonised. Second, harmonising the tax base (and, if appropriate, other tax construction elements, such as taxpayers). Third, harmonising tax rate(s). As is

³⁷ For tax harmonisation issues, several parts from Radvan, 2011 are used.

³⁸ Kubátová, 1998, pp. 2–7.

³⁹ Nerudová, 2008, p. 18.

⁴⁰ Šíroký, 2010, p. 28.

evident from the historical development at the EU level, reaching the third stage of tax harmonisation is not always necessary; EU Member States have some discretion regarding available rates, leading to a competitive environment.

European tax law science defines tax harmonisation differently with regard to the fundamental EU principles. For example, Terra⁴¹ defines tax harmonisation as an instrument that leads to the main objective of creating a single market. Here, it is helpful to note that Terra recognised several obstacles to a single market: the taxation of the free movement of legal persons and the free transboundary movement of goods, services, capital, and revenues; the difference in the tax treatment of domestic and imported goods and services; substantial differences between national tax legislation that results in distorted markets; and differences in the tax treatment of residents and non-residents, domestic and foreign investments, and income (in particular, the double taxation of income from sources located outside a country's territory).

From our personal perspective, tax harmonisation is not merely an objective – a resulting condition – but also an actual process. This process can be either positive or negative. Positive harmonisation refers to the process of approximating national tax systems through the implementation of directives and other legislative instruments. If the directives are implemented correctly, all EU Member States apply the same rules. Negative harmonisation results from the activities of the CJEU: measures are taken in national laws (national tax systems) based on the tax-related case law of the Court. Even if only the EU Member State, a party to the proceedings, must remove the concerned defective provision, case law also pushes other countries to check their national regulations and possibly adopt the necessary amendments. Case law also provides good interpretative guidance.

The previous section discussed the benefits of national tax sovereignty. In summary, advocates highlight the power of the state to impose, collect, and subsequently enforce taxes, while the state can autonomously redistribute the proceeds of these taxes at its own discretion and need. Every government must use tax rates as an instrument of domestic economic policy. There were also historical consequences for the national tax system. Different economic backgrounds and developments should also be reflected in taxation policies. Finally, competitiveness plays a crucial role. While low corporate income taxes might be troubling for old and more prosperous EU Member States and tend to harmonise for new and economically weaker states, tax competition might be a tool to catch up with more economically developed Western European countries.

Supporters of tax harmonisation disagreed, especially regarding the benefits of tax competition. For example, Nerudová states that

tax competition and the exploitation of mismatches between national tax systems have allowed many of the multinationals that use European infrastructure and other

41 Terra and Wattel, 2008, p. 1.

European public goods to use tax planning tools in a very aggressive way. [...] Their economic power even allows them to negotiate with Member States on the tax advantages they will grant them in order to build a warehouse or a factory in that country. Several questions need to be asked: do these companies pay an adequate level of taxes that could finance, for example, the renewal and maintenance of infrastructure?⁴²

Nerudová believes that it is necessary to harmonise the rules for the construction of tax bases in the EU because unification would mean significantly eliminating aggressive tax planning techniques, a level playing field where nominal tax rates would be equal to the effective tax rate, and the reduction of taxation costs, both on the part of taxpayers and the tax administration. However, Nerudová is a fan of competition in terms of the tax rate.⁴³ Other Czech economic experts have the same view; for example, Skořepa adds, *'other parameters of business regulation in the Czech Republic must be set so that companies actually have an incentive to use low-taxed profits for reinvestment in the Czech Republic instead of sending them abroad.'*⁴⁴

With regard to public budgets, Zahradník warns that

harmonization can also be considered as a possible increase in the share of the EU Budget in the EU GDP and, in line with the subsidiarity principle, the creation of an interlinked budgetary hierarchy, where the different levels will be matched by the respective tax instruments. E.g., all environmental taxes would become compulsory revenue of the EU Budget, income taxes would remain at the level of the EU Member States, and, e.g., property taxes would be part of regional or municipal budgets.⁴⁵

Logically, the EU is the biggest promoter and most relevant advocate of tax harmonisation. In its statements, the EU highlights that Member States have the power to introduce, remove, or adjust taxes: each Member State is free to choose the tax system it deems most appropriate, provided it complies with EU rules:

The main priorities for EU tax policy are the elimination of tax obstacles to cross-border economic activity, the fight against harmful tax competition and tax evasion, and the promotion of greater cooperation between tax administrations in ensuring control and combating fraud.⁴⁶

Additional topics are linked to digital and green transitions and several related important EU and international tax developments: green taxation, digital transition and its effect on taxation systems, and business taxation in the 21st century.

42 Macháček, 2019.

43 Ibid.

44 Ibid.

45 Ibid.

46 Angerer, 2023b. See also: European Commission, 2015.

One of the new ideas at the EU level is unanimous decision-making. The argument shows slow progress in agreement on proposals for directives in the tax field – the Commission intends to be more proactive and targeted in initiating legal action, believing that EU Member States' tax measures infringe upon EU law. The Commission also considers increasing the use of non-legislative approaches, such as recommendations. However, the Commission also stated that

the route of closer co-operation between sub-groups of like-minded Member States should also be considered where appropriate. The Commission suggests that this 'enhanced co-operation' approach could, in particular be considered in the field of environmental and energy taxation, where a majority of Member States have indicated a strong desire for co-ordinated action.⁴⁷

Most Czech tax experts do not find the idea of unanimous decisionmaking beneficial, mainly based on the argument for tax sovereignty. However, there are some exceptions. For example, Pícl states that the unanimity rule has caused proposals crucial for growth, competitiveness, or tax fairness in a single market to be blocked. He believes that unanimous decision-making might be a good tool for fighting tax evasion and that higher revenues can contribute to sustainable finance.⁴⁸ Meanwhile, Žáková points out that the unanimity rule is increasingly proving to be outdated and economically counterproductive; notably, it allows a single state to block generally well-received proposals for reasons that are unrelated to the issue at hand.⁴⁹

In dealing with the harmonisation of Czech and European law, it must be stated that national regulations fully correspond to EU regulations. The EU's official position that direct taxation is not directly governed by its rules is not entirely true. Several directives and the case law of the CJEU established harmonised standards for the taxation of companies and private individuals.⁵⁰ Along these lines, the Merger Tax Directive⁵¹ was transformed into the Income Taxes Act to deal with the common system of taxation for the transfer of business establishments and the exchange of shares, mergers, and divisions.⁵² The basic rule is that all such transfers are tax-neutral if the transaction is carried out for compelling economic reasons and not

⁴⁷ European Commission, 2001.

⁴⁸ Macháček, 2019.

⁴⁹ Ibid.

⁵⁰ Angerer, 2023a.

⁵¹ Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225, 20.8.1990, 1–5. Repealed by Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, OJ L 310, 25.11.2009, 34–46.

⁵² Arts. 23a–23h of the Income Taxes Act.

for tax avoidance. The Parent Companies and Subsidiaries Directive⁵³ was also incorporated into the Income Taxes Act;⁵⁴ notably, it states that profits distributed by a subsidiary to its parent company will not be subject to withholding tax under the conditions set out in the Act (according to the Directive) and that withholding tax will only be applied when paid to the parent company's shareholders. These rules remove, among other things, tax obstacles to reinvesting profits. Meanwhile, the Savings Directive⁵⁵ aims to enable savings income in the form of interest payments made in one EU Member State to beneficial owners, who are individual residents for tax purposes in another Member State, to be subject to effective taxation in accordance with the laws of the latter Member State. This Directive has been incorporated into the Income Taxes Act.⁵⁶ The last Directive in the area of direct taxation is the Interest and Royalty Payments Directive,⁵⁷ copied from the Income Taxes Act.⁵⁸ This Directive states that interest or royalty payments arising in an EU Member State shall be exempt from any taxes imposed on those payments in that state, whether by deduction at source or assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of an EU Member State.

VAT is a general indirect tax that has traditionally been regulated at the European level. The current core EU legislative text on the VAT is the VAT Directive.⁵⁹ The Czech regulation on VAT, the VAT Act,⁶⁰ fully follows European law regarding VAT. A taxable person usually has a turnover exceeding CZK 2,000,000 in the past 12 months, while others use the possibility provided by the VAT Act to register voluntarily. There are three VAT rates: a basic tax rate of 21% and two reduced tax rates of 15% and 10%. The lists of goods and services that are liable to reduce their VAT rates create annexes for the VAT Act. In excise taxes, Czech regulations align with European law; namely: the Horizontal Excise Directive,⁶¹ structural directives,

53 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20.8.1990, 6–9. Repealed by Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 345, 29.12.2011, 8–16.

54 Art. 19 of the Income Taxes Act.

55 Council Directive 2003/48/EC of 3 June 2003 on the taxation of savings income in the form of interest payments, OJ L 157, 26.6.2003, 38–48.

56 Art. 38fa of the Income Taxes Act.

57 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, 49–54.

58 Arts. 19 and 38nb of the Income Taxes Act.

59 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347, 11.12.2006, 1–118.

60 Act no. 235/2004 Sb., VAT Act, as amended.

61 Council Directive (EU) 2020/262 of 19 December 2019 laying down the general arrangements for excise duty, OJ L 58, 27.2.2020, 4–42.

and directives on the approximation of rates (alcohol,⁶² tobacco products,⁶³ energy products, and electricity⁶⁴). The national regulation can be found in the Excise Taxes Act⁶⁵ (which includes five ‘old’ excise taxes on petroleum oils, spirits, beer, wine and semi-products, and tobacco products, plus two non-harmonised excise taxes on rough tobacco and heated tobacco products) and, rather non-systematically, in the Act on Stabilising Public Budgets⁶⁶ (which includes three ‘new’ excise taxes on earth gas and other gases, solid fuels, and electricity). Generally, tax rates follow the minimum possible tax rates according to EU directives. In the case of beer taxes, small independent breweries enjoy lower rates. Meanwhile, the tax rate for non-sparkling wines is zero.

According to Czech tax law, taxes on motor vehicles are direct taxes; however, the EU classifies them as indirect taxes. This discrepancy may be due to two reasons: running motor vehicles negatively impact the environment and the registration tax on motor vehicles collected in many EU Member States has the characteristics of an excise tax. Czech legal regulations respect the Eurovignette Directive⁶⁷ only to the minimum extent necessary, officially because of Russian aggression in Ukraine and the related increase in petrol prices. Since 2022, the new definition of the object of road tax⁶⁸ has been determined by the current wording of this Directive, which regulates heavy goods vehicles as vehicles intended for the transport of goods with a maximum technically permissible laden weight exceeding 3.5 tonnes. However, only vehicles with higher permissible weights are effectively taxed based on the annual rates of the Eurovignette Directive. Thus, the new regulation reflects the fact that the effective taxation of the road tax on a vehicle with a certain number of axles occurs only from a certain specified tonnage of its maximum permissible weight (e.g. for single vehicles with two axles from 12 tons and for vehicles with three axles from 16 tons). This is achieved by selecting the categories of vehicles subject to road tax and setting the tax amount in a structured manner according to the parameters of the taxable vehicle. In other words, all vehicles with a total weight below 12 tons (and in several cases, even 16 tons) are no longer liable to road tax, regardless of whether they are used to run a business. Additionally, other structural components of road tax follow European regulations; for example, only vehicles registered in the Czech

62 Council Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages, OJ L 316, 31.10.1992, 21–27; Council Directive 92/84/EEC of 19 October 1992 on the approximation of the rates of excise duty on alcohol and alcoholic beverages, OJ L 316, 31.10.1992, 29–31.

63 Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco, OJ L 176, 5.7.2011, 24–36.

64 Council Directive 2003/96/EC of 27 October 2003 on restructuring the community framework for the taxation of energy products and electricity, OJ L 283, 31.10.2003, 51–70.

65 Act no. 353/2003 Sb., Excise Taxes Act, as amended.

66 Act no. 261/2007 Sb., Act on Stabilising Public Budgets, as amended.

67 Directive 1999/62/EC of the European Parliament and of the Council of 17 June 1999 on the charging of heavy goods vehicles for the use of certain infrastructures, OJ L 187, 20.7.1999, 42–50.

68 Act no. 16/1993 Sb., Road Tax Act, as amended.

Republic are liable to tax, the taxpayer is the operator of the vehicle, the scope of exemptions is similar, tax relief for combined transport (transport of cargo on roads combined with transport on railroads or water roads) is similar, the tax base is the sum of the highest admissible weights on the axles in tonnes and the number of axles, and the tax rate is fixed.

The Czech Republic would like to amend the Eurovignette Directive to ensure there is no obligatory tax on motor vehicles. During the ECOFIN meeting in November 2022, the Czech Minister of Finance opened a debate on the revision of the directive in the sense that the amendment would abolish the obligation to apply the European minimum motor vehicle tax rate to trucks of over 12 tons. This move was primarily motivated by the wish to allow greater tax liberalization and support small- and medium-sized enterprises. While EU Member States can set a zero-road tax rate, they can still tax trucks. Further, this move was also related to the costly administration of this relatively budget-poor tax.⁶⁹

It should be highlighted that the EU's efforts to harmonise taxes are ongoing. In May 2023, the European Commission published a report summarizing the results of a questionnaire on the design of the Business in Europe: Framework for Income Taxation (BEFIT) initiative. However, it did not include positive or negative feedback from Czech authorities on the initiative. On the contrary, the taxation of large-scale multinational groups in the form of a global minimum tax is taken seriously,⁷⁰ and the proposal of the Act on Equalisation Taxes for the Purposes of Ensuring a Minimum Level of Taxation of Large Multinational Groups and Large Domestic Groups is currently being discussed in Parliament, with an expectation that it will come into effect as of 31 December 2023. The aim of the new top-up taxes (equalisation taxes) is to ensure a minimum effective level of taxation for large multinational groups and large domestic groups with annual revenues of EUR 750 million or more in two of the four preceding accounting periods. The level of minimum effective taxation was set at 15% in accordance with the Directive. Under the proposed rules, a top-up tax is imposed on the parent entity of the group with respect to each country in which the group operates and in which the effective tax rate of the group is below 15%. Meanwhile, the alternative proposes that a top-up tax be imposed on each member entity of the group and not on the parent entity. Simultaneously, a qualified national (domestic) equalisation tax was introduced with the goal of preserving the Czech Republic's primary right to tax income derived from sources within its territory. The qualified national equalisation tax represents the national equivalent of the equalisation tax that would have been imposed on the parent entity if this national tax had not been introduced; further, it allows the Czech Republic to collect the

69 ECOFIN: *Ministers Discuss Assistance for Ukraine, Strengthening the Resilience of the Banks and Abolishing the Minimum Road Tax*, 2022.

70 Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, OJ L 328, 22.12.2022, 1–58; OECD initiative (Pillar 2) agreed under the OECD/G20 project Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules.

equalisation tax imposed with respect to the member entities of the group located in its territory.⁷¹

4. Selected tools to fight tax avoidance in the Czech Republic

Tax avoidance, tax evasion, and tax fraud have remained high on the agendas of every Czech government in the last few decades.⁷² The Anti-Tax Avoidance Directive (ATAD)⁷³ laid down rules against tax avoidance practices directly affecting the functioning of the internal market. The ATAD also addresses hybrid mismatches with non-EU countries.⁷⁴ The anti-avoidance measures in the ATAD, other than the rule on hybrid mismatches, comprise rules on controlled foreign companies (CFCs) to prevent them from shifting profits to a low/no-tax country, exit taxation to prevent companies from avoiding tax when relocating assets, interest limitations to discourage artificial debt arrangements designed to minimise taxes, and counteracting aggressive tax planning when other rules do not apply (a general anti-abuse rule or GAAR).⁷⁵

Except for the GAAR, all rules are transposed in the Income Taxes Act and have been in effect since the taxable period of 2020. The Czech transposition of the CFC rule⁷⁶ addresses CFC activities, including asset disposal, that contribute to the included passive income in the tax base of a Czech controlling company in a given tax year. Non-resident corporate taxpayers with direct or indirect Czech taxpayer participation (on the basis of ownership of more than 50% of share capital, voting rights, or profits) and foreign permanent establishments of Czech taxpayers are considered CFCs. As of 1 January 2021 the provision has been extended to include CFCs residing in non-cooperative jurisdictions on the EU list. Regarding exit taxation rules, only the minimalist transposition of the relevant provisions of the ATAD⁷⁷ deviates in determining the entry price during a transfer from another Member State to the domestic market (the transposition considers the market price directly, whereas the Directive primarily deals with the adoption of the foreign price if it is in line with the market price). Regarding the limitation

71 Ministry of Finance, 2023, Předkládací zpráva k návrhu zákona o dorovnávacích daních (not available publicly); Veselá and Folwarczny, 2023.

72 Kozieł, Krügerová and Bučková, 2022, p. 267.

73 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, 1–14.

74 Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, OJ L 144, 7.6.2017, 1–11.

75 Boháč and Hrdlička, 2018.

76 Art. 38fa of the Income Taxes Act.

77 Arts. 23g and 38zg of the Income Taxes Act.

on the deductibility of excessive borrowing costs, excess borrowing costs are tax deductible up to CZK 80 million in the tax year, or, if they exceed this threshold, up to 30% of the tax profit before interest, tax, and depreciation (tax EBITDA).⁷⁸ There are doubts about why these limits are so high; with lower limits, the rule would affect more taxpayers. Notably, the hybrid mismatch rule⁷⁹ addresses three problematic situations: double counting, netting without inclusions, and imported hybrid mismatches.

The GAAR is a part of the Tax (Procedural) Code.⁸⁰ Initially, there was no will to include the GAAR explicitly in Czech law, as it is an implicit part of legal regulation. Ultimately, this became one of the fundamental principles of tax law procedures valid for all taxes.⁸¹ Compared with the wording in the directive, two changes are essential. The first is the modification of the subjective criterion from a test of the main purpose of the conduct or one of the main purposes of the conduct. The rationale for this change is likely to alleviate interpretative ambiguities, as national courts have not yet used the test for one of the main purposes. The second change is the omission of the criterion regarding the absence of valid commercial reasons which reflect economic reality. This is probably connected to the Czech translation of the Directive, based on which this criterion could be understood as a consequence of the fulfilment of the subjective criterion.

Information exchange is a crucial tool in the fight against international trade agreements. The Act on International Cooperation in Tax Administration is the basic legal framework governing international cooperation in taxation. The Act includes the automatic exchange of information reported by financial institutions, and reporting and due diligence rules for financial account information. It also covers the entire issue of information exchange with the US. Additionally, the regulation of administrative cooperation and combating fraud in the field of VATs are directly applicable.⁸²

The Act on International Cooperation in Tax Administration and Other Taxes fully copies the Council's Directive on Administrative Cooperation in the Field of Taxation⁸³ and its amendments. Under the automatic exchange of information according to the DAC 3, preliminary (advanced) tax rulings in the Czech legal system mainly correspond to binding assessment decisions issued under the Tax Code and Income Taxes Act. Advance assessments of transfer prices, so-called advance price arrangements or advance price agreements (APA), correspond, in Czech law, to binding assessments of the manner in which the price negotiated between related parties was

78 Arts. 23e and 23f of the Income Taxes Act.

79 Art. 23h of the Income Taxes Act.

80 Art. 8 para. (4) of the Tax Code.

81 Act no. 164/2013 Sb., on International Cooperation in Tax Administration, as amended.

82 Council Regulation (EU) No 904/2010 of 7 October 2010 on administrative cooperation and combating fraud in the field of value added tax, OJ L 268, 12.10.2010, 1–18.

83 Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64, 11.3.2011, 1–12.

formed under the Income Taxes Act. The DAC 4 is copied in the Act on International Cooperation in Tax Administration, which states that groups with consolidated total sales of at least EUR 750 million must prepare for and submit country-by-country reports. In addition, the DAC 6 was fully transposed into the Act on International Cooperation in Tax Administration and brings mandatory disclosure rules – a new type of automatic exchange – to information exchanges by intermediaries in cross-border arrangements that have the potential to become aggressive. These intermediaries are typically tax advisors, accountants, and lawyers who design and/or offer tax planning models.

The newest DAC 7 requests became part of the Act on International Cooperation in the Tax Administration on 1 January 2023. This complements the existing automatic information exchange framework with a new circuit aimed at exchanging information from digital platform operators. The first notification and exchange of information will take place in 2024 and will concern data from the 2023 calendar year. Platform operators are required to notify tax authorities once a year, always by 31 January, of information relating to the income earned by their users, which the law refers to as vendors. The reporting obligation applies to platforms that facilitate the performance of the selected activities for consideration. There are four categories of reportable activities: (i) Provision of immovable property (residential immovable property, business immovable property, parking spaces, apartments, or any other immovable property or part thereof); (ii) Provision of a means of transport (this includes means of transport without a driver; the provision of transportation with a driver is a personal service); (iii) Personal service (the work of a natural person based on time or a task; it is irrelevant whether the service is provided online or in a physical environment); (iv) Sale of goods (tangible goods and animals).⁸⁴

The extension of the scope of the DAC Directive to include the exchange of information on electronic money and virtual assets, and common rules on administrative sanctions and tax compliance measures (DAC 8) will be supported by the Czech Republic.

The area of tax recovery harmonised by the European Union⁸⁵ was transposed into the Act on International Assistance for the Recovery of Certain Financial Claims.⁸⁶ It regulates the procedures and conditions under which Czech authorities provide international assistance in the recovery of tax claims in relation to other countries. The EU law on tax dispute resolution mechanisms⁸⁷ – which involves a harmonised procedure to resolve disputes over the interpretation and application of

84 *Zákon o mezinárodní spolupráci*, 2023.

85 Council Directive 2010/24/EU of 16 March 2010 on mutual assistance for the recovery of claims relating to taxes, duties, customs duties and other measures, OJ L 84, 31.3.2010, 1–12.

86 Act no. 471/2011 Sb., on International Assistance for the Recovery of Certain Financial Claims, as amended.

87 Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union, OJ L 265, 14.10.2017, 1–14.

double taxation treaties – became part of the new Act on international cooperation in resolving tax disputes in the EU.⁸⁸

5. Major Findings and *de Lege Lata* Recommendations

Tax law regulations and tax issues are crucial parts of public finance as most state policies are dependent on tax revenues. In the Czech Republic, tax law is not an independent branch of law. Rather, it belongs to the fiscal category of financial law. Tax law is defined as a system of legal norms regulating social relationships created, implemented, and completed during the process of creating public monetary funds. The object of the tax law relationship is tax in the economic sense; that is, public payments into public funds (e.g. the state budget, local self-government budgets, state funds). While taxes *sensu stricto* comprise public payments called ‘tax’, taxes *sensu lato* also include charges, customs duties, and similar levies. Taxes *sensu lato* create a tax system.

When discussing tax harmonisation and sovereignty, the Czech Republic, local legal and economic experts, and politicians seem to prefer tax sovereignty. Regarding the wording of the TFEU, it is necessary to highlight the differences between the definitions of direct and indirect taxes. A good example of a different approach might be the taxation of motor vehicles, which, according to Czech science, is a direct tax, but, for the European Union, it is an environmental tax, and therefore, an indirect tax.

Regardless of prevailing sovereignty issues, the Czech Republic fully follows EU law and transposes all EU directives into its national (tax) law. This statement is valid for both substantive law (direct and indirect taxes) and procedural law (mainly in the area of international cooperation on tax issues to prevent tax evasion and double taxation). However, the Czech Republic is notably seeking to amend the Eurovignette Directive to remove the obligatory tax on motor vehicles.

The Czech Republic is also sceptical of the European Commission’s proposal that the European Council (national government) should be able to vote on tax matters by majority. The Commission’s proposal contains formulations such as ‘rethinking the traditional concept of sovereignty’. These materials refer to the failure to introduce either a bank tax or a digital tax. The European Commission also wants to harmonise the tax base and unify the methodology for collecting VAT.⁸⁹ Fortunately, the proposal has no chance of passing given the clear and principled opposition of states such as Ireland, Luxembourg, and the Czech Republic. Tax competition is still

⁸⁸ Act no. 335/2020 Sb., on International Cooperation in Resolving Tax Disputes in the European Union.

⁸⁹ European Commission, 2001.

beneficial for small and poorly developed countries. In contrast, tax harmonisation may benefit large economies with high tax burdens by helping them maintain high tax rates without fear of profit and labour outflows. A reasonable compromise may be the unification of definitions and methodologies at the EU level. At the same time, decisions on the structure of taxes (tax mixes) and tax rates remain in the hands of EU Member States, who have the right to make their own policies.

De lege ferenda, it is necessary to react to the increasing public budget deficits. Primarily, it is crucial to limit the Svarcsystem: to reduce the high tax differentials between entrepreneurs and employees (including social and health contributions) and amend lum-sum expenses. Limiting the number of tax exemptions would also be helpful. The release of an electronic revenue registry makes it possible to control business entities' incomes. Other amendments are appropriate for property taxes, including increasing recurrent property taxes, re-launching car taxation based on CO₂ emissions, and re-launching property transfer taxes.

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HUNGARY: TAX COMPETITION Á LA HUNGARY: TAX THE TURNOVER AND RELINQUISH THE INCOME



BALÁZS KÁROLYI

Abstract

This chapter delves into the most recent issues of fiscal sovereignty regarding the Hungarian direct tax system. It highlights the actual and potential conflicts between domestic corporate tax rules (including not only corporate income tax provisions but also other types of special taxes) and primary and secondary EU law. In respect to clashes with primary EU law, this chapter explores the recent case law of the Court of Justice of the European Union in light of the fundamental freedoms and the EU Charter. Furthermore, regarding secondary EU law, this chapter considers the compatibility of domestic rules with the anti-avoidance directives as well as with the global minimum tax directive and argues that a proliferation of similar conflicts can be expected across the EU due to the peculiar nature and inherent mechanisms of the relevant directives.

Keywords: *tax sovereignty, fundamental freedoms, turnover taxes, global minimum tax, taxpayers' rights, EU law, transposition, tax avoidance, tax competition, corporate taxation*

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1. Introduction

The concept of the Economic Governance research project includes an introductory chapter that provides for an overview of the most important EU rules that are relevant for direct tax matters and highlights the recent trends in the jurisprudence of the CJEU from which the focal points of clash between EU law and national tax law can be inferred. Therefore, these general observations will not be repeated in this contribution. It will deal with country-specific issues.

Notably, the peculiar features of the Hungarian corporate tax system have fuelled many legal debates regarding the compatibility of national rules with EU law, and most of the recent trends in direct tax-related case law are reflected in Hungarian cases as well. Indeed, several cases on the compatibility of turnover-based business taxes with the fundamental freedoms and State aid rules and the potential violation of taxpayers' rights and that of the Charter of the Fundamental Rights of the European Union ('Charter') have a Hungarian origin. Although the Hungarian corporate income tax system is very competitive, with a very low general tax rate of 9% and numerous tax base narrowing items, it is complemented in many sectors with special corporate taxes (which notably include extra-profit taxes) that are often levied on turnover instead of profit and are often designed with a progressive tax rate structure. The contested provisions of the Hungarian corporate tax system are to a large extent attributable to these special corporation taxes. Therefore, it is important to involve them in the analysis and not to limit the focus on corporate income taxation in the strict sense as national corporate taxation consists of many other type of relevant taxes.

Following the introduction (Section 1), this contribution continues by addressing recent cases dealing with the compatibility of Hungarian corporate tax rules with primary EU law (Section 2). As pointed out in the preceding paragraph, this topic is also related to the question of State aid compatibility, however, it is a central issue for another chapter of the present book. Therefore, in order to avoid overlaps, it will not be dealt with separately in this chapter. Thus, the primary law conformity practically means conformity with the fundamental freedoms (Section 2.1.) and the Charter (Section 2.2.) for the purposes of this contribution. Within the fundamental freedoms subsection, the core part revolves around the compatibility of turnover-based business taxes because the CJEU had to rule on several occasions on that and it played an important role both in academic discussions and in shaping national tax systems (Section 2.1.1.). Another subsection deals with a more classic issue and examines the compatibility of a registration requirement and an extremely severe corresponding penalty with the fundamental freedoms (Section 2.1.2.). Regarding the potential violation of the Charter, the Hungarian case (Marcas MC) primarily deals with the scope of application of the Charter rather than the substantive provisions of the Charter themselves (Section 2.2.). Following the examination of consistency of the national corporation system with primary EU law, the next section deals with their recent or potential conflicts with

secondary EU law (Section 3.). Recently two major harmonization occurred in the field of substantive corporate taxation, namely the adoption of the ATA Directives and the GloBE Directive. As the former became effective only recently, while the latter is not yet applicable, this subsection attempts to highlight future issues as none of the conflicting matters have reached the CJEU yet. Eventually, some concluding remarks will be made (Section 4.).

2. Compatibility of Hungarian corporate tax rules with primary EU law

2.1. *Compatibility with the fundamental freedoms*

2.1.1. *Progressive turnover-based business taxes in light of the fundamental freedoms*

2.1.1.1. The *Hervis* case

In several instances, the CJEU has been asked to address the compatibility of progressive turnover-based business taxes with fundamental freedoms. First, it had to address the issue in the *Hervis* case¹ concerning the application of the Hungarian store retail trade tax. The basis of assessment of the tax was the net turnover derived by the taxpayer from retail trade and depending on the level of turnover, various tax rates were applied (0%–0.1%–0.4%–2.5%), gradually. The Austrian SPAR group had two Hungarian subsidiaries, SPAR and Hervis, engaged in grocery and sports retail shop operations, respectively. The store retail trade tax also contained a consolidation rule, pursuant to which the applicable tax rate to the revenue of Hervis was calculated on the basis of the aggregated Hungarian turnover of the whole group, including the SPAR shops that were not even present in the sport retail market. Thus, because of the progressive tax rate structure, Hervis was subject to a higher average tax rate than in a situation where it had been calculated solely on its own turnover. At the same time, its direct competitors' average tax rate was calculated on the basis of their own individual turnover as the consolidation rule was not applicable in their case. Owing to this specific situation, the CJEU examined the compatibility of a progressive tax rate structure of the turnover-based tax together with a consolidation rule applicable to group companies. Consequently, the CJEU held that group companies were disadvantaged due to the combination of two factors: (i) an obligation to aggregate the turnover of group member companies operating in the Hungarian store retail trade sector;

¹ CJEU, 5 February 2014, C-385/12, *Hervis Sport- és Divatkereskedelmi Kft.*, ECLI:EU:C:2014:47.

and (ii) steeply progressive tax rates, which had to be calculated based on this aggregated turnover.

The CJEU left it to the referring national court to verify whether the above-mentioned disadvantage resulted in indirect discrimination; that is, whether taxable persons falling into the highest tax band were, in the majority of cases, group members held by foreign parent companies.²

As the consolidation rule played an important role in deciding the *Hervis* case, the question of whether progressive turnover taxes violate the fundamental freedoms in themselves, remained unanswered. This more generic issue emerged in the *Vodafone* and *Tesco* cases, in which the consolidation rule of the special taxes (store retail trade tax and telecommunications tax) was not applicable.

2.1.1.2. Advocate General Kokott's interpretation of the indirect discrimination concept in the context of progressive turnover-based taxes

In the framework of turnover-based progressive taxes, the core issue revolves around the nature and extent of the connection that must exist between a seemingly neutral criterion of differentiation (i.e. the level of turnover) and the prohibited criterion of differentiation (i.e. the nationality of the legal entities)³ to establish the existence of indirect discrimination.⁴ As long as high-turnover enterprises are mainly foreign-owned and low-turnover enterprises tend to have domestic ownership, the question can be raised as to whether this differentiation under turnover-based taxes would constitute indirect discrimination against foreign-owned companies in breach of the freedom of establishment.⁵

As mentioned above, in the *Hervis* case, the Court embraced a broad concept of indirect discrimination. It sufficed that in the 'majority of cases', the disadvantaged group of taxable persons suffering from the highest tax band and thus from the highest average tax rate comprised foreign-owned companies. In addition, there was no requirement other than this majority rule. Therefore, even a totally incidental and factual correlation between the distinguishing criterion and the location of companies' seats may be sufficient to establish indirect discrimination.

2 C-385/12, paras. 32–39.

3 More specifically, regarding the location of the seat of parent companies, foreign ownership is also a prohibited criterion because the fundamental freedoms do not strictly protect foreign nationals but, more generally, all cross-border economic situations, encompassing cases where the foreign parent company exercises its freedom of establishment in the host country by way of incorporating domestic subsidiaries. See: CJEU, 1 April 2014, C-80/12, *Felixstowe Dock and Railway Company and Others*, ECLI:EU:C:2014:200, para. 23.

4 The question of indirect discrimination in the context of turnover-based business taxes is also scrutinized in detail in: Szudoczky and Károlyi, 2020b.

5 Provided that the foreign parent is incorporated in another Member State, as non-EU entities can only invoke provisions on the free movement of capital and not the freedom of establishment.

In the *Vodafone* and *Tesco* cases,⁶ Advocate General Kokott suggested – similar to some scholars⁷ – that the scope of indirect discrimination should be narrowed.⁸ In particular, she distinguished between qualitative and quantitative criteria with respect to the extent and nature of the correlation between the distinguishing criterion (i.e. turnover) and the protected criterion (i.e. seat/ownership of undertakings).

Regarding the quantitative criterion, she confirmed her previous position that the correlation should be identifiable in most cases.⁹ However, the new element in her reasoning was that a purely quantitative approach should not be sufficient and, therefore, a qualitative criterion must also be taken into consideration; the distinguishing criterion must intrinsically or typically affect foreign companies and a merely incidental link should not suffice.¹⁰ The purpose of the qualitative criterion is to exclude merely incidental quantitative correlations. She interprets an intrinsic connection to the distinguishing criterion as one that ‘clearly suggests the likelihood of the correlation in the vast majority of the cases’.¹¹ In the *Vodafone* and *Tesco* cases, this test boiled down to the question of whether the high level of turnover correlates intrinsically with foreign-owned companies. She was of the opinion that, although it is more likely that high-turnover companies will tend to be multinationals and thus operate across borders than companies with lower turnover, there is no clear reason to conclude that foreign companies will generate higher turnovers within the territory of a certain country than domestic companies.¹²

Furthermore, the Advocate General opined that the intention of the legislature to discriminate could also play a role in the indirect discrimination test as an alternative, second prong of the qualitative test. In this sense, evidence that the legislature intended to discriminate against foreign-owned companies may fulfil the qualitative test, even in the absence of an intrinsic correlation.¹³ Based on this prong, legal relevance should be assigned to the fact that the legislature intentionally chose the distinguishing criterion to disadvantage foreign-owned undertakings and that this effect was quantitatively measurable.¹⁴ This stems from the purpose of the qualitative criterion: if the legislature specifically intends to disadvantage foreign-owned companies, then the correlation can no longer be regarded as incidental. According to the Advocate General, this requirement can also be inferred from the principle of the prohibition of the abuse of rights – Member States cannot exploit special market situations or choose particular distinguishing criteria to shift the tax burden

6 Her opinions are basically identical in the two cases; however, her opinion in the *Vodafone* case is more elaborate and, therefore, reference will be made to her statements there.

7 Mason and Parada, 2019.

8 For a detailed description and analysis of the Advocate General’s opinions, see: Szudoczky and Károlyi, 2020a, pp. 22–26.

9 Opinion Advocate General Kokott, C-75/18, *Vodafone Magyarország*, para. 63.

10 Opinion Advocate General Kokott, C-75/18, para. 74.

11 Opinion Advocate General Kokott, C-75/18, para. 78.

12 Opinion Advocate General Kokott, C-75/18, paras. 79–81.

13 Opinion Advocate General Kokott, C-75/18, para. 84.

14 Opinion Advocate General Kokott, C-75/18, paras. 83–85.

on foreign-owned taxpayers. However, she emphasised that the examination of the legislature's intentions must be based on a strict, objective test: there must be clear evidence that disadvantaging foreign companies was the primary objective of the measure perceived and endorsed by Member States.¹⁵ Ultimately, Advocate General Kokott did not find an intrinsic correlation between the level of turnover and foreign ownership of undertakings, nor did she find that the primary objective of the legislature was to tax foreign enterprises. Thus, she concluded that no indirect discrimination had occurred.

2.1.1.3. Decision of the Court in the *Vodafone* and *Tesco* cases

After excluding the existence of direct discrimination,¹⁶ the Court examined whether the progressive rate structure of the tax brought about indirect discrimination. First, the Court turned to examining the impact of the tax (this can be regarded as the quantitative criterion in Advocate General Kokott's test) and referred to its previous case law, finding that the measure must disadvantage foreign-owned companies in most cases.¹⁷ Within the framework of this quantitative scrutiny, the Court found in its *Vodafone* judgment concerning the telecommunications tax that in the lowest tax-exempt band, only domestically owned companies fell; in the intermediate band, the ratio of foreign and domestically owned companies was equal; and in the higher bands, taxpayers were predominantly owned by shareholders of other Member States.¹⁸ In the *Tesco* case, regarding the store retail trade tax, it was established that the taxable persons that fell only within the exempted lowest tax band were all domestically-owned taxable persons, whereas those who fell within the third and fourth bands were predominantly foreign-owned taxable persons.¹⁹ Thus, a greater proportion of tax revenue was collected from foreign-owned enterprises, which were also subject to a substantially higher effective tax rate.

However, in the next step, the Court recalled that Member States are free to design their tax systems, including the adoption of progressive taxation, even in the case of taxes in which the basis of assessment is turnover. This is because the level of turnover is a neutral criterion of differentiation and it also 'constitutes a relevant indicator of a taxable person's ability to pay'²⁰. Here the Court also referred to the Preamble of contested special taxes according to which the objective of those taxes was to levy a tax on taxpayers whose ability to pay exceeded the general obligation to pay taxes.²¹

15 Opinion Advocate General Kokott, C-75/18, para. 92.

16 CJEU, 3 March 2020, C-75/18, *Vodafone Magyarország*, ECLI:EU:C:2020:139, para. 44.

17 C-75/18, para. 43.

18 C-75/18, paras. 47–48.

19 CJEU, 3 March 2020, C-323/18, *Tesco-Global Áruházak*, ECLI:EU:C:2020:140, para. 67.

20 C-75/18, paras. 49–51.

21 C-75/18, para. 51.

Reflecting to the outcome of the quantitative test, the Court stated that the fact that the greater part of the tax is paid by foreign-owned companies is not sufficient in itself to establish indirect discrimination as it is merely attributable to the market situation in Hungary where foreign-owned enterprises have a dominant position. Consequently, this outcome is a kind of matter of chance and would not be any different in the case of a proportional tax either.²² Therefore, the Court concluded that the progressive rate structure did not create inherently any discrimination.²³

2.1.1.4. Assessment of case law

Unfortunately, the *Vodafone* and *Tesco* judgments have left many questions open. This can be partly attributed to the very narrowly phrased question referred to the Court; specifically, the domestic court asked whether the fundamental freedoms precluded a national measure that caused the actual tax burden to fall on foreign-owned enterprises. As both the Court and Advocate General Kokott pointed out, had the answer been affirmative, practically all Hungarian taxes levied on businesses would conflict with the fundamental freedoms, as the local market is dominated by foreign-owned enterprises. The Court is certainly right when it states that Member States should be free to introduce business taxes even if the actual tax burden falls mainly on foreign-owned enterprises. It would have been interesting to observe the Court's approach to a question that stressed the disproportionate tax burden caused by the progressivity of taxes; in other words, it would have been interesting to see the Court's answer to the general query of whether the disproportionate differences in the tax burden, resulting from the progressive rate structure in the context of turnover taxes, appropriately track the ability to pay principle – the alleged aim of the contested business taxes.

The judgments have not unclouded the uncertainties pertaining to the indirect discrimination test either. Regarding the quantitative test, the Court referred to its previous case law and required the unfavourable treatment of the cross-border situation in most cases; however, it did not specify what exactly was meant by the term 'most cases'. In the *Vodafone* and *Tesco* cases, this condition was tacitly met as the Court moved forward to examine the relevant market situations. The verification of the quantitative test was insufficient to establish indirect discrimination.

Although the empirical evidence that the taxes at issue burdened foreign-owned undertakings in most of the cases did not eventually turn out to be conclusive, it is still questionable whether the Court has embraced the qualitative test put forward by Advocate General Kokott. It certainly required something more than the fulfilment of a pure quantitative criterion and stated that unfavourable treatment should not be fortuitous – not a matter of chance. Although it also used the terminology of inherent discrimination, a key concept of Advocate General Kokott's test, it did not explicitly

²² C-75/18, para. 52.

²³ C-75/18, para. 54.

refer to her opinion in this regard and only addressed this issue very briefly and exclusively within the narrow scope of the referred questions. The second prong of Advocate General Kokott's qualitative test – namely, the scrutiny of the intention of the legislator – was beyond the scope of the judgments. In my view, this is not a problem if the intention of the legislator is eliminated from the test, as it can seriously jeopardise legal certainty.²⁴ It is practically impossible to attribute intentions to a legislative body comprised of many individuals with different political views and intentions, and an indirect discrimination test should be based on objective criteria.

2.1.1.5. *Hervis* overturned?

It is obvious that a stricter standard was needed than mere majority rule – which was seemingly applied in *Hervis* – as the burden of a certain tax that falls mainly on foreign-owned economic operators should not amount to indirect discrimination in itself. In the academic literature, the *Tesco* and *Vodafone* judgments were assessed as superseding the *Hervis* ruling, where only a mere quantitative test was explicitly applied.²⁵

There is, however, a possible reconciliation of *Hervis* with the two more recent judgments. As mentioned previously, *Hervis* was based on a specific fact pattern because the consolidation rule was also applicable. It allows for an interpretation that the qualitative test – the requirement of inherent discrimination to exist – was tacitly also included in the judgment. One can argue that there is an inherent correlation between the high level of turnover and multinationals (i.e. groups with foreign ownership) because these group companies are the ones that tend to engage in cross-border economic activity, while domestic companies that conduct business only in their own countries typically do not operate in a group structure. Instead, they conduct business as standalone companies or contractors of a franchise system. Such a typical correlation between high turnover and foreign ownership/group structure was not denied in the *Vodafone* and *Tesco* cases by Advocate General Kokott, who stated that ‘high-turnover undertakings tend to operate across national borders within the internal market and there may therefore be a certain likelihood that such undertakings are also active in other Member States.’²⁶ However, she diminished the relevance of this statement due to the territorial character of the tax. As it was calculated based on the turnover generated within the territory of one Member State only, it cannot be inferred that foreign-owned enterprises will be those with the highest turnover.²⁷

In contrast to the cases of *Vodafone* and *Tesco*, the operation in a group structure was relevant in the *Hervis* case because of the consolidation rule that obliged *Hervis*

²⁴ Similarly, see: Lang, 2021, pp. 156–157.

²⁵ Lang, 2021, pp. 152–153; Mason, 2020, pp. 169–170.

²⁶ Opinion Advocate General Kokott, Case C-75/18, *Vodafone Magyarország*, para. 79.

²⁷ Opinion Advocate General Kokott, Case C-75/18, para. 80.

to aggregate the Hungarian turnover of the whole group for the purposes of calculating its own tax rate to its proportional turnover share from the overall group turnover. Thus, *Hervis* was taxed on a fictitious turnover due to its group membership and the judgment of the Court can be construed that it assumed that the high group turnover and the ensuing high average tax rate inherently stem from the group structure and from foreign ownership. It was only after this inherent correlation that the Court verified it by applying the majority test²⁸.

However, the Court admittedly did not refer to the possibility of inherent discrimination resulting from the logical correlation between multinational group companies and higher average tax rates. Therefore, the arguments that the *Hervis* judgment was partly overruled are strongly valid.

2.1.1.6. Potential justification of a prima facie discriminatory turnover-based tax

2.1.1.6.1. General remarks

In the *Tesco* and *Vodafone* cases, where the Court reviewed the conformity of these progressive turnover taxes with the freedom of establishment, the phases of comparability and justification were not reached as the Court concluded that there was no prima facie indirect discrimination in the first step. However, it is worth delving into the justification phase because some relevant implications can be inferred from such an analysis.

2.1.1.6.2. Justification of turnover taxes: The ability to pay principle, the welfare objective and the need to tackle aggressive tax planning

Unlike the Court, Advocate General Kokott analysed the justifiability of progressive turnover-based taxes. She identified the principle of taxation according to the ability to pay principle as a potential justification referring to the *Bevola* case, complemented and supported by the welfare state objective.²⁹ Although in the *Bevola* case the ability to pay principle played a supportive role in underpinning the main justification ground of the need to maintain the coherence of the tax system,³⁰ in the meantime, the State aid cases of the progressive turnover taxes³¹ have shown that the ability to pay principle can serve as a standalone basis for justifying distinctions between taxpayers. Under this justification, she found that the ability to pay principle could be a legitimate underlying objective of progressive turnover taxation of companies.

²⁸ Károlyi, 2022.

²⁹ Opinion Advocate General Kokott, Case C-75/18, *Vodafone Magyarország*, paras. 109–114.

³⁰ CJEU, 12 June 2018, C-650/16, *Bevola*, ECLI:EU:C:2018:424, paras. 49–50.

³¹ CJEU, 16 March 2021, C-562/19 P, *Commission v. Poland*, ECLI:EU:C:2021:201; CJEU, 16 March 2021, C-596/19 P, *Commission v Hungary*, ECLI:EU:C:2021:202.

Regarding the examination of the appropriateness element of the proportionality test, the Advocate General set up a lenient requirement according to which a measure is appropriate whenever the consistency between the tax and its underlying objective is not manifestly inappropriate.³² As there is an identifiable indirect connection between the level of turnover and financial capacity of the taxpayers, such a requirement has been met.³³

Regarding the necessity test, the Advocate General pointed out that a profit-based income tax would not entail a less onerous and equally appropriate means because a profit-based tax can also be payable in the absence of genuine financial capacity due to the non-recognition of certain items of expenditures and losses.³⁴

Further, the Advocate General dedicated a standalone section to the assessment of proportionality *stricto sensu*, in which she examined whether the potential restriction of fundamental freedoms was disproportionate to the objective of the ability to pay (equitable burden sharing). She was of the view that this objective was important and generally recognised and that imposing a disproportionate burden on taxpayers with disproportionate financial capacity aligns with this objective insofar as it does not reach a level that chokes the given economic activity.³⁵ Therefore, she concluded that special taxes could be justified by the overriding public interest in taxation based on the principle of the ability to pay.³⁶

It must also be noted that the Advocate General embraced a lenient approach towards Member States that attempted to justify their *prima facie* discriminative tax measures using the ability to pay principle. The only limit for a certain tax design to be in line with the ability to pay principle and to pass the proportionality test is to include a basis of assessment that is not completely disconnected from the financial capacity of taxpayers and to include tax rates that do not make it impossible for the taxpayers to carry on their business, i.e., that do not cause a choking effect.

An interesting aspect of Advocate General Kokott's opinion is how she used arguments related to the need to tackle tax avoidance and aggressive tax planning. Although she did not combine these grounds of justification with the ability-to-pay principle, they appeared in the proportionality test to support the appropriateness and necessity of turnover-based taxation. The argument is that as turnover (as the basis of assessment) makes these taxes less prone to tax avoidance strategies, they can more effectively approximate taxpayers' abilities to pay than profit-based taxes.³⁷

But how do progressive turnover taxes as a whole relate to tax avoidance? The Advocate General referred to tax avoidance not within the context of the examined special turnover taxes but in terms of the broader horizon of corporate taxation, especially corporate income taxation, pinpointing the fact that, in Hungary, half of the

32 Opinion of Advocate General Kokott, Case C-75/18, para. 117.

33 Opinion of Advocate General Kokott, Case C-75/18, paras. 120–123.

34 Opinion of Advocate General Kokott, Case C-75/18, paras. 125–128.

35 Opinion of Advocate General Kokott, Case C-75/18, paras. 130–131.

36 Opinion of Advocate General Kokott, Case C-75/18, paras. 133–134, 130–131.

37 Opinion of Advocate General Kokott, Case C-75/18, paras. 123, 128.

undertakings with the 10 highest turnovers do not pay any corporate income taxes.³⁸ Consequently, subjecting these entities to a turnover tax which increases disproportionately with the level of turnover can remedy the anomalies of corporate income taxation. Such a statement is surprising as the high-turnover taxpayers carried out substantial and genuine economic activity in the given sector, hence the attainment of their high turnover.

This position can be criticized.³⁹ First, it is overly vague to assume that every single taxpayer with high turnover is engaged in tax avoidance.⁴⁰ It is possible that certain high turnover undertakings also realize high level of income and it is also conceivable that – especially in cost intensive segments, such as store retail trade – the lack of income tax liability stems from the fact that the high level of turnover is accompanied with high level of costs and expenditures. Second, creating a link between tax avoidance and high turnover constitutes an irrebuttable presumption as the turnover tax is due irrespective of the income tax paid.⁴¹ Third, such ‘treatment’ of high turnover undertakings goes beyond the reestablishment of the non-abusive situation because it does not delve into the issue of the corporate income tax avoidance. Even if abuse was present, the turnover tax would be due merely on account of the level of turnover without any regard to the income tax liability that would have been incurred in the lack of tax avoidance. Therefore, none of the proportionality requirements are met when a hypothetical avoidance of income taxation is tackled by way of levying a different tax on the basis of turnover without taking into account the actual situation of the taxpayer in the income tax system.

2.1.2. Compatibility of a registration requirement and severe corresponding sanction with the fundamental freedoms: The Google Ireland case

The *Google Ireland* case concerned the contested procedural rules of the Hungarian advertisement tax. One of these rules prescribed a registration obligation, while the other levied a corresponding default penalty upon the failure of registration.

The registration obligation applied to all taxpayers, who have not been registered with the Hungarian Tax Authority for the purposes of any type of tax. It means that Hungarian companies were practically exonerated from this obligation because requesting a tax number and registering with the Tax Authority were inherent in the incorporation procedure of companies, therefore, this obligation, by definition, can only apply to foreign companies. Those foreign taxpayers, who were not engaged in

38 Opinion of Advocate General Kokott, Case C-75/18, para. 96.

39 Károlyi, 2022, p. 154.

40 CJEU, 5 July 2012, C-318/10, *Société d'investissement pour l'agriculture tropicale SA (SIAT)*, ECLI:EU:C:2012:415, paras. 54, 57, where the Court held that the definition of ‘appreciably more advantageous tax regime’ provided by the national legislation as a trigger for anti-avoidance measures was too vague without sufficient precision.

41 It is only partially mitigated by the fact that the special taxes are deductible from the corporate income tax base.

any economic activity in Hungary, except for advertising, had to register pursuant to this rule.

In case they failed to comply with this obligation, extremely rigorous default penalty were imposed on them. The initial amount of the penalty was HUF 10,000,000 (EUR 31,500) and any repeated infringement, which was established on a daily basis, entailed a default penalty, which was three times higher than the amount levied for the previous offense. The aggregate amount of default penalties was capped at HUF 1,000,000,000 (EUR 3,150,000). This final amount could be reached only within 5 days from the initial infringement.

The underlying facts of the case at issue are straightforward: Google Ireland Limited (Google), a company incorporated and being tax resident in Ireland did not have any establishment or economic activity in Hungary except for the provision of advertisement services by way of publishing advertisement on the internet in Hungarian language. Despite the fact that this advertising activity entails Hungarian advertisement tax liability, the company failed to register for advertisement tax purposes within the deadline. Consequently, the Hungarian Tax Authority imposed the default penalty on a daily basis, in accordance with the law, until the maximum amount of HUF one billion has been reached. Google brought an action against the resolution of the Tax Authority and requested its annulment. Google based its claim on the fact that only foreign undertakings are subject to the registration requirement, furthermore the amount of the default penalty is 2,000 times higher than the general level of default penalty in the Hungarian legal system and the right to effective remedy is also infringed by the limited tools of legal redress.

Advocate General Kokott did not delve into the question of whether the registration obligation had created a restriction on the freedom of establishment because she opined that it could be justified anyway by an overriding public interest, namely, the need to ensure effective fiscal supervision.⁴² Regarding the registration requirement, the CJEU came to the same conclusion as the Advocate General, albeit on different grounds. The CJEU highlighted that the exemption of taxpayers who had already registered with the Tax Authority did not constitute a difference in treatment capable of restricting their freedom to provide services because it was not proven that their registration requirement would have been less onerous than for those who had to register for advertisement tax purposes.⁴³

Regarding the provisions imposing a penalty for failure to comply with the registration requirement, the CJEU reiterated Advocate General Kokott's findings. Although the penalties were seemingly applied without distinguishing between resident and non-resident taxpayers, in reality, only taxpayers who were not residents in Hungary could be fined.⁴⁴ Thus, it amounted to indirect discrimination because service suppliers established in Hungary could be fined under the general rules that

42 Opinion of Advocate General Kokott, Case C-482/18, *Google Ireland Limited*, para. 61.

43 CJEU, 3 March 2020, C-482/18, *Google Ireland Limited*, ECLI:EU:C:2020:141, paras. 32, 35.

44 C-482/18, para. 41.

prescribed significantly lighter sanctions for registration failure.⁴⁵ Then, the CJEU proceeded to check whether such a difference in treatment could be justified by the need for effective fiscal supervision and collection of tax. In that regard, the imposition of penalties to ensure compliance with tax rules can be justified if it is in conformity with the proportionality requirement. However, the CJEU found the Hungarian rules to be disproportionate on several grounds. It held that the Hungarian system of penalties was disproportionate because it went beyond what was necessary, as the fines were imposed without the examination of the seriousness of the infringement, increased exponentially on a daily basis without giving the taxpayer a chance to comply with its obligations, and the final amount that had been reached within five days of the issuance of the first penalty was as high as EUR 3.100.000.⁴⁶ Consequently, the penalty regime corresponding to failure to register for advertisement tax purposes violated the freedom to provide services.

This judgment is far less controversial as those ruled on the progressive turnover tax cases. The registration requirement for advertisement tax purposes and the connecting default penalty are very good examples for indirect discrimination: due to the procedures of establishing a Hungarian company, such rules were logically and inherently only applicable to those enterprises that have not been established in Hungary and did not carry out economic activity there. Thus, this distinction could be used as textbook example for indirect discrimination. Furthermore, there was clear, less favourable treatment in the form of an extremely strict default penalty that did not fulfil any aspect of the proportionality requirement.

2.2. Taxpayers' rights under the EU Charter: the boundaries of the scope of application of the Charter: The Marcas MC case

2.2.1. Preliminary remarks

The increasing relevance of the fundamental rights in proceedings related to tax matters can be observed. Although the Charter does not contain any tax specific provisions, several generally phrased fundamental rights have been interpreted by the CJEU as including substantive and procedural taxpayers' rights as well.⁴⁷

Although the Charter qualifies as primary EU law, it is binding for the Member States only to the extent they implement EU law pursuant to Art. 51 para. (1) of the Charter. It is a significant restriction on the applicability of the Charter in the field of taxation where Member States retained their fiscal sovereignty. The reason for this limitation is to prevent the extension of the EU competencies laid down in the TFEU via the application of the Charter. Art. 51 para. (2) expressly states that the Charter cannot result in either extending the field of application of EU law beyond the powers

⁴⁵ C-482/18, paras. 42–43.

⁴⁶ C-482/18, paras. 49–51.

⁴⁷ Kokott, Pistone and Miller, 2021.

of the EU, or establishing any new power or task for the EU.⁴⁸ However, the CJEU began to extend the scope of situations in which Member States were considered to implement EU law or act within the scope of EU law. The term ‘implementing EU law’ is given a broad meaning that can be regarded to be synonymous to the notion of ‘acting within the scope of EU law’.⁴⁹ The latter notion can be found in the Explanations to the Charter which explain that it follows unambiguously from the case law that ‘fundamental rights defined in the context of the Union is only binding on the Member States when they act in the scope of Union law’.⁵⁰ The question arises as to when Member States act exactly within the scope of EU law. Here, the CJEU case law paved the way for two paths. According to the first line of case law, Member States are considered to act within the scope of EU law when they act as agents and implement EU law. Here, ‘implementation’ means both the transposition of EU directives and any act within the ambit of a directly applicable EU regulation.⁵¹ The second line of case law renders Member States to act within the scope of EU law – even in the absence of harmonisation – in situations where domestic law amounts to a violation of primary EU law, more specifically a restriction on the free movement provisions.⁵² The second line of case law clearly constituted an extension of the ambit of situations when Member States ‘act within the scope of EU law’ and thus, an extension of the ambit of the Charter.

2.2.2. *The Marcas MC case*

The *Marcas MC* case primarily addressed the exact scope of the fundamental rights enshrined in the Charter in a domestic procedure related to the field of non-harmonised corporate income taxation. The underlying procedure that gave rise to the preliminary ruling request revolved around the interpretation of accounting principles. *Marcas MC* asserted that the tax authority violated several of its procedural guarantees enshrined in the Charter – such as the principles of legal certainty, the right to a fair trial, and the protection of legitimate expectations – and claimed that the imposed sanctions breached the principle of proportionality. Thus, the Court first had to rule on whether the provisions of the Charter were applicable to a national tax procedure in the case of a non-harmonised tax and national sanctions.

Although the case involved royalty payments derived from a cross-border licensing activity, the issue of any restriction or discrimination against this cross-border economic activity did not even come up. Therefore, only the questions related

48 Art. 51 para. (2) of the Charter of Fundamental Rights of the European Union, OJ C 326, 26.10.2012, 391–407.

49 Perrou, 2021, p. 858.

50 Explanations to the Charter, OJ C 303, 14.12.2007, 17–35.

51 van Bockel and Wattel, 2013, p. 873. with reference to the *Wachauf* case and further judgments. Similarly, see: Haslehner, 2017, p. 160.

52 van Bockel and Wattel, 2013, p. 873. with reference to the *ERT* case and further judgments. Similarly, regarding derogating measures from the fundamental freedoms, see: Szudoczky, 2014, pp. 138–147.

to the interpretation of the accounting principles that were harmonized at EU level had a clear connection to the transposition of a Directive, while the sanctions were imposed by purely national rules.

Nevertheless, the Court in its judgment in the *Åkerberg Fransson* case stipulated that the national tax penalties and criminal proceedings that are partially connected to breaches of VAT obligations could be covered by the Charter.⁵³ Based on the VAT Directive, Member States have an obligation to take the necessary measures for ensuring collection of all the VAT due and to prevent tax evasion. Further, based on Art. 325 of the TFEU, Member States are also obliged to counter illegal activities affecting the financial interest of the EU (as part of the VAT revenues amounts to EU own resources).⁵⁴ Consequently, the Court concluded that the domestic tax penalties and criminal proceedings constituted the implementation of certain provisions of the VAT Directive as well as Art. 325 of the TFEU, even if those domestic rules have not been adopted for the purpose to transpose the Directive.⁵⁵

However, such a finding by the Court could not be *mutatis mutandis* applied to the present case. Indeed, the Court held that domestic rules related to sanctions and measures of fiscal supervision did not fall within the scope of EU law as a main rule. It is otherwise only when the sanctions concern anti-evasion measures that represent the fulfilment by the Member States of their obligation to take all measures appropriate for ensuring collection in full of a tax which generates own resources for the European Union.⁵⁶ This was not the situation in the case of the procedure of the tax audit of *Marcas MC*. Consequently, the Court established its lack of jurisdiction to rule on that part of the case on its merit as the situation was out of the scope of the Charter.

In summary, it can be noted that the Court consolidated its case law, including its *Åkerberg Fransson* judgment and did not go further in the extension of the meaning of ‘acting within the scope of Eu law’ and thus that of the ambit of the Charter in direct tax cases.

3. Secondary EU law and national law

3.1. Preliminary remarks: Tax sovereignty in the field of direct taxation

Due to Member States’ insistence on preserving their tax sovereignty, EU-level harmonisation in the field of corporate taxation occurred sporadically.⁵⁷ Limited

53 CJEU, 26 February 2013, C-617/10, *Åkerberg Fransson*, ECLI:EU:C:2013:105, para. 24.

54 C-617/10, paras. 25–26.

55 C-617/10, para. 28.

56 CJEU, 13 January 2022, C-363/20, *MARCAS MC*, ECLI:EU:C:2022:21, para. 38.

57 Szudoczky and Weber, 2019, pp. 34–35.

harmonisation occurred in respect of eliminating the double taxation of certain intra-group payments (dividends, interests and royalties)⁵⁸ and enhancing tax co-ordination among the tax authorities of the Member States.⁵⁹ The compliance of Hungarian tax laws with the first group of EU legislation concerning substantive tax rules has not been an issue as Hungary does not impose withholding taxes on outbound passive income based on its domestic law irrespective of whether the situation falls within the scope of the relevant directives or not. As regards the tax coordination rules, their Hungarian implementation has been timely and accurate and has not triggered any infringement procedures.

However, two very important and far-reaching harmonisation measures occurred in the last decade: the adoption of ATAD⁶⁰ and GloBE Directives.⁶¹ They are more likely to cause implementation complications (not only in Hungary), therefore, it is worth highlighting some actual and potential clashes between national law and these directives.

3.2. The ATAD and national law

Although the ATA Directives have already been adopted in 2016 and 2017, respectively, there has not been legal debates about their national implementation until recently. It can be explained by the fact that the implementation deadline for the various provisions of the directives expired only recently.⁶² Nevertheless, clashes can be expected to draw from both the taxpayer side and the Commission.

The ATAD entails minimum standards⁶³, i.e., Member States are entitled to incorporate stricter anti-avoidance rules than those laid down in the directives. Therefore, over-implementation will not give rise to clash between national law and the

58 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast) OJ L 345, 29.12.2011, 8–16 (Parent-Subsidiary Directive); Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States OJ L 157, 26.6.2003, 49–59 (Interest-Royalty Directive) and Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States (Codified version) OJ L 310, 25.11.2009, 39–46 (Tax Merger Directive).

59 Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64, 11.3.2011, 1–12 (DAC).

60 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market OJ L 193, 19.7.2016, 1–14 (ATAD 1); Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries OJ L 144, 7.6.2017, 1–11 (ATAD 2).

61 Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union ST/8778/2022/INIT, OJ L 328, 22.12.2022, 1–58 (GloBE Directive).

62 The directives prescribe several deadlines for the implementation and application of the various anti-avoidance rules, ranging between 2019 and 2024.

63 Art. 3 of ATAD.

directives. However, primary EU law, more specifically the fundamental freedoms set the boundaries for the Member States to phrase their anti-avoidance rules.⁶⁴ For instance, such rules cannot generally presume the abusive nature of certain situations and must provide the taxpayer the opportunity to present valid commercial and business reasons for its arrangements. In line with the proportionality principle, anti-abuse rules should restrict the free movement rights of taxpayers in the least onerous manner.⁶⁵ Consequently, taxpayers can be expected to challenge domestic anti-abuse rules that go beyond the minimum implementation obligations of the ATAD in light of primary EU law in preliminary ruling procedures.

The Commission also started to monitor the compliance of national transpositions with the directives. As over-implementation is not a problem under the directives, the focus of the Commission might be on the introduction of more lenient rules compared to the ones enshrined in the directives. Indeed, it also reviewed the Hungarian corporate tax rules and found that inconsistencies between national rules and the ATAD persisted. Consequently, it sent a letter of formal notice to Hungary (INFR(2023)2041) requesting that it align its corporate income tax rules with the ATAD I.⁶⁶ The Commission identified divergences between controlled foreign corporation (CFC) rules and the definition of an associated enterprise, which, under the directive, should include subsidiaries under common control.

The ATAD enables Member States to choose between the two models when introducing their CFC legislation.⁶⁷ Hungary has chosen the so-called ‘CFC light’ option according to which the non-distributed income of a CFC must be included in the tax base of the Member State’s taxpayer (i.e. that of the parent company or head office) provided that it arose from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. An arrangement is regarded as non-genuine arrangement,

to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company’s income.⁶⁸

The Hungarian definition of the CFC⁶⁹ is in conformity with the wording of the ATAD regarding the above. However, there is an interesting addition in the

64 Govind and Lazarov, 2019.

65 Károlyi, 2022, pp. 148–151 and cases referred therein.

66 European Commission, 2023.

67 Such legislation creates taxing right (and obligations) for the Member State of the taxpayer in respect of the undistributed low taxed or untaxed income of the taxpayer’s subsidiary/permanent establishment under certain circumstances.

68 Art. 7 para. 2 point b) of ATAD I.

69 Art. 4 para. 11 of the Hungarian Act LXXXI of 1996 on Corporate Income Tax (CITA).

Hungarian legislation which carves out permanent establishments situated in a third country from the CFC definition upon the condition that Hungary concluded a double tax treaty (DTT) with such country and based on the DTT, a permanent establishment exists in this third country and its attributable income is exempted in Hungary.⁷⁰

Such a carve out indeed seems to be at odds with the wording of the ATAD. The only provision that might be assumed to have been the legal source of the carve out is Art. 7 para. 2 point (a) that states that ‘where the controlled foreign company is resident or situated in a third country that is not party to the EEA Agreement, Member States may decide to refrain from applying the preceding subparagraph’. But the cited provision is embedded in the stricter CFC option that Hungary decided not to implement. Furthermore, the preceding subparagraph to which the given provision refers reads as: ‘This point [that is the stricter CFC option] shall not apply where the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances. Such a rule clearly deals with the *Cadbury Schweppes* exception formulated in the jurisprudence of the CJEU pursuant to which freedom of establishment can only be restricted by Member States in the case of abusive situations; that is, wholly artificial arrangements. Wholly artificial arrangements occur when the entity exercises its freedom of establishment only on ‘paper’ because it does not have the sufficient staff, equipment, assets and premises to carry out the necessary real economic activity.’⁷¹ Thus, the preceding subparagraph ensures that the ATAD’s CFC rules do not violate the free movement provisions. The cited subsequent paragraph merely allows for the Member States to introduce a stricter and more formal approach *vis-à-vis* third country CFCs because they are not covered by the freedom of establishment and the related case law.

In the light of the above, the carve-out of third country permanent establishments (PE) whose income is exempted under a DTT does not seem to be in line with the ATAD. The official explanatory memorandum of the Hungarian Corporate Income Tax Act (CITA) related to the CFC rules states that such an exclusion of third-country PEs from the CFC definition complies with the ATAD as they fall outside the scope of the Directive. However, this statement is incorrect. Art. 1 of the ATAD stipulates, ‘[t]his Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country’. Consequently, there is little doubt that entities subject to tax in Hungary are covered by the ATAD, and the CFC rules are applicable to their low-taxed third country subsidiaries and permanent establishments. Although the usage of the expressions of ‘paragraph’, ‘subparagraph’, and ‘point’ in the ATAD, including its English version, are rather inconsistent and

⁷⁰ Art. 4 para. 11 point h) of CITA.

⁷¹ CJEU, 12 September 2006, C-196/04, *Cadbury Schweppes and Cadbury Schweppes Overseas*, ECLI:EU:C:2006:544, paras. 51, 67.

confusing, the structure of the CFC rules implies that such a carve-out cannot be inferred from the Directive.

On the other hand, the application of the CFC rules is problematic *vis-à-vis* third country PEs because it raises the problem of a DTT override. Third countries did not contemplate that a future EU directive will affect their international agreements concluded with EU Member States and EU Member States should be able to comply with their obligation stemming from EU law without infringing their other international agreements. Although this issue goes beyond the boundaries of the present contribution, the relationship of potential DTT override and EU law obligation was worth mentioning as it could occur more frequently in various direct tax fields not only covered by ATAD but also covered by the global minimum tax directive.

As a reaction to the formal notice of the Commission, the Hungarian Ministry of Finance submitted and the Hungarian Parliament adopted an amendment according to which the above-cited provision will be repealed and a new provision will be enacted. The new rule merely states that in the case of checking whether a foreign company qualifies as a CFC for Hungarian tax purposes (i.e., whether it is subject to low-taxation), its foreign PE needs not to be taken into account if the country, where the foreign company is tax resident, exempts or does not subject to tax the income of such foreign PE to the contested rules.⁷²

The Commission also noted that the Hungarian definition of associated enterprises was a bit narrower in scope for the purposes of ATAD rules than the one prescribed by the Directive. In that regard, the Hungarian parliament already took measures to eliminate this inconsistency and sister companies with an at least 25% of common ownership will also be included in the scope of the associated enterprise concept for CFC purposes.⁷³

3.3. The GloBE and its national transposition

3.3.1. Process to the adoption of the directive

The global minimum tax directive has been preceded by an international agreement under the auspices of the OECD accepted by a large part of the international community in October 2021 on the Two-Pillar solution, including the commitment to implement the GloBE rules to achieve the taxation of multinational groups at an effective minimum tax rate of 15%. The consensus also ended the unilateral application of the digital services taxes (DSTs) by abolishing/suspending

⁷² Art. 12 of the draft legislation on the amendment of certain tax provisions submitted by the Ministry of Finance. See: *Egyes adótörvények módosításáról szóló törvénytervezet* [Online]. Available at: <https://kormany.hu/dokumentumtar/egy-es-adotorvenyek-modositasarol-szolo-torvenytervezet> (Accessed: 30 October 2023).

⁷³ Art. 12 of the draft legislation on the amendment of certain tax provisions submitted by the Ministry of Finance.

such temporary measures.⁷⁴ After the global agreement, the OECD began to publish related materials on GloBE rules. First, it released the GloBE Model Rules⁷⁵ in December 2021, followed by the related Commentary⁷⁶ and Illustrative Examples⁷⁷ in March 2022.

However, the committed states were not rushing to transposing the model rules into their domestic legal system. At the end of December 2022, the implementation of GloBE rules got an important impetus as they have gained a binding form at EU level when – following a fierce and politicized bargaining process⁷⁸ – the Member States eventually unanimously reached an agreement on the GloBE Directive Proposal⁷⁹ with an implementation deadline set by the end of 2023.⁸⁰ After the groundbreaking consensus, several other countries followed suit and announced the introduction of GloBE rules or certain elements of them in their domestic legal systems.⁸¹

3.3.2. The GloBE rules

The GloBE's scope affects multinational enterprises (MNEs) with a certain level of revenue. Specifically, it covers the constituent entities (CE) of multinational groups that generate an aggregate annual revenue (in at least two of the four preceding years) of at least EUR 750 million based on the consolidated financial statements of the ultimate parent entity (UPE).⁸² The scope of the EU GloBE Directive covers purely domestic groups to which the same revenue threshold applies. This extended scope is meant to ensure that the GloBE rules comply with the fundamental freedoms.⁸³

The GloBE rules entail three main sets of technical rules that serve the same purpose: to ensure that the in-scope MNEs are subject to an effective tax rate (ETR) of at least 15% in each jurisdiction in which they operate. These are called the Income Inclusion Rules (IIR), the Undertaxed Payment (or, as recently referred to, Undertaxed Profits) Rules (UTPR), and the Subject-to-Tax Rules (STTR). The first two are meant to be implemented in domestic legal systems; meanwhile, the third set of rules – which notably has priority in the order of the application of these rules – ensues from the modification of DTTs. It must be noted that the latter, i.e., the STTR

⁷⁴ OECD, 2021b. More recently: OECD, 2023a.

⁷⁵ OECD, 2021a. (hereinafter: GloBE Model Rules).

⁷⁶ OECD, 2022a. (hereinafter: Commentary to the GloBE Model Rules).

⁷⁷ OECD, 2022b. (hereinafter: GloBE Examples).

⁷⁸ *EU Member States unanimously adopt Directive implementing Pillar Two Global Minimum Tax rules*, 2022.

⁷⁹ GloBE Directive.

⁸⁰ European Council and Council of the European Union, 2022.

⁸¹ For example Japan and South-Korea, see: *Japan 2023 tax reform proposals include Pillar Two legislation*, 2023; *Korea enacts new global minimum tax rules to align with OECD BEPS 2.0 Pillar Two – Orbitax*, 2023.

⁸² GloBE Model Rules, Art. 1.1.

⁸³ GloBE Directive, Explanatory Memorandum, p. 6.

rule is not included in the Model Rules, nor in the GloBE Directive, consequently its date of implementation and its details are still uncertain.⁸⁴

The IIR will work as a sort of Top-up Tax that the residence state of the ultimate parent entity (UPE) of the multinational group can primarily (preceding the intermediate parent companies) levy on the low taxed profits of a subsidiary that had not been subject to the minimum profit tax of 15 % in its home state.⁸⁵ It is specific to the GloBE rules, that the minimum effective tax rate (ETR) is calculated at a jurisdictional level.⁸⁶ Unlike a CFC rule, the IIR does not apply the prevailing tax rate in the UPE country, rather the top-up Tax is levied up to the extent that the ETR of the CEs concerned reaches the 15%. However, the low-tax jurisdiction is entitled to introduce a domestic Top-Up Tax and collect the missing tax on its own.

The second pillar of the charging provisions of the GloBE rules is the UTPR, which is applied as a backstop rule if the IIR is not applicable. In such situations, when the IIR cannot be applied because the low-tax jurisdiction is the country of the UPE or no qualifying IIR rules are in force in the UPE country (or in any other lower-tier parent entity countries), then, the UTPR comes to the fore. It would function as denying the deduction of certain otherwise deductible items or requiring them to make an equivalent adjustment under domestic law (in an amount that results in an additional tax expense for the affected CEs that is equal to the UTPR Top-up Tax).⁸⁷ The allocation of top-up tax under the UTPR would be determined based on a formulaic apportionment that is calculated on the basis of the number of employees and the total value of tangible assets in the given jurisdiction.⁸⁸

3.3.3. Inherent risks of multilevel rule-making procedures

The GloBE rules will be effective in the EU by 2024. As a result, currently the conflict of national implementation with the EU rules is out of question. Nevertheless, besides the regular transposition issues, there is an extra layer of caveat: the overlap of EU and international rules is susceptible to give rise to future complications. When the GloBE Directive was adopted at the end of 2022, it was drafted in accordance with already-published OECD documents – namely, the GloBE Model Rules and their Commentary and Examples – with some necessary modifications to align the Directive with primary EU law. Indeed, recitals to the Directive provide that the Directive closely follows the content and structure of the GloBE Model Rules

84 As it stands now, this will entail additional taxation of certain cross-border payments between connected companies where the recipient is subject to a nominal corporate tax rate below 9%. This will only apply to specific types of payments, such as interest, royalties, insurance premiums, guarantees, and certain rental payments as well as payments for services. See: OECD, 2023b.

85 GloBE Model Rules, Art. 2.1.1.

86 GloBE Model Rules, Art. 5.1.1.

87 GloBE Model Rules, Arts. 2.4.1–2.4.2.

88 GloBE Model Rules, Art. 2.6.1.

and implements them at the EU level in accordance with the common approach included in the GloBE Model Rules.⁸⁹

However, since the adoption of the Directive, quite some developments have occurred at the OECD level, with new OECD documents, including three pieces of Administrative Guidance and an Implementation Handbook, issued.⁹⁰ The result of these new, post-Directive documents goes beyond merely clarifying the GloBE Model Rules and creating substantive rules that cannot be deduced from the latter. Such situation entails that these documents create new rules compared to the ones laid down in the Directive as well. The Directive and its recitals do not mention that any relevance should be given to future OECD documents during the course of the interpretation of the Directive. Such a situation can raise plenty of problems at EU level where the adopted Directive is based on the GloBE Model Rules.

Thus, the question can be posed what relevance should be attributed to the new developments at OECD level in the interpretation of EU law, i.e., that of the GloBE Directive.⁹¹

The theoretical short answer to this question should be none. One must agree with Advocate General Kokott that a concept of a directive qualifies as an autonomous EU law concept and must be independent of the definitions applied at the OECD level. The latter can serve as a source of inspiration for interpretation only to the extent it is explicitly indicated in the text of the Directive or its drafting history.⁹² Even if this is the case, only a static approach is acceptable, that is, only those OECD documents can bear relevance for the interpretation of an EU law concept that existed at the time of the adoption of the Directive – otherwise, the interpretation of EU law could be influenced by OECD countries, which would raise serious legitimacy questions.⁹³

In *Berlioz*,⁹⁴ when the CJEU interpreted the term ‘foreseeably relevant information’, it considered Art. 26 of the OECD Model Convention and its Commentary. It must be noted that in the explanatory memorandum of the mutual assistance directive (based on a proposal in 2009), an explicit reference was made to Art. 26 of the OECD Model Convention, which was modified in 2012. However, the CJEU has given relevance to it in the case that started in 2014. Seemingly, this amounted to a dynamic application of the OECD Model Convention and its Commentary; however, the new rules were consistent with the EU Directive even after their modification.

⁸⁹ Recitals 6 and 24 of the GloBE Directive.

⁹⁰ OECD, 2023c; OECD, 2023d; OECD 2023e; OECD, 2023f.

⁹¹ For an analysis to what extent the Court of Justice of the European Union takes into account OECD developments prior and after the birth of the EU legislation, see: Geringer 2023. Nevertheless, we must submit as problematic the lack of clear reference by the EU legislation itself to the OECD material to pay any heed to the latter from a democratic point of view, as not all the Member States are members of the Council of the OECD.

⁹² Opinion of Advocate General Kokott, C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 and others*, paras. 49–52.

⁹³ Opinion of Advocate General Kokott, C-115/16, C-118/16, C-119/16 and C-299/16, para. 53.

⁹⁴ CJEU, 16 May 2017, Case C-682/15, *Berlioz*, ECLI:EU:C:2017:373.

In the Danish beneficial ownership cases, the draft documents of the EU Directive contained an explicit reference to the 1996 version of the OECD Model Convention. Yet, later amendments were also taken into account by the CJEU in interpreting the same term of the Directive.⁹⁵ Thus, the CJEU adopted a more inclusive approach than that proposed by Advocate General Kokott.

However, in the *Cobelfret* case, which concerned a domestic implementation of the Parent-Subsidiary Directive, the Court was stricter with the Member States and held that secondary EU law must be interpreted on the basis of EU sources within the legal framework of the EU and did not allow for consideration of the rules of the OECD Model Convention to justify the violation of the Directive.⁹⁶

In the case of the GloBE Directive, there is only explicit reference to the GloBE Model Rules and their Commentary. Consequently, it can be derived from the jurisprudence of the CJEU that any subsequent set of guidelines at the OECD level can only play a role in the interpretation of the GloBE Directive to the extent that it merely clarifies the provisions of the GloBE Model Rules. If they go further and add new or even contradictory rules, it would be problematic to use them as interpretative tools for secondary EU law legislation. This situation can cause special implementation problems with respect to the GloBE Directive because the Directive either will not be able to catch up with the latest and internationally agreed rules on a global minimum tax, or the legitimacy of EU rules will be endangered if they are interpreted in light of later guidance issued by the OECD, to which not all Member States are parties. In the authors' view, the fact that both the ECOFIN Council and the Commission issued a statement on 9 November 2023 that they consider all subsequent Inclusive Framework (IF) developments in the field of GloBE rules to be consistent with the EU GloBE Directive does not eliminate the problem.⁹⁷ This may result in a pragmatic approach, whereby the latter guidance automatically overrides the original wording of the Directive in the event of a clash; however, dogmatically, it is an unacceptable solution that raises an array of problems from the perspective of legitimacy and legal certainty.

4. Conclusions

The introductory chapter on EU tax law pointed out that tax sovereignty, particularly in the field of direct taxation, is crucial for Member States and they insist on their liberty to collect revenue from direct taxes as they wish (provided that the

95 CJEU, 26 February 2019, C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 and others*, ECLI:EU:C:2019:134, para. 90.

96 CJEU, 12 February 2009, C.138/07, *Cobelfret*, ECLI:EU:C:2009:82., paras. 55–57.

97 Council of the European Union, 2023.

design is compliant with EU law requirements). Furthermore, taxation can be considered a macroeconomic tool for achieving certain economic goals. For instance, attracting foreign direct investment by creating a beneficial and competitive tax system for investors.

Another policy goal that Member States may strive to achieve through tax measures is the favourability and protection of domestic taxpayers. However, this policy objective is unacceptable within the internal market, and the fundamental freedom provisions clearly prohibit discriminative measures against nationals of other Member States. Consequently, Member States usually refrain from directly treating foreigners less favourably than domestic taxpayers. Nevertheless, they often attempt to achieve such an effect indirectly, devising their tax systems in a seemingly neutral way that, in effect, attributes a disadvantage to cross-border situations. Discrimination in an indirect form is also forbidden pursuant to the free movement provisions; however, it is often very difficult to delineate such situations from acceptable and neutral distinctions.

Several recent Hungarian cases presented in the preceding sections of this contribution revolved around the delicate issue of defining indirect discrimination. The turnover-based business tax cases showed that the Court seems to have taken a more lenient approach than in its previous case law *vis-à-vis* Member States. This tacitly requires a logical link between the distinguishing criterion and foreign nationality, which means that the discriminatory impact must be inherent in the design of the tax rather than the outcome of a special market situation. The very same cases proved that the ability-to-pay principle received the rank of a standalone justification and legitimate aim to be pursued by the Member States, which enjoy great liberty in implementing such an objective through their tax systems – the only limit being the standard of manifest inconsistency of the tax design with the ability-to-pay principle. However, highly progressive turnover-based taxes have not yet reached this limit.

Taxpayer rights enshrined in the Charter gain growing relevance in the jurisprudence of the CJEU not only because the taxpayers are getting more aware of their substantive rights laid down in the Charter but also because the ambit of the Charter's application is more extended than the wording of Art. 51 para. (1) would suggest. Nevertheless, the connected Hungarian case of *Marcas MC* can be regarded as a consolidation of the case law, without any further extension.

As far as secondary EU law is concerned, it can be stated that Hungary is largely compliant with the direct tax related directives in the course of transposing them. Nevertheless, the Commission discovered some inconsistencies with respect to the ATAD CFC rules, and the Hungarian answer in the form of a proposal for a legislative amendment does not necessarily eliminate all concerns. This may lead to an infringement procedure. Furthermore, the transposition of the GloBE Directive might result in plenty of legal concerns throughout the EU due to the fact that the development of GloBE rules took place both at OECD and EU level and the adoption of the EU Directive has been followed by new OECD documents. The interpretation of the

Directive in the light of these new developments is problematic; however, the inconsistent application of GloBE rules within and outside the EU is undesirable. likewise undesired. The future will tell how this issue will be handled. This is however not a country-specific problem.

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POLAND: TAX LAW AND POLICY IN POLAND – BOLD AND EXPECTED CHANGES



ROBERT OKTABA

Abstract

This publication addresses the issues related to the concept and processes of the co-existence of tax harmonisation in the EU and the sovereign tax policies of individual Member States. An important task in the context of the creation and application of EU tax law regulations is determining the tax sovereignty of Member States and the legitimacy of implementing an autonomous tax policy adapted to the current social and economic needs of a given country. These phenomena also affect the tax competitiveness of a given country in the international arena. Importantly, implementing a sovereign tax policy allows state authorities to take flexible actions to counteract tax avoidance and combat tax fraud in a given country. Thus, eliminating unfair competition from the market strengthens the position of law-abiding taxpayers. Moreover, this interdependence contributes to economic growth and employment opportunities. As a result, it is possible to increase tax revenues from the taxation of both the growing economic turnover and the income of natural persons and entrepreneurs. Therefore, the possibility of implementing a sovereign tax policy allows for the creation and maintenance of a tight and functional tax system, which is a key element of economic and social order. It is worth emphasizing here that macroeconomic data, both domestic and international, indicate that Poland's sovereign tax policy has yielded excellent results over the last seven to eight years.

Keywords: *tax sovereignty, tax avoidance, tax policy, budget revenues*

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1. Tax Law and Policy in Poland

1.1. Introductory remarks

The authority of the European Union (EU) to create legal regulations in various areas of law is important because of the limitations of its Member States. The accession of individual countries to the EU does not mean that they have given up full sovereignty in favour of the EU's body of international law. Moreover, the consequence of each country's accession to the EU was their adoption of the *acquis communautaire*,¹ which requires them to harmonise their legal orders and accept common European standards in the field of taxes;² specifically, the EU's legal system for taxes requires Member States to harmonize their regulations for the common internal market.³

Therefore, the directions chosen for tax policy play an important role in deepening the economic integration of the EU and achieving its fundamental goals, including the creation of an internal market.⁴ However, full tax harmonisation is virtually impossible because of diverging national interests;⁵ therefore, a selective approach to the tax policy of Member States is currently implemented. Most of the attention in this area is devoted to indirect taxes, which affect the functioning of internal markets.⁶ By contrast, direct taxation is only slightly subject to adjustments. Importantly, harmonisation in this area occurs when the different regulations of individual Member States restrict the free movement of capital⁷ between Member States.

Member States enjoy considerable freedom in designing direct tax systems⁸ to meet their internal tax policy objectives and requirements. Poland, like other EU Member States, retains sovereignty over its fiscal policies. This sovereignty is also visible in the organizational and structural spheres. Although individual Member States currently shape the structure and functions of their tax administration, they may not continue to enjoy this freedom in the future – within the EU, there are clear tendencies towards centralisation and gradual encroachment into the regulatory areas of Member States.⁹

1 Mik, 2018, p. 184.

2 Brzeziński and Kalinowski, 2017, p. 17.

3 Litwińczuk, 2020, p. 42.

4 Andrzejewska-Czernek, 2013, p. 24.

5 Oręziak, 2007, p. 141.

6 Chalmers, Davies and Monti, 2010, p. 674.

7 Lipniewicz, 2011, p. 40.

8 Majdowski, 2020.

9 Kuś, 2014.

1.2. Tax sovereignty: Content and scope

The concept of “sovereignty” is defined as legal independence from external factors and the competence to regulate all relations within the state. What has been important since the beginning of functioning statehood is the ability to establish and collect taxes which determined the sovereignty of a given state or lack thereof. Currently, sovereignty is no longer perceived as the ability of the state not to submit to external influences, and the concept of unlimited sovereignty is a thing of the past. A conscious limitation of sovereignty resulting from the will of the state occurs in relations between individual nation-states and the EU.¹⁰

Therefore, the decision to deepen harmonisation – in this case, to deepen tax harmonisation – will limit one’s own national fiscal sovereignty in favour of the economically integrated group. Therefore, it plays a highly important role in continuing the process of both economic and social integration within the EU. The current process of equalising the legal systems of EU Member States has brought the EU much closer to full integration and, at the same time, significantly moved it away from the European formula made up of fully sovereign nations.

At this point, it should be emphasised that the possibility of a national tax policy within the EU is one of the few areas of economic policy in which member states retain relative sovereignty. The fact is that EU law does not entirely regulate the tax system but refers only to individual issues, most often those related to cross-border economic turnover. Thus, the EU’s tax law is not the exclusive responsibility of the EU; Member States have their own separate and independent tax systems, which are only subject to common harmonisation to a certain extent. Therefore, general tax issues are not solely determined by the EU.¹¹

Currently, the European Commission is pushing to change the rules for making decisions in the tax area. This gives rise to considerations regarding whether doing so is in the interest of the entire EU and motivated by a desire to make the process more democratic. Indeed, this change seems to be about suppressing countries that block deeper integration in the tax area, since such decisions may not yield economic and social benefits for these countries. Further, a change in the currently applicable rules may result in some EU Member States being taxed against their will, as a result of decisions taken by other countries – citizens of outvoted countries will have to submit to decisions made by governments of other Member States. Considering how much the history of tax law is related to the issue of national self-determination, it seems unlikely that the European Commission’s approach is more democratic than a unanimous procedure.¹² The unanimity principle is an expression of the limited trust of states in terms of their foreign or security policies. In this sense, it can also support

¹⁰ Dobrowolski, 2014, p. 183.

¹¹ Kuś, 2014.

¹² Antas, 2019.

their unity. Simultaneously, making decisions through majority voting in sensitive areas may trigger disintegration.

It is worth recalling that, in 2015, Germany forced a majority vote on the relocation of migrants and refugees, which led to deep divisions between the Member States of the EU that persist to this day. Thus, the declared effectiveness may be very effective.¹³ On the departure from the unanimity rule in the EU, the Polish Minister of Foreign Affairs, Prof. Zbigniew Rau, presented the position of the Polish government, stating that Poland would not agree to replace unanimity with a majority in voting in the EU. Further, he added that Germany strongly tends to prefer majority voting for matters that are currently legally subject to unanimity, such as issues related to tax, and, most importantly, security and foreign policy. However, we do not agree with this statement.¹⁴

German ideas for achieving economic happiness and development in the EU are still well acknowledged, including the Nord Stream1 and Nord Stream2 initiatives, and the invitation of migrants from around the world. This is why it is surprising to see a push for erroneous ideas, such as moving away from unanimity or creating a federal state over the heads of sovereign societies. Fortunately, social awareness of and resistance to such ideas are growing in other EU countries.

Undoubtedly, it is very important for each state to be able to exercise tax powers resulting from tax sovereignty and the related independence in shaping its tax policy. The power to tax is of key importance for the sovereignty of Member States, which have granted the EU only limited power in this area. Even limited national tax sovereignty enables a tax policy tailored to social and economic needs and, further, affects the level of tax competitiveness in a given country. Poland's recent tax policy was the result of the decisive actions of its government. During the last seven to eight years, intensive reconnaissance has been conducted on the nation's social and economic needs, including in the field of tax law. Based on the findings, tax law was profoundly changed. As a result, the current tax burden¹⁵ is lower and tax revenues to the state budget are higher.

1.3. Tax harmonisation

As already established above, tax harmonisation in the EU, on the one hand, limits the tax sovereignty of Member States, and, on the other hand, maintains Member States' tax sovereignty by effectively stopping harmonisation processes in specific tax areas. Unlike indirect taxes, direct taxes are clearly subjected to the harmonisation process to a very small extent.¹⁶ Indeed, this is the underlying condition for maintaining tax competitiveness among EU Member States.

¹³ Cichocki, 2022.

¹⁴ Osiński, 2023.

¹⁵ Cooter and Ulen, 2007, p. 6.

¹⁶ Selera, 2010.

Notably, the difficulty of harmonising direct taxes is a result of the actual reluctance of Member State governments to further lose sovereignty in the area of tax policy and, additionally, is largely related to the differences in the structure of taxes in these countries. Recently, however, some space has been developed for a common understanding of the significant deepening of the tax harmonisation process.

Currently, EU tax law provides for the introduction of a global minimum tax for transnational corporations. The Directive for the introduction of such a tax was adopted by EU finance ministers in December 2022, with the regulation applying to international capital groups with annual consolidated revenues over EUR 750 million. EU member states have implemented this solution since 2024. It should be emphasised that these regulations also apply in countries with nominally higher income tax rates. The key issue with the minimum tax is that transnational corporations must pay the difference between the tax due at the minimum rate of 15% and the tax actually paid in the jurisdiction concerned. Therefore, the Directive establishes the effective tax rate for a specific country based on two factors: (i) the income of concern in a given country, calculated as net accounting income for the tax year based on consolidated financial statements and not adjusted for intra-group transactions; (ii) the qualified tax, which includes adjusted income taxes or profit taxes imposed on qualified entities in a given country.

Such a solution may mean that in cases where a subsidiary of concern generates income in a given country but, for various reasons, does not pay tax or pays a low tax, there will be a reason to charge an additional compensatory tax. The tax amount reflects the difference between the tax effectively paid and the 15% rate if the tax paid is lower. Importantly, the tax is not paid by government entities, investment funds, companies investing mainly in real estate, and subsidiaries in which at least 95% of shares belong to these exempt entities. The tax is also not levied on international corporations just beginning their operations; specifically, the capital group must operate in no more than six countries, and the value of fixed assets of the entire group cannot exceed EUR 50 million. This amount does not include the value of fixed assets in the country in which the given concern has the greatest impact.¹⁷

Importantly, the Directive provides an exemption for companies that conduct business in a given country. This is usually evidenced by the possession of fixed assets (e.g. buildings, machines, and other devices) and the workforce employed. Therefore, the Directive allows part of the value of fixed assets and employees' salaries to be excluded from taxable income with the new tax. Ultimately, the excluded value amounts to 5% of the value of fixed assets and payroll costs. The Directive provides for a transitional period until 2032. Then, the value of exclusion will increase, following which it is expected to gradually decrease every year. In the first year of the directive (2024), it is 10% for salaries and 8% for fixed assets. It should be emphasised that compensatory taxes will not always be paid in one place. The directive provides for the rule of income inclusion, which means that a compensatory tax

¹⁷ Rochowicz, 2022.

will be payable in the country of residence of the parent company of a given group. However, it will be possible to transfer the right to tax to the source country; that is, the country in which such an obligation arose. Thus, such a country is entitled to a share of the compensatory tax. However, this option is only possible if the country in which the group's headquarters are located decides not to implement the rules.¹⁸ Therefore, much will depend on the content of future national laws implementing the directive, both in Poland and other EU countries.

The new global minimum taxation system is primarily intended to combat various activities aimed at avoiding taxation, particularly by establishing entities that do not engage in actual economic activity. The main purpose of the regulation defining the global minimum tax is to combat aggressive tax structures and jurisdictions that offer tax rates that are too low.

However, it seems that Council Directive (EU) 2022/2523 in its proposed form may discourage large corporations from investing in regions such as Central Europe because it may be a common practice for a corporation with a subsidiary in Poland to pay a new tax in another country. The negative consequences may affect countries that offer legal solutions that promote innovative activities and create new jobs. One of the significant drawbacks of the Directive is its failure to consider tax incentives for investors, especially in poorer countries that want to attract foreign investment in this way. With the introduction of global minimum tax regulations, the world's largest corporations will likely have to charge a compensatory tax on activities in such countries. Therefore, in its current form, this regulation may direct investments to other countries where, for example, the issue of refundable tax relief does not exist; this will negatively affect Poland and other Central European countries. Unfortunately, the Directive does not clearly determine how to treat income legally exempt from tax, such as income earned in Polish Special Economic Zones or in the Polish Investment Zone system. This may lead to a situation in which international corporations will be less willing to invest in countries such as Poland, which cannot offer them said relief; at the same time, these corporations will have to pay a compensatory tax to the country in which their headquarters are located. Unfortunately, this may distort the long-formulated goal of taxing income where it is generated.¹⁹

Importantly, the Directive provides provisions that would allow not imposing a compensatory minimum taxation in cases where so-called refundable tax credits are used. These reliefs are closer to government grants than to deductions from tax bases or taxes. Unfortunately, almost all relief measures active in Poland, including those provided for Special Economic Zones and the Polish Investment Zone, may not have such a character; they are limited by the amount of tax income. The only exception may be relief for R&D combined with relief for innovative employees; however, this is not a universal rule. As a result, the use of such relief by global concerns seriously affects the effective tax rate shown in Poland and, as suggested above, will

¹⁸ Rochowicz, 2022.

¹⁹ Rochowicz, 2022.

probably force them to pay a compensatory tax in the country where their headquarters are located. Therefore, to avoid such an effect, the Polish legislature would have to thoroughly restructure the Polish system of investment relief in the direction of returnable relief, which may turn out to be too challenging.

The global minimum tax should not be confused with the Polish tax entered into the CIT Act,²⁰ charged to companies generating losses or showing profitability lower than 1.5% of their revenue. It applies not only to large enterprises but also to those with a turnover exceeding EUR 2 million per year. Importantly, the provisions of the Polish minimum tax remain suspended, and it is not clear from the previous statements of the representatives of the Ministry of Finance whether both minimum taxes will ultimately apply. A regulation is being analysed in which one of the solutions may be to separate the scope of both taxes so that any given enterprise does not pay the two taxes at the same time.²¹

1.4. Tools to combat tax evasion on the basis of Polish tax laws

Combating tax avoidance and tax fraud²² is a course of action that has included many changes²³ consistently implemented in Poland in recent years. Such tax policies made it possible to introduce lower tax rates for individuals and companies, while increasing tax revenues to the state budget. In 2022, budgetary tax revenues were over 80% higher than in 2016. The largest changes were recorded in the VAT revenue. Notably, Poland is at the forefront of EU countries that are reducing the VAT gap at the fastest pace. Since 2016, there has been a rapid increase in CIT revenue (see Table 1). Excise tax revenues have also grown regularly.

An important element of the tax policy pursued in Poland was the reform of the tax and customs administration. The National Revenue Administration (NRA) was established and, from 1 March 2017, replaced the existing tax administration, tax inspection, and Customs Service. The reform improved the flow of information between different bodies of the NRA.²⁴ This resulted in a more effective collection of taxes and duties and strengthened the fight against criminal economic activities. As a result, state budget revenues began to grow significantly. Importantly, the administration focused on supporting honest taxpayers and securing the interests of legal businesses. Accordingly, taxpayers positively assessed cooperation with the NRA, with satisfaction surveys showing that the quality of taxpayer services in tax offices throughout Poland has grown systematically. Within two years, the satisfaction of taxpayers (including entrepreneurs) after a visit to the tax office increased from 78% to 87%, and the percentage of solving any given matter during one visit increased

20 Knap and Grosicki, 2023.

21 Rochowicz, 2022.

22 Kujawski, 2016, p. 11.

23 Klonowska, 2017, p. 6.

24 Melezini and Teszner, 2018, p. 45.

from 77% to 85%.²⁵ Legal changes were also introduced to help tighten the tax system²⁶ and effectively combat tax avoidance and fraud.²⁷

The Council for Counteracting Tax Avoidance was established as an independent body issuing opinions on the appropriateness of applying a general clause against tax avoidance and measures limiting contractual benefits in individual matters. The Council's task is to provide opinions on draft tax laws and changes in tax law provisions contained in other acts of normative regulation related to counteracting tax avoidance. The council can also express opinions on the presented assumptions or general project clarifications on the applicability of the general anti-tax avoidance clause or other anti-tax avoidance provisions if a tax scheme or category of tax schemes is used and opinions on matters relating to the withdrawal of avoidance effect taxation. The Council for Counteracting Tax was appointed for its first term by the Minister of Finance in September 2016 and, in October 2020, the Council for the second term was established for 2020–2024.²⁸ Comprising nine experts in tax law and finance, the Council is an independent body that provides opinions on the validity of applying a clause against tax avoidance in individual cases. Importantly, the Minister of Finance can request an opinion during tax proceedings regarding tax avoidance. Moreover, when the Minister decides on a given matter for the application of the clause, the interested party may appeal the decision and request the Council's opinion. In addition to government representatives, the council also gathers tax advisors, entrepreneurs, university representatives, and local governments. Individuals appointed to the Council must have knowledge, experience, and authority in the fields of tax law, the financial system, financial markets, economic turnover, or international economic law to guarantee the proper functioning and implementation of the Council's tasks.

The rich jurisprudence of administrative courts in Poland²⁹ has played an important role in counteracting tax avoidance and tax fraud, especially over the last seven to eight years. As a result, the fight against black markets and value-added tax (VAT) mafias is becoming increasingly effective. The most important solutions are listed below: (i) *Anti-tax avoidance clause*: This clause was introduced in July 2016. The provisions of the clause in Polish law are set out in Arts. 119a to 119f of the Tax Ordinance and are applied in accordance with the provisions of Council Directive (EU) 2016/1164, establishing counteracting tax-avoidance practices that have a direct impact on the functioning of the internal market. Importantly, the clause should be used only in situations where the transactions created by the taxpayer have no economic justification; that is, if the action would not have taken place if it

25 *Skąd miliardy do budżetu* [Online]. Available at: <https://www.podatki.gov.pl/skad-miliardy-do-budzetu> (Accessed: 9 August 2023.).

26 Gajewski, 2020, p. 17.

27 Cień, 2022, p. 40.

28 *Rada do Spraw Przeciwdziałania Unikaniu Opodatkowania* [Online]. Available at: <https://shorturl.at/emL7G> (Accessed: 20 September 2023).

29 Gajewski, 2022, p. 24.

was not about achieving a tax advantage.³⁰ This means that the anti-tax avoidance clause is a tool that allows one to fight aggressive tax planning, the essence of which is to carry out activities primarily or exclusively for the purpose of obtaining a tax advantage, provided that the method of operation is artificial. Therefore, aggressive tax optimisation that may be covered by the clause includes activities that are non-market in nature and are carried out primarily to obtain a tax advantage. Simultaneously, it should be emphasised that optimisation activities are permissible if they are conducted in the course of real economic activities; (ii) *Reporting JPK VAT*: The JPK VAT is a Uniform Control File – an electronic collection of information on an entrepreneur's economic operations for a given period. Initially, the JPK VAT was introduced in July 2016 for large enterprises and extended to other companies (i.e. medium, small, and microenterprises that are VAT payers) in October 2020. However, in October 2020, taxpayers submitted one JPK VAT file with a declaration (instead of separate JPK VAT files and VAT returns). This current approach to electronically reporting the JPK VAT with a declaration means fewer submitted documents and fewer tax audits for the taxpayer. The JPK VAT system automates verification activities, and the NRA authorities react faster to irregularities and attempts at tax fraud. Owing to the analysis of data from files, inspections require less time, are less burdensome, and cost less. Moreover, the algorithms automatically select fictitious transactions that carry out the so-called company poles. Consequently, the authorities of the NRA detect VAT fraud more effectively, thus limiting unfair competition and protecting law-abiding taxpayers; (iii) *The fuel package*: Introduced in August 2016, the fuel package streamlined the rules for importing fuel into the country and significantly reduced the shadow economy in this market. New solutions were implemented in the VAT, excise duty, and concession regulations, which eliminated fraud in liquid fuel trading. Increased revenue from VAT to the state budget was observed. Originally, a taxpayer importing fuel from EU countries to Poland had to pay VAT within five days of import. This regulation significantly shortened the payment deadline compared with the standard rules, which provided for settlement by the 25th day of the month following the month of intra-community acquisition. However, it is now possible to apply the settlement deadline to the 16th day of the month following the intra-community acquisition of goods; (iv) *Transport Package – Electronic Transport Supervision System (SENT)*: The SENT was introduced in April 2017 to facilitate the monitoring of the transport of sensitive goods, such as fuel and heating fuels, liquified petroleum gas, fully and partially denatured alcohols, vegetable oils, dried tobacco, goods for the production of cigarettes, waste, coal, coke, drugs at risk of unavailability to Polish patients, and selected agricultural products. As a rule, the carriage of goods is reported to the SENT register by the sending entity, receiving entity, or carrier. These actors register with the system and receive the status of an intermediary (for sellers) or recipient (for buyers). Before purchasing goods, the buyer must generate a transaction code from the system and use it to confirm the

30 Mariański, 2020, pp. 12–13.

receipt of diesel fuel from the supplier; otherwise, the supplier will refuse to deliver the products. Importantly, transportation vehicles must be equipped with devices that transmit geolocation data to the systems of the NRA. Thanks to this, the transport of goods is monitored in real time, which allows for a quick reaction from Customs and Tax Service officers in the event of a risk of irregularities. This regulation clearly reduced the shadow economy in these areas and contributed to an increase in state budget revenues; (v) *ICT System of the Clearing House (STIR)*: The STIR was introduced in January 2018 to prevent tax fraud caused by abuse of the banking system and enables information exchanges between banking systems and the NRA. The STIR is also used for financial analyses to identify flows typical of tax fraud. This gives the NRA the ability to react to suspicious transactions in real time. For example, it enables the risk analysis of using the activities of banks and cooperative savings and credit union entities to commit fiscal crimes, submit fraudulent VAT refunds, or issue so-called ‘empty invoices’; (vi) *Reporting tax schemes – Mandatory Disclosure Rules (MDR)*: The MDR were introduced into the legal order in January 2019. This regulation is a partial transposition of Council Directive (EU) 2018/822 in the scope of the mandatory automatic exchange of information in the field of taxation with regard to reportable cross-border arrangements. Importantly, in Poland, aggressive tax planning affects not only international arrangements but also those of a national nature. As a result, it was decided that the reporting mechanism would also cover schemes that did not have a cross-border element if they were concerned with taxpayers whose activities may significantly affect state budget revenues; (vii) *Tax on income from unrealized profits (Exit Tax)*: The Exit Tax was introduced in January 2019. The tax applies to the transfer of an asset outside Poland’s territory as a result of which the Polish tax authority loses, in whole or in part, the right to tax income from the transfer of this asset, provided that the transferred asset remains the property of the same entity. In addition, taxation is also subject to a change in tax residence by a taxpayer subject to unlimited tax liability in Poland that causes Poland to lose, in whole or in part, the right to tax income from the sale of an asset owned by that taxpayer in connection with the transfer of its place of residence in another country;³¹ (viii) *Online cash registers, cash registers in the form of software, e-receipt regulations*: These regulations were introduced in May 2019. Online cash and virtual cash registers are tools that not only limit the grey economy but also make money laundering more difficult. Otherwise, they could be legalised by charging cash registers for transactions that did not actually take place. An e-receipt is an electronic fiscal receipt. To address this issue, a virtual or online cash register must be used. According to Polish law, it is recognised, just like a paper receipt, as valid proof of purchase and payment. The seller does not have to print it, but can deliver it online (e.g. by e-mail). These documents are saved in fiscal or protected memory and sent to the National Tax Administration’s Central Repository of Cash Registers; (ix) *List of VAT taxpayers*: This list was introduced in September 2019 and

31 Mariański, 2020, p. 12.

operates electronically. It includes a single and free database of VAT taxpayers that entrepreneurs can use to verify contractors and thus increases the security of economic transactions. The list contains the data of entities registered as VAT payers, unregistered, deleted, and restored to the VAT register. Importantly, it is updated every working day; (x) *Split Payment Mechanism (SPM)*: The SPM protects honest taxpayers from the consequences of being unknowingly involved in VAT fraud. This mechanism was introduced in November 2019. The essence of the split-payment mechanism is that the payment of a VAT invoice for purchased goods or services can be divided into two streams: the first means that the buyer's payment corresponding to all or part of the net sales value goes to the supplier's settlement account, while the second stream means that the payment of the amount corresponding to all or part of the VAT is paid to the supplier's special VAT account.³² Importantly, the split payment mechanism is mandatory for invoices above a gross value of PLN 15,000, which relate to sensitive goods and services; (xi) *The National e-Invoice System (NeIS)*: The NeIS was introduced in January 2022 to further strengthen the tax system. Currently, e-invoicing is voluntary and functions as a permitted form of sales documentation, next to paper and electronic invoices. However, from July 2024, e-invoicing is expected to become a mandatory and common settlement system for economic transactions, which will make it easier for entrepreneurs to run their businesses. Importantly, for small entrepreneurs who do not settle for VAT, the deadline will be postponed and will enter into force on 1 January 2025.

From our Polish point of view, an important issue in the creation of a new tax order in the EU is the dispute with the European Commission regarding retail sales tax. This case illustrates the circumstances in which an important EU authority hinders and deliberately blocks the sovereign tax policy of a Member State. This situation was presented in an exceptionally clear way by legal adviser Maciej Toroń:

In July 2016, Poland introduced a new retail sales tax. This tax was to be charged to all retailers selling goods to consumers. The amount of the tax depended on monthly revenues, with the proviso that monthly revenues of stores not exceeding PLN 17 million are exempt from tax, the surplus revenues above PLN 17 million and below PLN 170 million are taxed with retail sales tax at the rate 0.8%, surplus revenues over PLN 170 million are taxed at the rate of 1.4%.

Two months later, the European Commission issued a decision by which it initiated a formal investigation procedure and applied an interim measure in the form of an order to suspend tax collection until the matter was clarified. After conducting the explanatory proceedings, the European Commission issued a second decision, stating that the Polish retail sales tax was incompatible with EU law: in the Commission's opinion, Poland's new tax constituted an illegal aid measure for entrepreneurs, with the Commission finding that the conditions for prohibited state aid were met. The decision not to collect taxes from some entrepreneurs (i.e. those with monthly sales revenue below PLN 17 million) is a benefit derived from state funds, as the

³² Wesołowska, 2020, p. 33.

state resigns from collecting the tax. This aid is addressed to selected entrepreneurs who obtain lower sales revenue, which is not concealed by the Polish government, indicating that the retail sales tax will be charged mainly to large retail chains, enabling smaller entrepreneurs to effectively compete with them. In the opinion of the Commission, the Polish government indicated that by introducing a tax affecting large retail chains, Poland intended to influence the structure of the retail market, which also sought to disrupt competition in the EU market.

The Polish government disagreed with the Commission's position and appealed to the EU's Court of Justice. In the Court Judgment issued in May 2019, the Court (the former Court of First Instance) shared the position of the Polish government – it acceded to some of the allegations made by Poland and Hungary (which supported Poland). Consequently, the General Court annulled both contested decisions.

If the Polish government is correct, then the European Commission erroneously decided that the introduction of the tax on retail sales revenues using progressive tax rates constitutes prohibited public aid because it gives rise to a selective advantage for some entrepreneurs who, in practice, will not be obliged to pay this public levy owing to the exemption of revenues below the threshold of PLN 17 million from tax. The court also decided to repeal the decision to initiate the investigation procedure and suspend the application of the tax, indicating that at that stage of the proceedings there were no reasonable doubts regarding the existence of a prohibited state aid measure that would indicate the need for the Commission to investigate.

The European Commission did not agree with the Court's judgment and decided to make an appeal. The Tribunal, acting on a bench of 15 judges, issued a judgment that dismissed the Commission's appeal and agreed with the Court's position regarding irregularities in the Commission's classification of the retail sales tax introduced by Poland as prohibited state aid for some entrepreneurs. In the opinion of the Tribunal, the Court correctly determined that in the case of the Polish tax instrument, one of the conditions constituting state aid (i.e. a selective advantage for a specific group of entrepreneurs) did not occur. It should be emphasised here that the Court only examined this aspect because it was covered by the scope of the complaint specified by the Commission in the appeal.

The European Commission claimed that the introduction of progressive tax rates, as a result of which some entrepreneurs will not be obliged to pay the tax, is of decisive importance for recognising the Polish commercial tax as prohibited state aid. In both instances, EU courts did not share this view. The Court recalled that, to the extent not harmonised by EU law, Member States are free to shape their tax systems. This tax sovereignty also includes the choice of a progressive system of tax rates and applies not only to the taxation of natural persons but also to taxes levied on legal persons. The Tribunal emphasised that such a progressive taxation system may constitute unlawful state aid in a situation where it favours specific entrepreneurs or groups of entrepreneurs; however, the Commission, which is obligated to prove the existence of unlawful state aid, failed to prove the existence of this selective advantage. The Commission's assumption of an ideal system in which Polish sellers

pay the same tax regardless of the amount of their revenue, as a point of reference, was wrong.

The effects of the court's judgment on the Polish trade tax should be considered on several levels. First, from the perspective of entrepreneurs and sellers, the judgment finally ends the dispute between the Commission and Poland over the compliance of trade tax with EU law, resulting in the need to pay the tax. The Polish government began collecting taxes on 1 January 2021 after a favourable opinion of the Advocate General of the Tribunal, without waiting for the final decision of the tribunal. Second, the judgment of the Court, which confirms that the Commission made errors in assessing the Polish trade tax as illegal state aid and that there were no grounds for suspending tax collection from September 2017 to March 2021, potentially opens the way for Poland to pursue possible compensation from the EU for losses incurred by the state budget due to the lack of tax collection in the above-mentioned period as a result of the Commission's decision. The Polish government is considering this possibility, as the estimated revenue from the retail sales tax exceeds PLN 2.5 billion per year; however, as a result of the Commission's decision, the Polish government has been unable to collect the tax for over three years. Third, the consistent position of the Court on progressive taxation systems (in another judgment issued on the same day, the Court dismissed the Commission's appeal against the judgment of the Court, annulling the Commission's decisions on the non-compliance of the Hungarian turnover tax on advertising with EU law) has forced the European Commission to be more careful in preparing a justification in case the Commission intends to question similar taxes introduced by the member states of the EU in the future.³³

2. Conclusions

The current stage of social and economic development in the EU is defined, on the one hand, by the integration of common freedoms and, on the other hand, by national differences, including those related to economic conditions (e.g. degree of industrialisation or debt). The preservation of tax sovereignty in individual Member States seems to be a natural consequence of these differences. Moreover, merely maintaining the current framework of tax sovereignty can support tax competition in the EU and help many countries (and societies) achieve economic development, as if Europe had never been divided into Eastern and Western Europe.

The use of tax sovereignty has historically been based on the same two distinct stages. The first stage involves a thorough analysis of the current social and economic situation in a given country, which makes it possible to identify barriers to

³³ Toroń, 2021.

the development of society and the national economy. After defining the barriers, measures should be taken to gradually remove them. This stage ends with a political decision to launch a legislative path and introduce security measures into the tax and legal order. The second stage covers the process of applying tax laws by all addressees of the established standards; that is, taxpayers and tax authorities. The simultaneous monitoring of both macroeconomic (budget) and microeconomic (household budgets and entrepreneurs) effects allowed us to assess the quality and legitimacy of the introduced tax and legal regulations.

In recent years, in Poland, tax policy has clearly contributed to microeconomic trends by increasing societal wealth, both on the demand and supply sides. On the contrary, along the macroeconomic plane, it has significantly increased not only budget revenues, but also economic and, relatedly, employment growth.

Table 1 presents data from the government's annual reports on the implementation of the state budget,³⁴ including tax budget revenues over the last full eleven years. Attention has been paid to the clear increase in revenues since 2016, especially in comparison with the stagnation of budgetary tax revenues in this area in previous years.

*Table 1: Budget revenues from taxes and customs in Poland in 2012–2022
in billion PLN³⁵*

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
<i>Total budget revenues</i>	287,60	279,15	283,54	289,14	314,68	350,42	380,05	400,54	419,80	494,84	504,82
<i>VAT</i>	120,70	113,41	124,26	123,12	126,58	156,80	174,95	180,89	184,55	215,73	230,39
<i>Excise</i>	60,45	60,65	61,57	62,81	65,75	68,26	72,11	72,40	71,79	75,80	79,77
<i>PIT</i>	39,81	41,29	43,02	45,04	48,23	52,67	59,56	65,45	63,80	73,61	68,11
<i>CIT</i>	25,16	23,08	23,27	25,81	26,38	29,76	34,64	40,00	41,29	52,37	70,14
<i>PNIF³⁶</i>	–	–	–	–	3,51	4,34	4,51	4,70	4,82	5,29	6,08
<i>PG³⁷</i>	1,44	1,30	1,24	1,34	1,41	1,64	1,90	2,34	2,34	3,05	3,89

34 Oktaba, 2019, p 14.

35 The table was based on the data provided by the annual reports of the State Budget Department. See: *Revenue, expenditure – execution* [Online]. Available at: <https://www.gov.pl/web/finance/revenue-expenditure-execution> (Accessed: 3 August 2023).

36 Tax on selected financial institutions.

37 Tax on games.

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Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
<i>PWNK</i> ³⁸	1,43	1,92	1,43	1,55	1,28	1,79	1,70	1,54	1,67	3,69	3,79
<i>PSD</i> ³⁹	–	–	–	–	–	–	–	–	–	2,63	3,30
<i>Customs</i>	1,97	2,02	2,44	2,93	3,18	3,56	4,04	4,41	4,56	6,41	8,27
<i>Budget deficit</i>	30,41	42,19	28,98	42,61	46,16	25,35	10,49	13,74	86,80	26,37	12,58

38 Tax on the extraction of certain minerals.

39 Retail tax.

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ROMANIA: THE RELATIONSHIP BETWEEN TAX LEGISLATION, TAX COMPETITION, AND SOVEREIGNTY



DIANA CÎRMACIU

Abstract

Dealing with a topic related to taxation involves engaging complex issues, both in terms of incidental legislation and its role (i.e. its economic and social functions). The state plays a decisive role in economic development, but its intervention in this field must not have a restrictive character, evident in the adoption of rigid – and sometimes even arbitrary – legal provisions. Interventions in the economy, which have a long history, are done naturally according to emerging needs, assuming the implementation of a predictable fiscal policy to adapt the business environment to the challenges of the contemporary period (e.g. economic crises, health crises, armed conflicts). When, for various reasons, economic values are overturned, reform is necessary to bring the economic sphere into harmony with legal norms, which must then be recovered and developed. In light of these ideas, this study briefly analyses the state of fiscal legislation in Romania and clarifies related technical terms and definitions. We follow the trends in Romanian taxation, the fiscal policies which the governors assume, and the measures to ensure budget revenue (these measures are not always popular, but are arranged for the benefit of the general interests of the community). The field of taxation often raises problems, and such analyses can yield ways to implement combinations of taxes that enable public authorities to cover budgetary needs (taking into account the nation's level of development and specific economic features).

Keywords: *tax legislation, taxes, the Fiscal Code, fiscal sovereignty, tax fraud*

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1. Introduction: General considerations regarding taxation in the European Union

Doctrine often suggests that taxes only exist to ensure the coverage and financing of all public expenses. For example, as early as 1888, it was stated that ‘the tax is simply a contribution, either direct or hidden, which the public authority claims from the citizens to support the government’s expenses’.¹ Indeed, taxes fulfil a financial function, but they are also recognised as having a social function because they change the distribution of national income.

Although there are a number of challenges and measures related to the harmonisation of tax legislation and various procedures for the administration of taxes and fees at the European Union (EU) level, fiscal competences belong to Member States. The competences of the EU in the field mainly aim to harmonise the legal framework regarding indirect taxes and the functionality of the single market (for which the rules of fairness and fair fiscal competition are essential). In addition, sustained efforts have been made to prevent and fight tax evasion.

In the constantly dynamic economic context, Member States have the right to choose their taxation systems according to their own needs and realities; however, they are also required to consider the regulations of the EU and its general fiscal policy directions.

As we have shown, it is necessary to continue to improve the efficiency of administrative cooperation to fight tax fraud and support mutual efforts to recover tax debts. Fighting tax fraud (even tax evasion) remains a priority of EU institutions, intensifying cooperation between states. Recently, the danger and increased size of carousel fraud, which illegally diminishes the public revenues of the EU, has been increasingly discussed, with annual losses of approximately EUR 50 billion. The European Public Prosecutor’s Office (EPPO) plays an essential role in protecting the financial interests of the EU and can act more quickly than the national authorities (although the Chief Prosecutor of the EPPO claimed in a public speech that continuous improvement of the means to fight tax fraud with regard to value-added tax (VAT) is still needed²).

The operative exchange of fiscal information and development of debt recovery assistance are encouraged. In addition, the exchange of good practices plays a role in modernising and transforming the institutions involved in an efficient administration, ensuring all conditions for the fulfilment of tax obligations by taxpayers. The concept of revenue fraud has been defined by European rules, including illegal conduct, which has, consequently, reduced the revenues of the EU budget.³

1 Beaulieu, 1888, p. 112.

2 Tang, 2023.

3 Convention drawn up on the basis of Art. K.3 of the Treaty on European Union, on the protection of the European Communities’ financial interests, OJ C 316, 27.11.1995, 49–57; See also: Onea, 2021.

On agendas, we often hear the term “fiscal reform”. The Commission has also drawn attention to the need for fiscal reforms. For example, in its 2022 Annual Report on Taxation, it advised that in the context of the COVID-19 pandemic and the Russo-Ukrainian conflict, Europe must think about its strategy for the future of taxation.⁴ The Commission’s annual reports on taxation are important and useful because they present useful information, such as statistics on the state of affairs, reforms applied in Member States, and concise assessments of Member States’ tax policies. The priorities of the EU in the fiscal field are also set; specifically, they currently focus on: (i) energy taxation in accordance with the climate objectives of the EU (to fight climate change), (ii) fair taxation of the digital economy in compliance with the principle of good fiscal governance (with the aim of achieving a digital transition), and (iii) taxation of enterprises.⁵

Decision makers must consider the fact that the fiscal policy of the EU is required to be simple, efficient, sustainable, and capable of supporting sustainable economic recovery. Finally, we retained the components of the EU’s fiscal policies. Thus, in the case of indirect taxation, efforts are focused on the coordination and harmonisation of consumption tax rules (VAT and excise) to avoid the distortion of competition in the internal market. In the field of direct taxation, actions aim to apply and comply with harmonised standards for the taxation of legal entities and natural persons, promoting measures related to fighting tax fraud, preventing double taxation, eliminating discrimination, and removing tax barriers. In addition, initiatives in the field of direct taxation support cooperation and transparency.⁶

2. Tax harmonization, sovereignty, and tax competition in the European Union: Changing the hierarchy of tax law sources after Romania’s accession to the European Union

Romania’s accession to the EU implicitly involved changes to the sources of law in the tax system. Alongside the country’s fundamental law (the Constitution), EU law was also positioned, and Romania had to transpose directives on indirect and direct taxation into national legislation (and tax regulations).⁷ Romania is also obliged to comply with EU regulations, principles, and rules applicable to taxation. Thus, in the system of tax law sources, in addition to the constitution, law, government ordinances, emergency ordinances, and administrative acts, the aforementioned sources

⁴ European Commission, 2022.

⁵ European Commission, 2021, Communication from the Commission to the European Parliament and the Council Empty – Business Taxation for the 21st Century’, Brussels, 18.5.2021, COM(2021) 251 final, p. 14.

⁶ Cirmaciu, 2010, p. 165.

⁷ Bufan et al., 2016, pp. 175–176.

also appear. Further, the importance of judgments by the Court of Justice of the European Union (CJEU) in the field of indirect taxes (which are binding under the Romanian Tax Code) will also be considered.

Given the importance of taxation and the fact that taxes, by the way they are levied, can have beneficial or negative effects on economic and social life, debates on the harmonisation of tax legislation within the European Union have been very intense. As mentioned above, in our analysis, we start from the rule that EU Member States have tax powers. Thus, any measures proposed in tax matters will be subject to adoption by Member States, with their unanimity required for approval. While some consider the unanimity requirement an obstacle to tax harmonisation, the exercise of Member States' powers in the area of taxation is conditional – for example, it may be conditional on the obligation to ensure undistorted competition in the Single Market and compliance with the provisions of the Fiscal Compact.

Broadly, EU tax policies provide a functional and effective framework for the coordination and surveillance of Member State tax policies. The legal basis for tax issues at the EU level is the Treaty on the Functioning of the European Union (TFEU). A few articles are worth noting here: (i) Arts. 110–113, which comprise tax provisions on the harmonisation of legislation on turnover tax, excise duties, and other indirect taxes; (ii) Arts. 107–109, which indicate forms of state aid that do not distort competition and are therefore compatible with the requirements of the internal market; (iii) Arts. 114–118, which constitute approximations of laws (rules applicable to taxes which may have an indirect effect on the internal market); and (iv) Arts. 191–192, which consider tax provisions that may be adopted to prevent and/or remedy environmental problems, particularly in the context of the challenges posed by climate change.

Harmonisation is required and continues to require ambitious action plans to prevent, reduce, and fight against tax evasion and tax fraud; to coordinate taxation; to reduce the amount of compliance costs incurred by taxpayers carrying out cross-border taxable activities, and so on. The guiding principle for tax harmonisation is that European law takes precedence over national law, with the supremacy of European law laid down in a judgment of the CJEU on 15 July 1964.⁸ This is an essential prerequisite to applying the principle of loyal cooperation.

At present, tax harmonisation aims to make Member States' tax provisions as uniform as possible, adapted to the modern, digitised economy. Tax policies at the EU level must also support the economic growth and proper functioning of a single market. The difficulties and controversies that have arisen in the process of tax harmonisation are caused by conflicts between the objectives of the EU and those of each Member State (notably, Member States often give priority to covering public expenditure through tax revenue).

⁸ We recall here the Landmark Judgment of the CJEU in *Flaminio Costa v. E.N.E.L.*, 15 July 1964, C-6/64, ECLI:EU:C:1964:66.

We have shown that harmonisation measures have concentrated mainly on indirect taxes (precisely to ensure the free movement of goods, services, and capital, and to restrict unfair competition between Member States in tax matters) and that, with regard to direct taxes, the approximation of legislation has been achieved through a policy of small steps. The preamble to Directive 2006/112/EC⁹ states, it was stated that it was necessary to harmonise turnover taxes by introducing the VAT system. reduce or even eliminate distortions of competition (both internal and EU-wide), the legal rules on VAT are characterised by clarity, simplicity (no arbitrariness), and neutrality.

The appropriation of Member States' tax laws is also difficult because there are different approaches to the share and structure of taxes in the total tax revenue. In general, countries with prosperous developed economies emphasise direct taxation, while less-developed countries use indirect taxation mechanisms together with high social security contributions (let us not forget that during the COVID-19 pandemic, several countries implemented measures to postpone tax payment deadlines or even approved temporary reductions in the payment of certain taxes).¹⁰ According to official statistics, the previous year's tax resources accounted for 41.2% of GDP in the EU.¹¹ Thus, in 2022, the share of direct taxes (on wealth and income) increased to 13.4% of GDP. Regarding indirect taxes, a decrease in their share of GDP was noted (from 13.8% in 2021 to 13.6% in 2022, the reference year). This decrease may also be due to the facilities promoted by some Member States in the energy sector (i.e. tax reductions on energy products). However, it should be borne in mind that national tax revenues fluctuate from year to year due to a number of factors (e.g. changes in tax legislation, financial crises).

Following studies devoted to the analysis of taxation, we note that it will be seen as an attribute of sovereignty, but the will of the taxpayer – his consent to taxation – must also be considered. However, within the supranational legal order represented by the EU, fiscal sovereignty must be seen in close connection with certain obligations of Member States. The legal framework in this area is based on three strands: direct taxes, indirect taxes, and administrative cooperation (e.g. 'vital' administrative cooperation through the automatic exchange of tax information, established to fight VAT fraud¹²).

In terms of direct taxation, a distinction can be made at the EU level between 1) the legal status of the individual taxpayer, governed by specific national rules (retaining the exclusive competence of the Member States but respecting freedom of movement and nondiscrimination, with any national provision which contravenes these rules

9 Council Directive 2006/112/CEE on the common system of value added tax, OJ L 347, 11.12.2006, 1–118.

10 Cîrmăciu, 2020, pp. 441–445.

11 *Statistici privind veniturile fiscale* [Online]. Available at: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Tax_revenue_statistics&action=statexp-seat&lang=ro#Prezentare_general.C4.83 (Accessed: 1 September 2023).

12 Dragodan, 2018.

thus prohibited) and 2) the legal status of the taxpayer as a legal person,¹³ where the EU (European Commission) prohibits any tax provision or any limitation which could jeopardise the single market. With regard to indirect taxes, as we have already pointed out, the rule is harmonisation, with the objective of guaranteeing a single market.

Based on the provisions of EU law, directives have been drawn up to harmonise legislation in the field of excise duties; for example, the transposition into Romanian national law of Council Directive (EU) 2020/262 on 19 December 2019 laying down general arrangements for excise duty (recast).¹⁴ Specifically, Directive (EU) 2020/262 introduced new provisions concerning the movement and taxation of excised goods after their release for consumption. In order to create the necessary legal framework for the implementation of the EU provisions and to meet the transposition deadline of 31 December 2021, the following measures were introduced by government ordinance: (i) The incorporation into the Tax Code of the provisions on the quantitative limits purchased from another Member State and transported to Romania by individuals for their own use from the Methodological Norms for the application of Law no. 227/2015 on the Tax Code, approved by GD no. 1/2016 with subsequent amendments and additions. (ii) In the case of distance sales from another Member State to Romania, the elimination of the recipient of excise goods from the obligation to pay excise duties, taking into account that the provisions of Directive (EU) 2020/262 give Member States this possibility. (iii) The introduction of the concepts of ‘certified consignor’ and ‘certified consignee’ as persons registered with the competent authority who, in the course of their business, dispatch excise goods released for consumption in the territory of one Member State and who move to the territory of another Member State or receive excise goods released for consumption in the territory of another Member State. (iv) The establishment of a new procedure for the movement of excise goods which have been released for consumption in the territory of a Member State and which are moved to the territory of Romania to be delivered for commercial purposes – specifically, this new procedure involves: (iva) the establishment of a computerised system for monitoring the movement of excise goods released for consumption in the territory of one Member State and moving to the territory of another Member State for use there or for commercial purposes; (ivb) the procedure for registering certified consignees and certified consignors. (v) The supplementation of the arrangements for irretrievable loss of excise goods by introducing provisions relating to situations where excise duty is not chargeable (i.e. in the case of total or partial irretrievable loss due to the nature of the goods occurring during their transport in the territory of a Member State other than that in which they were released for consumption, where the amount of the loss falls within the

13 Examples of measures to approximate national legislation in this area include the Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, 49–54.

14 By Government Ordinance no. 4/2022, published in the Official Gazette of Romania No. 92/28.01.2022.

common threshold of partial loss for those excise goods, unless a Member State has reasonable grounds for suspecting fraud or irregularity; where irrecoverable total or partial loss of excise goods is established, the possibility of releasing the security lodged, in whole or in part, as appropriate, on production of appropriate evidence, is introduced). (vi) In the case of irregularities occurring during the movement of excise goods within the territory of a Member State other than that in which the goods were released for consumption, the charging of the excise duty in the Member State in which the irregularity occurred. Where more than one person is liable to pay the same excise duty, those persons shall be liable to pay the excise duty jointly and severally. (vii) The introduction of remission, which implies exemption from the obligation to pay an excise duty which has not been paid (i.e. the total or partial waiver of the excise duty due). (viii) The introduction of contraventions and penalties for failure to comply with the provisions relating to the movement of excise goods which have been released for consumption in the territory of a Member State and which are moved to the territory of Romania for commercial purposes.

Technical correlations have also been taken into account, involving the alignment of the terminology in Directive (EU) 2020/262 with the terminology used in the Fiscal Code; further, in order to ensure a comprehensive transposition of the provisions relating to the movement of excise goods after release for consumption, Section 17 has been structured into subsections.

At the same time, to ensure a gradual transition from the use of the accompanying document presented in paper form to the use of the computerised system, transitional provisions are provided for the movement of excise goods. This is regarding those goods that have been released for consumption in the territory of a Member State, which are moved to Romania, or the movement of excise goods which have been released for consumption in the territory of Romania and moved to the territory of another Member State to be delivered for commercial purposes. Thus, until 31 December 2023, Romania allowed the receipt and dispatch of excise goods using current formalities and accompanying paper documents.

Administrative cooperation plays a key role in taxation. By infringing on the rules of tax law and disregarding the correctness of taxation, significant losses are incurred in public budgets; however, the effects even have repercussions for the proper functioning of the single market. National tax authorities must cooperate to limit and fight against these negative phenomena.

It should also be mentioned that, in procedural matters, there are directives that require Member States to cooperate in the exchange of information and to assist in the recovery of budget claims. Regarding measures of extended administrative cooperation (in tax matters) aimed at discouraging illicit behaviour, infringement, or the evasion of tax regulations, we provide the following examples: (i) Council Directive 2011/16/EU, which focuses on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC.¹⁵ This directive was transposed into Romanian

¹⁵ OJ L 64, 11.3.2011, 1–12.

national law in 2016, in Title X, Chapter I of Law No. 207/2015 Tax Procedure Code.¹⁶ (ii) Council Regulation no. 904/2010 on administrative cooperation and the fight against fraud in the field of VAT¹⁷ (regulating administrative cooperation between the Member States of the EU in the field of VAT was necessary because this indirect tax represents an important resource for the budget). (iii) Council Directive 2010/24/EU, which concerns mutual assistance for the recovery of claims related to taxes, duties, and other measures.¹⁸ This Directive was transposed into Romanian national law in 2016 in Title X, Chapter II of Law No. 207/2015. (iv) Commission Implementing Regulation (EU) No. 1189/2011, which lays down detailed rules related to certain provisions of Council Directive 2010/24/EU concerning mutual assistance for the recovery of claims related to taxes, duties, and other measures.¹⁹

To empower the fight against tax evasion, a more complex exchange of tax information between EU Member States has been implemented (in this respect, even the European Court of Auditors pointed out in a report²⁰ that, although the exchange of tax information within the EU has solid foundations, applying the legal framework to concrete situations can be problematic). The amendments to Council Directive 2011/16/EU by Council Directive (EU) 2021/514²¹ aimed to remove the legislative loopholes that facilitated income tax avoidance. They also introduced the obligation to exchange information on cryptoassets (information to be delivered by cryptoasset service operators) and regulate the exchange of advanced rules with cross-border applications by wealthy people.²²

It should be noted, as a novelty, that on 12 June 2023, the President of the National Agency for Tax Administration of Romania (NAFA) issued an order²³ appointing the person responsible for administrative cooperation in the field of taxation, both with the Member States of the European Union and third countries (signatories of treaties/conventions in this regard with our country). Thus, the International Information

16 Law no. 207/2015 Fiscal Procedure Code, published in the Official Gazette of Romania no. 547/23.07.2015.

17 OJ L 268, 12.10.2010, 1–18.

18 OJ L 84, 31.3.2010, 1–12.

19 OJ L 302, 19.11.2011, 16–27.

20 European Court of Auditors, 2021.

21 OJ L 104, 25.3.2021, 1–26.

22 The notion of tax fairness is constantly reiterated, and it is believed that administrative cooperation in tax matters can strengthen this fairness. Looking closely at the history of financial science reveals concerns about using tax in social policies, as ‘Several taxes are of a noble, just human character; so are [...] those whose object is to help misery and suffering’. See: Leon, 1915, p. 33. It may seem pejorative ‘to take from the rich to give to the needy’, but the words of Professor Leon still come to mind; without disregarding the major role of scientific research in financial science, Professor Leon concluded, ‘In fact everything that is written has been written, everything that is thought has been thought’. See also: Cîrmaciu, 2010, p. 5.

23 Order No. 915/2023 on the designation of the Central Liaison Office responsible for administrative cooperation and exchange of information in the field of taxation, published in the Official Gazette of Romania 585/28.06.2023.

Exchange Service of the NAFA structure, named the Central Liaison Office, will exercise the power to cooperate and exchange information in this field.

In conclusion, issues of fiscal sovereignty and harmonisation in this area still raise problems that require solutions. Yes, sovereignty gives Member States the right to decide on taxes, contributions, and various levies, but to reduce the differences between the member states' tax systems, concerted action must be taken through harmonisation (which involves not simply approximating and aligning national legislation with that of the EU, but jointly exercising state sovereignty at the EU level).

As far as tax competition is concerned, we note that it is related to the strategy whereby Member States seek to secure tax revenues (by collecting the taxes set) and attract investment (e.g. job-creating foreign investment). In this way, tax competition manifests as competition between different tax jurisdictions, with EU Member States seeking to adopt and apply measures that are attractive to taxable persons (e.g. granting reductions, exemptions and deductions when determining the tax base, ensuring an efficient, transparent tax administration and lower tax rates than in other countries). Taxpayers often seek such facilities by choosing to leave their country of residence, resulting in an increased share of tax receipts in the host countries.

European and international tax harmonisation bodies are aware of the interest in working towards uniform tax solutions. The introduction of such harmonisation measures would lead to a reduction in the 'migratory' tendency of the taxable object. If tax competition is within acceptable limits (even at low tax rates), tax policy could be the engine of business development and increased competitiveness (it is assumed that if a taxpayer pays lower taxes, he/she maintains a larger share of his/her income and thus supports his/her development, which in the long run would lead to an increase in the tax base and tax revenues). Member States must act in the fiscal field to exercise consolidated fiscal sovereignty while respecting important principles, such as transparency, fair tax competition, and effectiveness. This is the only way to ensure that tax policies can respond promptly to the challenges of globalisation and benefit EU citizens while also fulfilling the social policy function of taxation.

There are still opposing views on tax competition, against arguments that are only natural, given that we can see this area as dependent on the economic or political interests of the Member States. Developed countries are mainly arguing against tax competition, whereas countries with less developed economies are arguing against it.

Finally, we should also mention a very important approach at the EU level; namely, that of establishing a list of non-cooperative jurisdictions for tax purposes (this is the third jurisdiction analysed in relation to certain criteria of tax transparency, tax fairness, and criteria related to anti-BEPS measures, the OECD minimum standards in this area). The EU list of non-cooperative jurisdictions for tax purposes includes countries that do not comply with good tax governance, transparency, and tax fairness or that have not fulfilled their obligations to reform their tax systems to comply with the above requirements. The EU Council initiated a dialogue with these third countries and recommended revising the legal framework to remedy negative

aspects and identify shortcomings. The Code of Conduct Group (business taxation) is responsible for updating the list.²⁴

3. Tax law and tax policy in Romania

3.1. General considerations

In the present day dynamic and sometimes excessive context in which structural changes are shaping a new architecture of economies or even reshaping society as a whole, tax systems must be constantly adapted. The challenges faced by different tax categories must be analysed. Projections are required to levy taxes that have a high yield and induce the least economic distortion.²⁵ Tax legislation must respect the principles of fairness, efficiency, and fiscal sustainability.

In Romania, the government's agenda includes a number of objectives in the fiscal sphere, such as measures for fiscal consolidation and the promotion of a fiscal policy that respects the principle of the predictability of taxation (i.e. the stability of taxes, contributions, and duties for a minimum period of one year²⁶). This doctrine draws attention to the need for fiscal reform. Without necessarily formulating critical opinions, leading authors in the field have pointed out that the government's projections and measures sometimes lack direction and are merely a set of provisions that neither stimulate investment nor help economic growth.²⁷

Fiscal policy, a component of a state's economic policy, refers to the totality of regulations on the establishment and collection of taxes, duties, and contributions, thereby shaping the state's choices in terms of taxes and duties.²⁸ Tax policy aims to influence economic development, for example, through tax concessions. Some authors also see fiscal policy as the process of raising budget revenue and shaping expenditure to sustain an economy without inflationary problems and maintain high employment. Fiscal policy has both direct and indirect means of action or stabilisation. Moreover, tax systems must aim in their evolution to satisfy the need for funds through the number and size of taxes, promote simplified tax collection

24 Currently the list includes the following countries: American Samoa, Bahamas, Guam, Russia, Trinidad and Tobago, Vanuatu, Anguilla, Belize, Palau, Samoa, Turks and Caicos Islands, Antigua and Barbuda, Fiji, Seychelles, Panama, US Virgin Islands. See: *EU list of non-cooperative jurisdictions for tax purposes* [Online]. Available at: <https://www.consilium.europa.eu/en/policies/eu-list-of-non-cooperative-jurisdictions/> (Accessed: 17 October 2023).

25 Cîrmaciu, 2010, p. 93.

26 Art. 3 point e of Law no. 227/2015 Fiscal Code, published in the Official Gazette of Romania no. 688/10.09.2015.

27 Biriş, 2012, p. 38.

28 Cîrmaciu, 2010, p. 95.

procedures, introduce taxes that are as bearable as possible for taxpayers, and increase the number of taxpayers by eliminating inequalities.²⁹

In this study, we discussed aspects of the rationale for taxes. Given the criteria of the purpose pursued, we distinguish between financial taxes (aimed at raising public revenue) and taxes of order (which seek to limit or stimulate certain activities, where appropriate, in view of the interests of the state). Therefore, Romania's tax policy must consider the influence of taxes on economic and social life. These effects can be constructive (development of the economic sphere, increase in living standards, etc.) or *destructive* (when the legislator pursues only one goal: taxation). In the case of financial taxes, Romanian legislators seek a formula that generates the highest possible revenue for the budget, sometimes neglecting the fundamental principles of taxation.

3.2. The principles of taxation in Romania

The taxes and duties that are legally regulated by the Fiscal Code³⁰ are based on the following principles: (i) *neutrality* of tax measures in relation to the different categories of investors and capital, such as the form of ownership, to ensure equal conditions for investors, Romanian and foreign capital; (ii) *certainty* of taxation; this is accomplished by drawing up clear legal rules, which do not lead to arbitrary interpretations, and precisely establishing payment deadlines, methods, and amounts for each payer to enable them to understand their tax burden and determine the influence of their financial management decisions on their tax burden; (iii) *fairness* of taxation or tax *equity* at the individual level, accomplished by taxing income differently according to size; (iv) *efficiency* of taxation, which appears as a rendering of a budgetary policy objective, namely: maintaining the stability of tax revenues; (v) *predictability* of taxation, accomplished by ensuring that the provisions of the Fiscal Code are stable for a certain period of time (at least one year) so that they do not lead to unfavourable retroactive effects for natural and legal persons in relation to the taxation in force at the time they make major investment decisions. It is considered³¹ that this principle, due to its closeness to the budgetary sphere, should be included in other framework laws (Law on Fiscal Budgetary Responsibility³² or in the Law on Public Finances³³).

29 Cîrmăciu, 2010, p. 94.

30 According to international and national experience in the field of taxation, it is necessary to establish an effective set of regulations in this area. Thus, many European countries have moved to codify tax rules by adopting their own Fiscal Code, which provides a coherent legal framework for the conduct of legal relations under tax law. The codification process was based on the premise that the establishment of this code would ensure the transparency of legal tax relations, providing the participants in these relations with precise knowledge of their situation and also showing them what to do.

31 Duca, 2021, p. 14.

32 Law No. 227/2015 Fiscal Code.

33 Law No. 69/2010 on fiscal-budgetary responsibility republished in the Official Gazette of Romania No. 330/14.05.2015.

In Romania, the principle of the *legality of taxation* is enshrined in the Constitution, according to which budget tax revenues are established only by law.³⁴ The principle of *fair taxation* is also a constitutional principle, as citizens are obliged to contribute to public expenditure (through taxes and levies, with this obligation reflecting the *principle of contributivity*); however, the legal system of taxation must ensure the fair distribution of tax burdens.³⁵ It is also important to bear in mind another principle enshrined in the Constitution; namely, equal rights: citizens are equal before the law and public authorities and, thus, implicitly, before tax authorities.³⁶ These principles outline the features of the concept of sovereignty from a fiscal perspective (e.g. the establishment of taxes by law, the obligation of citizens to contribute to public expenditure through taxes, and the legal regulation of the way in which public financial resources are constituted, administered, used, and controlled³⁷). In addition, as a Member State of the EU, Romania directly applies the general principles of EU law in tax matters, such as the principles of proportionality, the priority of European law over national law, legislative certainty, and legitimate expectations.

3.3. *The state of affairs and trends in Romanian taxation*

The Romanian government has initiated tax reform, which is also enshrined in the National Recovery and Resilience Plan. The first step was the adoption of Law No. 296/2023,³⁸ which aimed to prevent and fight unjustified public spending, fight waste, strengthen the fight against tax evasion, and ensure tax fairness.³⁹ It has also been stated that Romania is experiencing a silent tax revolution, achieved by eliminating tax incentives and increasing the tax burden (but by means other than tax increases).

The World Bank completed a report on China's tax system in the first months of 2023, making recommendations for the necessary reforms.⁴⁰ Statistics show that tax revenues in Romania represent 26.3% of GDP, the second-lowest rate in the EU.

34 Art. 139 para. 1 of the Romanian Constitution.

35 Art. 56 para. 2 of the Romanian Constitution.

36 Art. 16 paras. 1–2 of the Romanian Constitution. It is pointed out in the doctrine that violations of the principle of equality occur in EU law when 'preferential treatment is granted to activities carried out within the limits of the national territory'. See: Lazăr and Florea, 2023, p. 2.

37 Puț, 2015

38 Law No. 296/2023 on some fiscal-budgetary measures to ensure Romania's long-term financial sustainability, published in the Official Gazette of Romania No. 977/27.10.2023.

39 These ideas are also supported by the Romanian Prime Minister who declared that tough measures must be taken where there is fraud, where there is evasion, where there is waste in state spending. I believe that the only way for this country to develop is through an honest and real partnership between government and businesses. Romania cannot afford that only those with low salaries pay taxes correctly and those with high incomes keep optimising them! From today everyone will pay according to how much they earn. *Legea nr. 296/2023 privind unele măsuri fiscal-bugetare pentru asigurarea sustenabilității financiare a României pe termen lung*, 2023.

40 Ministerul Finanțelor, World Bank, 2023.

The current state of affairs is considered to have been generated by extensive preferential tax regimes and exemptions from income taxation for certain categories of the labour force and micro-enterprises, reduced VAT rates, and the taxation of personal income at 10%. These measures have narrowed the tax base, causing distortions and negatively affecting the fairness of the tax system.

The new measures introduced in the Romanian taxation system by Law No. 296/2023⁴¹ notably concern (i) minimum turnover taxation; (ii) modified income tax rates for micro-enterprises (1% for micro-enterprises with revenues below EUR 60,000 and 3% for micro-enterprises with revenues above EUR 60,000 or carrying out software and IT activities, HORECA (catering industry, n.t.) activities, some legal, medical or dental assistance activities; (iii) limiting tax relief for IT, construction, and agriculture; (iv) a 70% tax rate on income earned by individuals, ascertained by tax authorities in accordance with the law and whose source has not been identified (this rate will be applied to the adjusted tax base); (v) modified VAT tax rates (e.g. the VAT rate applicable to supplies of social housing to individuals increases from 5% to 9% and the VAT rate applicable to supplies of photovoltaic panels and the rest of the category of goods for the generation of green energy, supply of these goods with installation, and components increases from 5% to 9%; meanwhile, the exemptions introduced during June 2023 for specifically defined medical supplies made directly to hospitals are removed and only those made through NGOs remain); and (vi) the application of a special tax on high-value immovable and movable property (the luxury tax) of 0.3% to be paid by individuals who own residential buildings worth more than EUR 500,000 and individuals and legal entities who own cars registered/matriculated in Romania worth more than EUR 75,000. The question has already been raised as to whether or not the legal provisions on the luxury tax are in line with the provisions of the Basic Law or with those of EU law. Thus far, the Constitutional Court of Romania has ruled on the constitutionality of this law in its entirety (the Court has been asked by 59 Members of Parliament to review its constitutionality beforehand or *a priori*). Regarding compliance with European legislative standards, problems could arise from the discrimination made by Romanian legislators between natural and legal taxpayers, since only the first category pays luxury tax on residential buildings over EUR 500,000.

Another measure aims to eliminate the possibility of paying half of the accounting, tax, and similar fines. These are no longer payable at half the minimum within 15 days.

Regarding RO e-Factura (RO e-Invoice system, n.t.), the transmission of invoices via RO e-Factura is compulsory as of 1 January 2024 for established taxable persons (regardless of whether they are registered for VAT purposes) and non-established taxable persons registered for VAT purposes in Romania. The e-invoice is considered the only original document for exercising the right of deduction. In practice, VAT

41 Published in the Official Gazette of Romania no. 977/27.10.2023.

will no longer be deductible if the requirements for transmission via the e-invoicing system are not met.

A new customs system, RO e-Sigiliu (RO e-Seal, n.t.), was introduced and implemented to monitor the consignment of goods. Electronic devices (i.e. smart seals) are used to record data and transmit status and position information to IT applications to track the movement of goods by road. The application of smart seals and the monitoring of the transport of goods by road in national territory are carried out by the NAFA and Romanian Customs Authority on the basis of a risk analysis.

Finally, even if this is only a legislative projection, we should mention that the Ministry of Public Finance has published a draft law to ensure a global minimum level of taxation for multinational enterprise groups and large national groups.⁴²

The draft addresses Romania's obligation to transpose the provisions of Council Directive (EU) 2022/2523 to ensure a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the EU.⁴³

Thus, in line with the provisions of the Directive, Romania proposes to establish two common measures to ensure a minimum effective tax rate of 15% for multinational and domestic groups of companies with an annual income of at least EUR 750 million recorded in at least two of the four financial years preceding the reference year: *the income inclusion rule and the under-taxed profits rule*.

At the same time, the draft law also regulates the establishment of a *national supplementary tax* to be levied on subsidiaries of multinational and national groups of companies subject to the law, which are taxed at a reduced rate in Romania.

3.4. Brief considerations regarding the fight against tax avoidance and tax fraud in Romania

Tax evasion is a social phenomenon with financial implications, and consists of the evasion of tax liabilities, in whole or in part, using legislative loopholes and ingenious manoeuvres.⁴⁴ Broadly, tax evasion is complex and interferes with other economic, social, and moral phenomena. In the state-taxpayer conflict over tax evasion, if we look at the individual level, we are inclined to agree, especially when taxation is excessive and becomes an obstacle to economic growth and individual prosperity. If we consider the state's general interests, we should only be on the state's side to the extent that the fight against tax evasion is conducted under reasonable tax conditions.

The current legal regime for preventing and combating tax evasion is represented by Law no. 241/2005.⁴⁵ It should be mentioned that the Romanian legislator

42 See: *Expunere de motive* [Online]. Available at: https://mfinante.gov.ro/static/10/Mfp/transparenta/EMproiectLegeimpozitaremultinationale_04102023.pdf (Accessed: 23 October 2023).

43 OJ L 328, 22.12.2022, 1–58.

44 Gliga, 2007, p. 30.

45 Published in the Official Gazette of Romania no. 672/27.07.2005.

transposed Directive (EU) 2017/1371⁴⁶ with great delay⁴⁷ after the European Commission had previously initiated an action against our country for the incomplete transposition of the Directive. The new legal text proposes to complete the transposition of the Directive by criminalising new offences affecting ‘the resources of the European Union budget’, that is, any action or inaction committed within the framework of fraudulent schemes of a cross-border nature which reduce the resources of the EU budget by at least the equivalent of EUR 10 million (equivalent in) by methods such as: the use or submission of false, incorrect or incomplete VAT statements or documents; the non-disclosure of VAT information where such information is required to be disclosed by law; and the submission of correct VAT statements to fraudulently conceal non-payment of or undue entitlement to VAT refunds. The penalty is imprisonment for 7–17 years and disqualification from exercising certain rights. A penalty can be imposed on both natural and legal persons; in the latter case, it is a criminal fine. In addition to recovery from the damage caused by the offence, the provisions of the Criminal Code, which require the confiscation of assets acquired through the offence, and the provisions of Law No. 241/2005, which require insurance measures (including the suspension of the company’s activities), are also relevant from a penalty perspective. Regarding the activity of the competent authorities in terms of tax control and anti-fraud control, statistical data show that for 2022, the inspectors of the General Directorate of Anti-Fraud quantified tax implications in the field of VAT, and other taxes, in a total amount of RON 1,038.6 million. In addition, 194 referrals to competent prosecution bodies were made because damage to the state budget was identified (for these reasons, precautionary measures were ordered). Obviously, this study cannot exhaustively address the subject of tax evasion given the complexity of the phenomenon, which is why we only briefly present the latest legislative developments in Romania.

The fight against tax evasion is affected by a multitude of causes and factors that lead to or encourage tax evasion (e.g. complexity and shortcomings of tax legislation, tax burden, lack of harmonisation between the state institutions involved in tax administration, inefficiency of tax control institutions, and economic factors). It is clear that international cooperation through good tax governance and the exchange of information between the tax administrations of different countries will play an important role in making this fight more effective.

46 Directive (EU) 2017/1371 of the European Parliament and of the Council on the fight against fraud to the Union’s financial interests by means of criminal, OJ L 198, 28.7.2017, 29–41.

47 In this regard, Law No 125/2023 was adopted on supplementing Law No 241/2005 on preventing and combating tax evasion, published in the Official Gazette of Romania No. 440/22.05.2023.

3.5. Conflicts between Romanian tax law and EU law

A report by the Ministry of Foreign Affairs⁴⁸ on Romania's representation before the CJEU and other EU institutions provides data on the infringement proceedings initiated by the European Commission against Romania. At the time of the report, there were 54 infringement proceedings, two of which were in the field of taxation and customs unions concerning the failure to notify national transposition measures

48 Ministerul Afacerilor Externe, 2023. Also, among other actions pending before the Court, we recall some of the recent references for a preliminary ruling in which Romania has submitted observations: CJEU, 23 November 2023, C-532/22, *Westside Unicat*, ECLI:EU:C:2023:919, a reference for a preliminary ruling from the Cluj Court of Appeal. The questions referred for a preliminary ruling concern the interpretation of Art. 53 of Council Directive 2006/112/EC. The Court reserved its ruling in this case. Case C-696/22 – C (interpretation of Arts. 63, 64 and 66 of Directive 2006/112/EC on the common system of value added tax, the right of deduction of value added tax and the general EU law principle of respect for the rights of the defense). The questions referred for a preliminary ruling are as follows: (i) Do Arts. 63, 64 and 66 of Council Directive 2006/112/EC on the common system of value added tax preclude an administrative practice of a tax authority – such as the one in the present case, which imposed additional payment obligations on the taxable person, a professional limited liability company (SPRL) through which administrators of insolvency proceedings may exercise their profession – consisting in defining the chargeable event and the chargeability as being at the time at which the services were provided in the context of insolvency proceedings, where the insolvency administrator's fee was determined by the insolvency court or the assembly of creditors, with the result that the taxable person is obliged to issue invoices no later than the fifteenth day of the month following the month in which the chargeable event occurred? (ii) Do Arts. 63, 64 and 66 of Council Directive 2006/112/EC on the common system of value added tax preclude an administrative practice of a tax authority, such as the one in the present case, consisting in imposing additional payment obligations on the taxable person – a professional limited liability company (SPRL) through which administrators of insolvency proceedings may exercise their profession – in so far as that taxable person issued invoices and collected VAT only on the date on which payments were received for services provided in the context of insolvency proceedings, even though the general assembly of creditors established that the payment of the insolvency administrator's fee is subject to the availability of liquid assets in the debtors' accounts? (iii) In the case of a co-branding agreement between a law firm and the taxable person, is it sufficient, for the purpose of granting the right to deduct, that the taxable person, when proving the existence of a direct and immediate link between the purchases made by the upstream taxable person and the downstream transactions, demonstrate, after the agreement, an increase in the turnover/value of the taxable transactions, without further supporting documentation? If so, what are the criteria to be considered in order to determine the actual scope of the right to deduct? (iv) Is the general EU-law principle of respect for the rights of the defence to be interpreted as meaning that, where, in the course of a national administrative procedure for ruling on a complaint against a notice of assessment that has established the payment of additional VAT, new factual and legal arguments are accepted as compared with those contained in the tax audit report on the basis of which the notice of assessment was issued, and the taxable person has been granted interim judicial protection measures, pending the decision of the court dealing with the substance of the case, by suspending the debt, the court hearing the action may take the view that there has been no breach of that principle without examining whether the outcome of that procedure might have been different, had it not been for such an irregularity? It should be noted that in this case, too, the Court has stayed its judgment. It should be borne in mind that this preliminary ruling procedure is very important in ensuring uniform interpretation of EU law.

(Cases 2022/0169 and 2022/0171),⁴⁹ which were at the pre-litigation stage (late notification). It should be noted that the competent Romanian authorities have fully transposed the directives concerned.

If we look back at the relationship between Romanian tax law and the EU's tax regulations, we must remember the problem raised by the special tax on cars and motor vehicles introduced in Law No. 343/2006.⁵⁰ Special taxes are paid when vehicles are first registered in Romania (vehicles previously registered in other Member States). It was necessary to introduce this compulsory levy on the budget because, in the field of tax policy, it was necessary to improve the legal framework by considering the evolution of macroeconomic indicators and future budget projections. The aim was to ensure a constant source of revenue for the budget (given that, as a Member State of the European Union, Romania was no longer able to exercise the right to levy customs duties, excise duties, and VAT on intra-community acquisitions of vehicles). The Romanian legislature believed this would 'reset' the car taxation system. However, this tax contravened the provisions of Art. 90 of the TEC (now Art. 110 of the TFEU), and as a result, unanimous case law⁵¹ ordered the reimbursement of the amounts collected by the competent tax authorities (the specialised structures of the NAFA) to the payers.

Moreover, on 29 June 2022, Government Emergency Ordinance No. 93⁵² was adopted, ordering the refunding of, among other things, the special tax for cars and motor vehicles, the refunding measure motivated by the infringement procedure initiated against Romania by the European Commission for the imposition of taxes in violation of EU law. It was also intended to prevent the Commission from referring the matter to the CJEU for the non-conformity of Romanian legislation with the principles of EU law regarding the refund of taxes collected, as we have already mentioned, in breach of EU law.

Another case reflecting the impact of the CJEU rulings on tax law and practice in our country is the ruling pronounced in case C-558/19.⁵³ The referring court was Cluj Court. The application was made in a case pending before the national court regarding a dispute between the Cluj branch of *Impresa Pizzarotti & C SPA Italia*, on the one hand, and the National Tax Administration Agency (General Directorate for the Administration of Large Taxpayers), on the other, on the annulment of a tax

⁴⁹ See details: under Title 2 of this study.

⁵⁰ Law No. 343/2006 amending and supplementing Law No 571/2003 on the Fiscal Code, published in the Official Gazette of Romania No. 662/01.08.2006.

⁵¹ *Costaş and Puț*, 2023, p. 50.

⁵² GEO No. 93/2022 on the refund of the amounts of the special tax for passenger cars and motor vehicles, the pollution tax for motor vehicles, the tax on pollutant emissions from motor vehicles and the environmental tax for motor vehicles, published in the Official Gazette of Romania no. 646/29.06.2022. It should be noted that the same fate (of refund) has been suffered by the taxes on vehicle pollution, the taxes on pollutant emissions from motor vehicles and the environmental tax on motor vehicles.

⁵³ CJEU, 8 October 2020, C-558/19, *Impresa Pizzarotti*, ECLI:EU:C:2020:806.

administrative act issued by authority and of the tax assessment decision drawn up on the basis of that act.

Between July 2016 and September 2017, the above-mentioned competent tax body carried out checks at Impresa Pizzarotti in its capacity as a taxpayer for corporate income tax purposes. It was found that, in 2012, this branch had concluded, as a lender, two loan agreements with its parent company: one for a loan of EUR 11,400,000 and one for a loan of EUR 2,300,000 for a fixed period of one year. It was stated that the loan period could be extended by an additional deed. The loan agreements did not contain any clauses relating to the charging of interest by the parent company, and although on 1 January 2013 the outstanding amount was EUR 11,250,000, in April 2014, both loans were fully repaid. According to Art. 11 para. 2 of the Romanian Tax Code (which was in force at the time), transactions between Romanian and non-resident affiliates were subject to transfer pricing rules, and according to Art. 29 para. 3, the notion of ‘Romanian persons’ covered the permanent establishment of a non-resident person. Therefore, the tax authority considered that the complainant company in the main proceedings had to be considered an affiliated person of Pizzarotti Italia and that the interest rate on those loans should have been set at the market price, according to the transfer pricing rules, as if they had been made under the conditions of normal competition.

As a result, on the basis of the inspection report, the tax authority issued a tax assessment decision and assessed Impresa Pizzarotti for an additional tax of RON 297,141.92 (at that time, approx. EUR 72,400) and an increase in the tax base of RON 1,857,137 (at that time, approx. EUR 425,595). Pizzarotti’s appeal of this decision was dismissed as unfounded.

The company brought an action before the referring court for the annulment of those two decisions and submitted, in essence, that the national provisions relied on by the tax authority infringed on Arts. 49 and 63 of the TFEU. These provisions provide that the transfers of funds between a branch established in one Member State and its parent company established in another may be subject to transfer pricing rules, which are not applicable if the branch and its parent company are established in the same Member State. The national court remained in the proceedings and referred the following question to the CJEU.

Articles 49 and 63 of the Treaty on the Functioning of the EU preclude national rules such as Articles 11 paragraph (2) and 29 paragraph (3) of the Tax Code, which provide for the possibility of reclassifying a bank transfer of funds from a branch resident in one Member State to a parent company resident in another Member State as an income-generating transaction, with the consequence that the transfer pricing rules must be applied, where, if the same transaction had taken place between a branch and a parent company, both resident in the same Member State, it could not be reclassified in the same way and the transfer pricing rules would not apply?⁵⁴

54 See: C-558/19, para. 14.

The Court, examining the facts of the case, found that the national legislation at issue in the main proceedings must be examined only in light of the provisions on freedom of establishment in the TFEU. If it were accepted that the Member State in which the resident branch is established is free to apply different treatments to that branch simply because its parent company is established in another Member State, Art. 49 of the TFEU would be meaningless. In this case, the Romanian Tax Code treats branches as separate persons only when they are permanent establishments of a non-resident legal person. Thus, the income of a branch is not adjusted under transfer pricing rules unless the parent company is established in another Member State. If, on the contrary, the branch and the parent company are established in Romania, no adjustment of income is made. It follows that a branch of a non-resident company, such as Impresa Pizzarotti, benefits from less favourable treatment than a branch of a resident company carrying out similar transactions with its parent company. In these circumstances, the EU court found that differences in the tax treatment of branches (based on where their parent companies were established) involved in transactions characterised by conditions which would be unusual between third parties may restrict the freedom of establishment provided in Art. 49 of the TFEU. Thus, the parent company could be induced to refrain from acquiring, setting up, or maintaining a subsidiary in a Member State other than that in which it is a resident because of the tax burden associated with a cross-border situation, with conditions which would be unusual between third parties.

The transfer pricing rules in the Tax Code are designed to prevent the tax base in the state of residence of the permanent establishment of a non-resident company from being reduced because of the transactions carried out by that permanent establishment with its parent company which would not align with market conditions. The national rules provide for taxation of the permanent establishment on the basis of the amount of deemed remuneration for the advantage granted without consideration to the parent company. This is done to account for the amount that the permanent establishment would have had to declare as its profit if the transaction had been concluded on market terms. Thus, Romania can exercise its tax jurisdiction over activities carried out in its territory. The CJEU has therefore held that such legislation – which seeks to prevent profits generated in the Member State concerned from being transferred, without being taxed, outside its tax jurisdiction by means of transactions out of step with market conditions – maintains the sharing of tax jurisdiction between Member States. Under these circumstances, the Court verified that such legislation does not go beyond what is necessary to achieve the objective pursued. In this regard, national legislation based on an analysis of objective and verifiable factors to determine whether a transaction has the characteristics of an artificial arrangement for tax purposes must be regarded as proportional to the objectives of ensuring a balanced allocation of tax jurisdiction between Member States and preventing tax avoidance.

Thus, subject to verification by the referring court, the Romanian legislation at issue in the main proceedings does not go beyond what is necessary to achieve the

legitimate underlying objective. In light of these considerations, the CJEU held that Art. 49 of the TFEU must be interpreted as not precluding, in principle, legislation of a Member State under which a transfer of funds made by a resident branch to its parent company established in another Member State may be reclassified as an ‘income-generating operation’, so that the application of the transfer pricing rules becomes mandatory, whereas if the same transaction had been carried out between a branch and a parent company both established in the same Member State, it would not have qualified as such and those rules would not have applied. In this case, the Court’s judgment was in line with observations made by the Romanian Government. In addition, in support of the fact that the case law of the CJEU is very important⁵⁵ for the interpretation and respect of EU law, we mention the judgment in Case C-677/19.⁵⁶

Reference has been made to the CJEU regarding a preliminary ruling by the Vâlcea Tribunal on the interpretation of the principles of loyal cooperation, equivalence and effectiveness versus the provisions of Art. 1 para. 2 of the Government Emergency Ordinance No. 52/2017.⁵⁷ The request was made in the context of a dispute between SC Valoris SRL, on the one hand, and the Regional Directorate General of Public Finances of Craiova (County Administration of Public Finances of Vâlcea) and the Administration of the Environment Fund, on the other, concerning the refund of an amount the company paid as an environmental tax for motor vehicles, which was declared incompatible with EU law after its payment. Specifically, in August 2014, Valoris, a Romanian legal entity, paid a tax of RON 2,451 as an ‘environmental stamp duty for motor vehicles’ to register a second-hand car from the Netherlands in accordance with Art. 4 point (a) of GEO No. 9/2013. In August 2017, GEO No. 52/2017 entered into force, whereby several pollution taxes applicable to motor vehicles in Romania, including the above-mentioned tax, were declared, contrary to EU law. This gave taxpayers the right to request the reimbursement of payments related to taxes considered contrary to EU law, in addition to the payment of legal interest due for the period between the collection and reimbursement dates.

However, by way of derogation from the provisions of Art. 219 of the Code of Tax Procedure, which establishes a limitation period of five years from 1 January of the year following the year in which the right to a refund arose, such claims had to be submitted to the competent tax authority under penalty of forfeiture by 31 August 2018. In December 2018, Valoris applied for the refund of the amount paid by way of

55 See also: Art. 11 para. 11 of Law No. 227/2015 on the Tax Code according to which ‘in the field of value added tax and excise duties, the tax authorities and other national authorities must take into account the case law of the Court of Justice of the European Union’.

56 CJEU, 14 October 2020, C-677/19, *Valoris*, ECLI:EU:C:2020:825.

57 Art. 1 para. 2 of GEO No. 52/2017: ‘The taxpayer’s right to claim a refund shall arise on the date of entry into force of this emergency ordinance, regardless of when the tax was levied, and by way of derogation from the provisions of Art. 219 of Law no. 207/2015, as subsequently amended and supplemented, refund applications shall be submitted, under penalty of forfeiture, by 31 August 2018.’

environmental stamp duty for motor vehicles to the Vâlcea County Administration of Public Finances, but its application was rejected as late.

The company brought an action before the court in Vâlcea, requesting that the Romanian authorities reimburse the tax in dispute, together with interest on late payment at the statutory rate. In that context, the preliminary question was whether ‘the principles of loyal cooperation, equivalence and effectiveness must be interpreted as precluding national legislation such as that contained in Art. 1 para. (2) of GEO No. 52/2017, which sets a limitation period of approximately one year for the submission of claims for the reimbursement of charges levied in breach of EU law, where national law does not provide for a similar period for the exercise of the right to reimbursement of sums collected in breach of national rules?’⁵⁸

The Court stated that in the absence of EU legislation on the refund of national charges levied but not due, each Member State is responsible for laying down the procedural rules applicable to legal proceedings intended to ensure the protection of rights arising under EU law. These rules must comply with the principles of equivalence and effectiveness, particularly in establishing the limitations or prescription periods applicable to such actions. Compliance with these requirements must be examined in light of the place occupied by the rules in question in the procedure as a whole, the conduct of the procedure, and the specific features of these rules before various national courts. A time-limit of one year for bringing claims or actions based on an infringement of EU Law is not in itself unreasonable, provided that the starting point of that time limit does not make it practically impossible or excessively difficult for the person concerned to exercise the rights conferred by EU law.

In the present case, the referring court compared the procedural arrangements: on the one hand, the limitation period of approximately one year laid down in Art. 1 para. (2) of GEO No. 52/2017 for claims for repayment of sums paid but not due to Romanian pollution charges incompatible with EU law and, on the other, the limitation period of five years laid down in Art. 219 of the Code of Tax Procedure for the recovery of tax claims. Moreover, the time-limit laid down in Art. 1 para. (2) of GEO No. 52/2017 is expressly referred to as ‘by derogation from the provisions of Article 219 of the Code of Tax Procedure’. The CJEU observed that claims under the former provision and claims under the latter have similar subject matter and cause of action, that is, a claim for a tax refund. However, only the referring court was able to verify this. Subject to this reservation, the EU court found that the claims for the repayment of the charges referred to in GEO No. 52/2017, based on an infringement of EU law, are subject to a procedural time limit of approximately one year, which is considerably shorter and, therefore, less advantageous than the five-year time limit applicable to claims for the repayment of tax debts based on an infringement of national law. The adoption of GEO No. 52/2017, which imposes 31 August 2018 as the deadline for claiming the refund of Romanian pollution taxes, has had the

⁵⁸ *Judgment of the Court* [Online]. Available at: <https://ilegis.ro/eurojurisprudenta/ro/index/act/34730/lang/ro> (Accessed: 23 October 2023).

favourable effect of extending the refund period applicable to some taxpayers who have paid these taxes. However, the adoption also had the disadvantageous effect of reducing the refund period applicable to other taxpayers who lost the full benefit of the five-year period provided in Art. 219 of the Tax Procedure Code. While the latter provision remained fully applicable to tax claims paid, this was not due to national law. However, the principle of equivalence does not allow a disadvantage suffered by one group of taxpayers to be offset by an advantage granted to another group in a similar situation. Taking all these considerations into account, the CJEU ruled:

The principle of effectiveness in conjunction with the principle of sincere cooperation must be interpreted as not precluding the legislation of a Member State from laying down, under the sanction of forfeiture, a time limit for the lodging of applications for the repayment of charges held to be incompatible with EU law which is approximately one year, which begins to run from the entry into force of that legislation seeking to remedy the infringement of that law. The principle of equivalence, in conjunction with the principle of sincere cooperation, must be interpreted as precluding the legislation of a Member State from laying down, on pain of forfeiture, a time limit of approximately one year for the lodging of applications for repayment of charges held to be incompatible with EU law, where no such time limit has been laid down by that Member State with respect to similar applications for repayment based on an infringement of national law.

4. Conclusions

Before moving on to the conclusions, it is important to point out that while the present study was not intended to be a ‘didactic’ work, certain notions were still explained in detail to clarify their meanings. This study broadly evidenced trends towards increased tax competition, the reconfiguration of tax systems, and the need for Romania to find its place among countries of interest for investors. While low taxation is a benefit, we should not neglect the fact that most investors are also looking in detail at the predictability of elements such as tax legislation, political stability, infrastructure, and the labour market. In this context, Romania must adopt a tax system based on principles of fairness, fiscal sustainability, efficiency, and transparency – this is the only way for it to become more competitive. These reforms must also include extensions to environmental taxation. As far as fiscal sovereignty is concerned, with the deepening of the provisions of EU Treaties (and the rules adopted to implement them), it appears that Member States have unanimously chosen to limit their fiscal sovereignty in the sense that they have unanimously adopted EU rules limiting the content of national fiscal and budgetary policies.

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SERBIA: TAX POLICY AS PART OF NATIONAL ECONOMIC GOVERNANCE



DUŠAN V. POPOVIĆ

Abstract

This chapter analyses three specific characteristics of Serbian tax law and policy: tax competition, the prohibition of discrimination, and the prohibition of the abuse of law. First, we analyse the extent to which the Serbian legislative and executive powers resort to tax competition. Tax competition, a form of regulatory competition, exists when governments reduce fiscal burdens to encourage the inflow of productive resources or discourage their exodus. Non-discrimination is one of the fundamental principles of international tax treaty law, which may be found in hundreds of bilateral double taxation treaties that are currently being applied globally. This principle is articulated in most tax treaties concluded by the Republic of Serbia. Finally, this chapter analyses the general anti-abuse rule, such as the one incorporated in the EU Anti-Tax Avoidance Directive, which is the ‘minimum standard’ and does not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases. Notably, in the Serbian legal system, the prohibition of the abuse of law is not articulated as a general principle of tax law. Instead, the legislature introduced the principle of facticity. Both administrative and judicial case law related to the application of the principles of facticity are limited.

Keywords: *taxation, Serbia, European integrations, abuse of law, tax competition, principle of non-discrimination*

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1. Introduction

The fulfilment of economic criteria is a key requirement for membership in the European Union (EU), as set out in the Copenhagen criteria; this implies the existence of functioning market economy with the capacity to withstand competitive pressure inside the single market. Following the pre-accession experience of countries in Central and Eastern Europe, which joined the EU in 2004 and 2007, the EU defined its enlargement policy based on the Stabilization and Association Agreements (SAAs) it made with each Southeast European country.

Serbia's EU accession process lasts for almost 20 years, during which the country advanced from a potential candidate to a candidate. Under the SAA, Serbia and the EU agreed to cooperate in the field of taxation, including through measures to further reform Serbia's fiscal system and restructure tax administration to ensure the effectiveness of tax collection and fight fiscal fraud.¹ Such cooperation must take due account of priority areas related to EU *acquis* in the field of taxation and in the fight against harmful tax competition. Cooperation must also be geared toward enhancing transparency and fighting corruption; thus, relevant measures are also related to information exchanges between EU Member States to prevent tax fraud, evasion, and avoidance.² As of 2015, all candidate countries and potential candidates submitted their annual economic reform programs to the European Commission. These programs are expanded versions of the previous Pre-Accession Economic Programmes for candidate countries and include medium-term macroeconomic projections (including GDP growth, inflation, trade balance, and capital flows), budgetary plans for the next three years, and structural reform agendas.

In this chapter, three specific characteristics of the Serbian tax law and policy shall be analyzed: tax competition, the prohibition of discrimination, and the prohibition of the abuse of law. We shall first analyze to what extent the Serbian legislative and executive powers resort to tax competition methods. Tax competition, as a form of regulatory competition, exists when governments reduce fiscal burdens to encourage inflows of productive resources or discourage the exodus of those resources.³ Non-discrimination is one of the fundamental principles of international tax treaty law, which may be found in hundreds of bilateral double taxation treaties (DTTs) now being applied globally. This principle is also articulated in most tax treaties concluded by the Republic of Serbia. In the Serbian legal system, the prohibition of the

1 SAA, Art. 100.

2 SAA, Art. 100.

3 In the context of EU state aid law, prescribing tax rules which give preferential treatment to foreign companies is referred to as 'unfair tax competition'. This concept is meant to strengthen the economy of the 'poaching' state, which grants tax incentives by offering foreign capital attractive tax conditions. In the end, it is by definition a domestic business with domestic employees (e.g. the domestic subsidiary of a foreign company conducting finance or coordination work) which benefits from the tax incentive offered at the expense of the economy and the tax revenue of the other Member State. See: Schön, 1999, pp. 934–935.

abuse of law is not articulated as a general principle of tax law. Instead, the legislator introduced the principle of facticity, which is not being consistently interpreted and applied by administrative bodies and courts.

2. Tax competition

Fiscal policy can be a powerful instrument for attracting foreign investment. However, there is a conflict between the interests of the state, on the one hand, to attract as much investment as possible (a desire to lower the tax burden), and, on the other hand, to raise as many funds as possible to finance public functions (a desire to increase the tax burden). Tax competition is an important indicator of overall competitiveness. For every economy, particularly one with the strategic goal of EU membership, sustainable development is of the utmost importance.⁴ The most obvious negative effect of tax competition is a sort of ‘race to the bottom’, precisely because countries compete to reduce tax rates to create equally attractive business environments that are favourable for foreign investors.⁵ Many investors bargain with different governments to obtain the best incentive package, and governments generally fear that investments would be lost if the demanded tax incentive is not provided.⁶

According to surveys published in Serbian economic literature, most foreign investors marked tax incentives in corporate income tax (35.2%) as the most significant and determining factor for investment in Serbia. Subsequently, tax incentives for recruiting new workers (26.1%), tax incentives for exporting enterprises (21.6%), tax incentives for investing in underdeveloped regions (18.2%), tax incentives for investing in certain industries (11.4%), tax incentives for the establishment of small and medium enterprises (9.1%), tax incentives for personal income tax (6.8%), and tax incentives for businesses in free zones (6.8%) were found to contribute to the decision to invest in Serbia.⁷

Financial incentives from the state may be awarded for financing greenfield or brownfield investment projects⁸ in the manufacturing sector in line with the Investments Act⁹ and the Regulation on Determining the Criteria for Granting Incentives.¹⁰ Applications for financial incentives from the state are submitted to the Development Agency of Serbia by investors – domestic or foreign companies – through a related

4 Marjanović, Domazet and Simović, 2020, p. 971.

5 Marjanović, 2018, p. 96.

6 Marjanović, Domazet and Simović, 2020, p. 973.

7 Marjanović, 2018, p. 99.

8 In brownfield investment project, an investor invests in an already existing facility instead of creating an altogether new set-up as in the case of a greenfield investment.

9 *Official Journal of the Republic of Serbia* 89/2015 and 95/2018.

10 *Official Journal of the Republic of Serbia* 1/2019, 39/2023 and 43/2023.

beneficiary with a seat in the Republic of Serbia. Two main types of incentives can be granted: (i) investments in material and non-material assets, starting from the submission date of the application for incentive granting until the expiration date of the period for the realisation of the investment project and (ii) gross salaries for newly employed persons over a period of two years after the achievement of full employment with the beneficiary of incentive funds. The government prescribed minimum investment amounts in the production sector related to the NUTS region,¹¹ where the investment project takes place. For example, in the Vojvodina region (in the northern part of Serbia), the minimum number of new employees is 40, and the minimum amount of investment is set at EUR 400,000. In addition, beneficiaries can be granted an increase of up to 30% in eligible investment costs for material and non-material assets. The Government has also adopted the following sector-specific laws: (i) regulation on conditions and methods of attracting direct investments in the food manufacturing business;¹² (ii) regulation on determining the criteria for awarding incentives to attract direct investments in the automation of existing capacities and innovations;¹³ and (iii) regulation on conditions and methods of attracting direct investments in the hotel accommodation service sector.¹⁴

The CITA prescribes a special tax relief for large investments, subject to the fulfilment of the following conditions: (i) investment of over RSD 1 billion (approximately EUR 8 million) in fixed assets which are used for registered business activities (investments in progress are not considered fixed assets in use until activation) and (ii) employment of 100 new employees for an indefinite period of time during the period of investment.¹⁵ Finally, Serbia introduced payroll tax incentives which could not be combined with the financial incentives. Specifically, the employment of persons registered with the National Unemployment Agency for more than six months entitles employers to a sizable relief of taxes paid on net salary from the moment of employment: (i) 1–9 new jobs grants a 65% reduction; (ii) 10–99 new jobs grants a 70% reduction; and (iii) more than 100 new jobs grants a 75% reduction.

3. Prohibition of discrimination

The non-discrimination clause in international tax treaties is widely harmonised, given that countries rely extensively on the OECD Model Tax Convention¹⁶ to draft their bilateral tax treaties. The OECD Model Tax Convention follows the following rule:

11 NUTS stands for ‘Nomenclature of Territorial Units for Statistics’.

12 *Official Journal of the Republic of Serbia* 1/2019, 23/2023 and 39/2023.

13 *Official Journal of the Republic of Serbia* 18/2022.

14 *Official Journal of the Republic of Serbia* 33/19, 42/19 and 18/22.

15 CITA, Art. 50a.

16 OECD, 2017.

The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is more burdensome than the taxation and connected requirements to which nationals of that other state in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both Contracting States.¹⁷

The national legal doctrine¹⁸ differentiates the three groups of Serbian DTTs according to the manner in which the non-discrimination principle is formulated. The first includes DTTs which do not contain a provision dedicated to prohibiting discrimination. This group is illustrated by a treaty concluded between the Republic of Serbia and Kuwait.¹⁹ The second group includes DTTs which contain a non-discrimination clause identical or similar to that laid down by the OECD Model Tax Convention. This group of treaties is illustrated by a treaty concluded between the Republic of Serbia and Switzerland.²⁰ Although certain treaties belonging to this category follow the wording of the OECD Model Tax Convention in their English versions, they depart from it in Serbian.²¹ The heterogeneity of this group of treaties is further emphasised by the fact that some of them, such as the treaty concluded between the Republic of Serbia (SFR Yugoslavia) and the Kingdom of Sweden in 1980,²² lay down non-discrimination clauses which encompass only natural persons and thus exclude legal persons. The third group of treaties encompasses those that prohibit discrimination based on residence and not nationality. This is contained in the DTT between the Republic of Serbia (FR Yugoslavia) and Poland.²³ Serbian legal doctrine explains the residence-based non-discrimination provisions found in several DTTs by the inability to cover persons other than individuals under the term “nationals”.²⁴ This approach is typically found in older DTTs concluded in the SFR Yugoslavia and FR Yugoslavia eras. The more recently concluded Serbian DTTs recognise that residents and non-residents are in different situations and must often be treated differently for tax purposes.

17 OECD, 2017, Art. 24 para. 1.

18 Kostić, 2014, pp. 143–149.

19 Act on ratification of the Agreement on avoidance of double taxation concluded between the FR Yugoslavia and Kuwait, *Official Journal of the FR Yugoslavia* 4/2003.

20 Act on ratification of the Agreement on avoidance of double taxation concluded between the Ministerial Council of the State Union of Serbia and Montenegro and the Swiss Federal Council, *Official Journal of the State Union of Serbia and Montenegro* 11/2005, Art. 24. Please note that this DTT is soon to be amended. In September 2023, the Republic of Serbia and the Swiss Confederation concluded a Protocol on amendments, which is to be ratified by both parties (24 September 2023).

21 Kostić, 2014, p. 145.

22 Act on ratification of the Agreement on avoidance of double taxation concluded between SFR Yugoslavia and Kingdom of Sweden, *Official Journal of the SFR Yugoslavia* 7/81, Art. 23.

23 Act on ratification of the Agreement on avoidance of double taxation concluded between FR Yugoslavia and the Republic of Poland, *Official Journal of the FR Yugoslavia* 2/98, Art. 25.

24 Kostić, 2014, p. 149.

Outside the context of international tax treaties, the issue of discrimination is rarely regulated by Serbian national tax or commercial laws. The Constitution of the Republic of Serbia²⁵ lays down a general prohibition of discrimination, according to which ‘(e) everyone shall have the right to equal legal protection, without discrimination’ and ‘(a) ll direct or indirect discrimination based on any grounds, particularly on [...] national origin [...] shall be prohibited’.²⁶ The Investments Act²⁷ prescribes the application of the principle of national treatment to foreign investors as follows: ‘Investors who are foreign legal or natural persons, in terms of their investments, enjoy in all equal status and have the same rights and obligations as domestic investors, unless this or other law provides otherwise’.²⁸ However, the Investments Act also prescribes that investment projects awarded in accordance with international agreements and regulations governing state aid and attracting direct investments, which are in progress, shall continue to be executed in accordance with the regulations by which they were awarded.²⁹ Finally, the Foreign Trade Act³⁰ proclaims the principle of the most-favoured nation and the principle of national treatment. The most-favoured-nation treatment is applicable to foreign trade with a state or customs territory to which such treatment has been accorded under an international treaty or by the government’s decision.³¹ Under the principle of national treatment, foreign goods imported to the territory of the Republic of Serbia shall not be given less favourable treatment than similar domestic goods.³² However, the application of these principles is conditioned by the existence of an international treaty or a government decision.³³

4. Abuse of law

In the European civil law legal family, the abuse of law existed for almost a century and a half when it first appeared in the liberal legal order of the second half of the 1800s as an incorrect exercise of subjective rights. EU law also prioritises abuse. The abuse of law is the source of a nearly thirty-year-old jurisprudence of the Court of Justice of the European Union (CJEU) that confirmed the right of the EU and its Member States to oppose the presence of abusive behaviour, even in the absence of a norm that explicitly defines this authority. The main domain

25 *Official Journal of the Republic of Serbia* 98/2006 and 115/2021.

26 Art. 21 of the Constitution of the Republic of Serbia.

27 *Official Journal of the Republic of Serbia* 89/2015 and 95/2018.

28 Art. 7 para. 1 of the Investment Act

29 Art. 44 of the Investment Act.

30 *Official Journal of the Republic of Serbia* 36/2009, 36/2011, 88/2011 and 89/2015.

31 Art. 6 para. 1 of the Foreign Trade Act.

32 Art. 7 para. 1 of the Foreign Trade Act.

33 Art. 6 para. 1 and Art. 7 para. 3 of the Foreign Trade Act.

of the application of *fraus legis* has been tax avoidance; however, one may consider that this abuse of law principle has a potentially vast application in EU law, both in tax-harmonised and tax-non-harmonised areas.³⁴ Most legal authors consider the principle of the prohibition of abuse of law to be a general principle of EU law rather than an interpretative one. It follows that the general anti-abuse rule, as set out in the directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (hereinafter: the Anti-Tax Avoidance Directive [ATAD]),³⁵ which was adopted in 2016, must be seen merely as a partial codification of this general principle as applied to taxation.³⁶ The ATAD establishes rules against tax avoidance practices that directly affect internal market functioning.³⁷ The general anti-abuse rule incorporated in the ATAD is the ‘minimum standard’ and shall not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases.³⁸ As indicated in the preamble of the Directive, it is important to ensure that the general anti-abuse rules are applicable in domestic situations within the EU and *vis-à-vis* third countries in a uniform manner so that their scope and results of application in domestic and cross-border situations do not differ.³⁹ Although full harmonisation would be more optimal, an approximation via a minimum standard is a step forward, particularly in the domain of direct taxation.⁴⁰ Given that the harmonisation of Serbian tax rules with EU law is ongoing, the former is yet to be fully aligned with the provisions of the ATAD.

Serbian tax law does not explicitly recognise the abuse of the law principle. Instead, one may rely on the substance over form doctrine prescribed under the Act on Tax Procedure and Tax Administration (ATPTA).⁴¹ The ATPTA lays down the principle of facticity, introduced by amendments to the ATPTA in 2003, as a general principle of the tax procedure.

Tax facts shall be established based on their economic substance. If a simulated legal transaction is used to conceal a different legal transaction, the base for assessing the tax liability shall be the dissimulated legal transaction. When proceeds and/or assets are acquired illicitly, the Tax Administration shall assess the tax liability in keeping with the law governing the corresponding type of tax.⁴²

34 Piantavigna, 2011, p. 135.

35 OJ L 193, 19.7.2016, 1–14.

36 de la Feria, 2020, p. 146.

37 Art. 6 of the Anti-Tax Avoidance Directive.

38 Art. 3 of the Anti-Tax Avoidance Directive.

39 Preamble para. (11) of the Anti-Tax Avoidance Directive.

40 Scherleitner and Korving, 2023, p. 1079.

41 *Official Journal of the Republic of Serbia* 80/2002, 84/2002, 23/2003, 70/2003, 55/2004, 61/2005, 85/2005, 62/2006, 63/2006, 61/2007, 20/2009, 72/2009, 53/2010, 101/2011, 2/2012, 93/2012, 47/2013, 108/2013, 68/2014, 105/2014, 91/2015, 112/2015, 15/2016, 108/2016, 30/2018, 95/2018, 86/2019, 144/2020, 96/2021 and 138/2022.

42 ATPTA, Art. 9.

Other principles of tax procedures enshrined in the ATPTA are the principles of legality, the principle of temporal applicability of tax regulations, the principle of allowing the review of facts, the principle of confidentiality in tax procedure, and the principle of acting in good faith.⁴³ Although some authors⁴⁴ consider the principle of facticity under the ATPTA to be the general anti-avoidance rule in Serbian tax law, the linguistic interpretation of this rule may lead to absurd situations.⁴⁵ For example, tax liability may be minimised without relying on simulated legal transactions. Furthermore, the manner in which the principle of facticity is formulated in the ATPTA makes it difficult to grasp whether it is intended for use in the context of tax avoidance, tax mitigation, or tax evasion.

Both administrative and judicial case law related to the application of the principles of facticity are limited. In 2006, the Supreme Court of Serbia, which was competent in administrative disputes until 2009, applied the principle of facticity to the Tax Administration. The Court found that the Tax Administration wrongfully concluded that the transfer of property from the owner to its company should qualify as a donation merely because the former was completed without any payment.⁴⁶ The Supreme Court reminded the Tax Administration that the facts should be assessed in accordance with their 'economic substance'. Another example may be found in the 2014 decision of the Administrative Court, which concluded that when the Tax Administration qualifies one transaction as simulated, it must also indicate which transaction was dissimulated and allow for the party (parties) to actively participate in such proceedings.⁴⁷ Finally, the opinions issued by the Ministry of Finance do not contribute to a better understanding of the principles of facticity. Under the ATPTA, implementing acts (e.g. explanations, rulings, instructions, guidance) for bylaws within the competence of the Ministry of Finance, issued by the Minister of Finance, are binding for the Tax Administration.⁴⁸ Although the Ministry of Finance typically ends its opinion by referring to this principle, the relationship between the content of an opinion and the reference made to the facticity principle remains unclear. The Serbian legal doctrine considers this reference to be 'abstract'; it is designed to remind the Tax Authority that it alone is responsible for solving an individual tax affair, and that it cannot transfer this responsibility to the Department for Fiscal System within the Ministry of Finance.⁴⁹

Given that Serbia is still not a Member State of the EU, its tax rules do not prescribe the abuse of the law principle *per se*. While waiting for such a principle to be formally introduced into the Serbian tax law system, the legal doctrine recommends that the abuse-of-law principle be used as a tool for interpreting the facticity principle

43 ATPTA, Art. 4–8.

44 See for example: Popović, 2022, pp. 66–70.

45 Kostić, 2016, p. 117.

46 Supreme Court of Serbia, case no. U 120/04, 23 February 2006. As cited by: Popović, 2022, p. 67.

47 Administrative Court, case no. 24 U 3062/12, 7 March 2014. As cited by: Popović, 2022, p. 67.

48 ATPTA, Art. 11 para. 3.

49 Kostić, 2016, p. 122.

laid down by the ATPTA.⁵⁰ Indeed, this departs from the position of the CJEU, which understands the prohibition of the abuse of law as a general principle rather than an interpretative tool. However, the Republic of Serbia is not an EU member state that allows such an exercise. Another argument in favour of employing the abuse of the law principle as a tool for interpreting the facticity principle may be found in the fact that both pursue the same objective.

5. Concluding remarks

The national legal doctrine differentiates the three groups of Serbian DTTs according to the manner in which the non-discrimination principle is formulated. The first includes DTTs which do not contain a provision dedicated to prohibiting discrimination. The second group includes DTTs which contain a non-discrimination clause identical or similar to that laid down by the OECD Model Tax Convention. The third group encompasses treaties that prohibit discrimination based on residence rather than nationality. The Serbian legal doctrine explains the residence-based non-discrimination provisions found in several DTTs by the inability to cover persons other than individuals under the term ‘nationals’. This approach is typically found in older DTTs concluded in the SFR Yugoslavia and FR Yugoslavia eras.

Serbian tax law does not explicitly recognise the abuse of law principle. Instead, one may rely on the substance over form doctrine, as prescribed under the ATPTA. The Act establishes the principle of facticity as a general principle of tax procedures. Both administrative and judicial case law related to the application of the principles of facticity are limited. References to the principle of facticity can be found frequently in opinions issued by the Ministry of Finance. However, the relationship between the content of an opinion and references made to the facticity principle remains unclear. The Serbian legal doctrine considers this reference to be ‘abstract’; the purpose is to remind the Tax Authority that it alone is responsible for solving an individual tax affair, and that it cannot transfer this responsibility to the Department for Fiscal System within the Ministry of Finance.

Tax competition is an important indicator of overall competitiveness. However, this may lead to a ‘race to the bottom’ between states. Data on the structure of tax revenues show that in Serbia, the tax burden is almost equally split between (personal and corporate) income taxes and consumption taxes, while in Central and Eastern European countries, especially in Western European countries, income taxes account for a much larger share of total tax revenues.⁵¹ In Serbia, there are two main types of incentives from the state that may be awarded for financing greenfield

⁵⁰ Vasović, 2022, p. 357.

⁵¹ Randelović, 2022, p. 105.

or brownfield investment projects in the manufacturing sector: (i) investments in material and non-material assets, starting from the submission date of the application for incentive granting until the expiration date of the period for realisation of investment projects, and (ii) gross salaries for newly employed persons over the period of two years after the achievement of full employment with the beneficiary of incentive funds. There are also financial incentives for direct investments in the food manufacturing business, automation of existing capacities and innovations, and the hotel accommodation service sector. Research and development costs related to activities performed in the Republic of Serbia may be double-deducted from corporate income taxes. This incentive does not apply to research costs incurred in extractive industries (e.g. those related to extracting oil, gas, or minerals). Further, the Serbian tax system recognises special tax relief for large investments, as well as payroll tax incentives which cannot be combined with financial incentives.

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SLOVAKIA: TAXATION POLICY IN THE LIGHT OF EU TAX POLICY



ANNA VARTAŠOVÁ

Abstract

This chapter presents a broad overview of the dynamics of the coexistence of a Member State – the Slovak Republic – and the European Union (EU), which share competencies in the area of taxation. From the perspective of the Slovak Republic, this chapter examines the general concept of state sovereignty; further, it explores how the Slovak Republic's sovereignty is affected by its membership in the EU, especially in light of new tax legislation. Conferring part of its sovereignty to the EU, the Slovak Republic applies the monistic principle of regulating the relationship between EU law and national law and prioritizes EU law over its own. Notably, this chapter also explores the EU's direct legislative competences in tax matters and its visions and efforts in the sphere of direct taxation, where its legislative position differs from that for indirect taxes. In this regard, Slovakia can be seen as a supporter of EU legislative actions that lead to a more cooperative approach towards common European problems; however, not all initiatives were perceived as beneficial for the Slovak Republic – some may hold risks for the state's economy. Given that a Member State's sovereignty and tax competence are closely connected to tax competition, this chapter also considers this topic; in particular, this chapter explores why Slovakia did not positively receive some of the EU's proposals, particularly the Common Consolidated Corporate Tax Base (CCCTB). Subsequently, this chapter turns to the Slovak Republic's overall policy and particular measures in the fight against tax evasion in light of its attitude towards EU. This area is of special importance for the Slovak Republic. In the last decade, the Slovak Republic has introduced action plans for fighting tax evasion and tax fraud and many related individual measures.

Anna Vartašová (2024) 'Slovakia: Taxation Policy in the Light of EU Tax Policy'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 585–615. Miskolc–Budapest, Central European Academic Publishing.

https://doi.org/10.54237/profnet.2024.znecogov_26

Further, Slovakia generally affirms the EU's related measures as helpful in solving tax evasion. The data show that these activities are yielding positive outcomes in Slovakia, with the amount of taxes evaded generally declining.

Keywords: *Slovakia, tax law, tax sovereignty, tax harmonisation, implementation of EU measures, tax competition, fighting tax avoidance*

1. The elements of tax sovereignty

1.1. The concepts of state and tax sovereignty and the conferral of relevant competences in the field of tax law

State power is a legally regulated social force capable of determining the actions of the inhabitants of the state's territory through legal and non-legal methods.¹ As a specific sign of state power², its sovereignty is defined as independence of state power unanswerable to any other power inside or outside the borders of the given state³ – put differently, there is no higher political power than the political unit itself when the state is sovereign.⁴

Tax sovereignty is one of the attributes of statehood.⁵ Historically, the existence of a state has been associated with the right to impose taxes on a territory: 'When Thucydides mentions a nation that was recognized as independent, he writes in the sense that it is subject to its own laws, courts and taxes',⁶ which are used and redistributed by the state at its discretion.⁷ Tax is defined as 'a public monetary obligation of natural and legal persons to the state and its organic elements, strictly established by law, which is collected from them in a special process based on the coercive disposition of the state by the authorities designated by the state in the form of mandatory non-returnable and non-purposed payment'.⁸ Tax policy and tax sovereignty are symbols of a state's national sovereignty.⁹ According to the Constitution of the Slovak Republic ('Constitution'), taxes can be collected at the state and local levels and imposed only by law or on the basis of the law (Art. 59), that is, by a national act

1 Krošlák, Balog and Surmajová, 2020, p. 42.

2 Procházka and Káčer, 2013, p. 39.

3 Brörtl, 2023, p. 58; see also: Procházka and Káčer, 2013, p. 39.

4 Brörtl, 2023, p. 59.

5 Babčák, 2019a, p. 798.

6 Brörtl, 2023, p. 58.

7 Mrkývka, 2015, p. 111.

8 Stieranka, Sabayová and Šimonová, 2016, p. 19.

9 Široký, 2018, p. 21.

of prescribed force; this reflects the so-called ‘principle of legality of the imposition and collection of taxes’.¹⁰ ‘Taxes from a legal point of view are a powerful instrument of the state explicitly stated in Article 59 of the Constitution’.¹¹ Therefore, the only legislative body with the competence to approve the imposition and regulation of tax obligations is the National Council of the Slovak Republic (‘National Council’); however, in the context of local taxes, the municipal council also serves as a legislative body with powers) – thus, neither the Government of the Slovak Republic (‘Government’) nor any other authority can determine tax obligations in the territory of the Slovak Republic (‘SR’). As articulated in II. US 362/2019:

The provision of Art. 59(2) of the Constitution is essentially a constitutional safeguard, the purpose of which is to make it impossible for the executive power (the Government and public administration bodies) to impose tax or fee obligations on individuals and legal entities on the basis of their own discretion, with the fact that the imposition of such obligations is the prerogative of the legislative power and it can therefore only be realised by law or on the basis of the law.

However, this statement can be applied both internally and externally.

Externally, the sovereignty of a state manifests in the arrangement of mutual relations between individual states within the framework of international law and is reflected in the principle of sovereign equality, according to which no state can be forced to accept an international legal obligation without giving consent.¹² This follows general international law and is connected to state equality, one of the basic principles expressed in the UN Charter.¹³ However, the external sovereignty of a state is relativised by international law, which obliges states to act in particular ways, and by their membership in international organisations and other supranational associations, such as the EU.¹⁴ In this context, Krunková and Skalická¹⁵ state that, today, few recognize sovereignty as absolute sovereignty; instead, sovereignty is popularly limited to so-called ‘relative sovereignty’; that is, freedom in the context of a relationship of submission to the will of another state.

In this context, the basic law of the state, the Constitution, declares in Art. 1 that ‘the Slovak Republic is a sovereign, democratic and legal state’, but also states that it ‘recognises and observes the general rules of international law, the international treaties by which it is bound, and its other international obligations’. Pursuant to Art. 7 para. (2) of the Constitution, the Slovak Republic can transfer the exercise of part of its rights to the European Community and the EU by an international treaty that has been ratified and declared in the manner established by law or on the

¹⁰ Babčák, 2019a, p. 448.

¹¹ PL. ÚS 5/2012.

¹² Procházka and Káčer, 2013, p. 39.

¹³ Vršanský and Valuch, 2016, p. 44.

¹⁴ Krošlák, Balog and Surmajová, 2020, p. 44.

¹⁵ Krunková and Skalická, 2011, p. 39.

basis of such a treaty. This was brought about by the Treaty on the Accession of the Slovak Republic to the EU, to which the National Council consented on 1 July 2003 by resolution no. 365 and at the same time situated as a contract according to Art. 7 para. (5) of the Constitution, which takes precedence over the laws of the SR. The president ratified the treaty on 26 August 2003 and the treaty entered into force on 1 May 2004.

Art. 7 para. (2) of the Constitution continues that ‘legally binding acts of the European Communities and the European Union have priority over the laws of the Slovak Republic’ and further states that ‘the adoption of legally binding acts that require implementation shall be carried out by law or Government regulation pursuant to Art. 120(2)’;¹⁶ this refers mainly to directives, as sources of EU law without general validity (binding only for Member States and only with regard to the result) – notably, these directives must be implemented into the national order, which is realised in the SR by issuing new or changing existing legal regulations.¹⁷ In the decision PL ÚS 2/09, the Constitutional Court confirmed the application of the primacy of EU law, according to which all authorities, not only general courts, are obliged *ex officio* not to apply national law that, in their opinion, contradicts EU law (with the possibility of verifying such an interpretation by asking a preliminary question to the Court of Justice of the EU [CJEU]). Therefore, a monistic principle regulates the relationship between EU and national laws,¹⁸ while the sources of EU law have priority over SR laws. In the case of the state’s membership in the EU, part of the state’s sovereignty is transferred to this entity, and the constitutional law of individual Member States must respond to such situations.¹⁹ Although, according to Orosz, Svák, and Balog,²⁰ the EU has a common systemic basis of generally recognised constitutional values, the adaptation of the constitutions of the Member States – the so-called ‘Europeanisation’ of national institutes and the incorporation of the so-called ‘integration clauses’ – casts the protection of Member States’ constitutional identities in a new light.²¹ The transfer of powers to the EU means that the Member States retain these powers, but do not always exercise them to the agreed extent because they are exercised by the EU; notably, the SR has transferred only the exercise of part of its powers²². Krunková and Skalická²³ emphasise that in the framework of any integration, only the exercise of part of sovereignty is transferred to joint bodies. The state does not relinquish its sovereignty, since that would *de facto* cause it to cease to exist.

In the tax sphere, primary EU law establishes the EU’s legislative limitations regarding the Member States and thus the scope of competencies. Specific guardrails

16 These are referred to as ‘approximation regulations’.

17 Klučka and Mazák, 2004, p. 135.

18 Orosz, Svák and Balog, 2012, p. 268.

19 Drgonec, 2001, p. 28.

20 Orosz, Svák and Balog, 2012, p. 260.

21 Orosz, Svák, and Balog, 2012, p. 260.

22 Orosz, Svák and Balog, 2012, p. 262.

23 Krunková and Skalická, 2011, p. 41.

are set in the Treaty on Functioning of the EU (TFEU), which prohibits protective and discriminatory taxes; emphasizes competence in the harmonisation of indirect taxation to ensure the establishment and functioning of the internal market and avoid distortion of competition (Arts. 110–113); and prohibits infringement of fundamental rights and freedoms, discrimination based on nationality (Arts. 63–65), and the approximation of other laws of the Member States that directly affect the establishment or functioning of the internal market (Art. 115), with the latter being mostly used for the partial approximation of direct taxation issues (where the competence of the EU is not determined as explicitly as in the case of indirect taxation issues). Nevertheless, it is not only the primary law, and subsequently the secondary law issued on its basis, but also general legal principles and CJEU's case law that need to be considered. Especially the case law is the means of control of the CJEU over the member States' compliance with the above-mentioned regulation, for which reason the CJEU is often being labelled as a negative legislator.²⁴

1.2. Standpoints regarding tax competition

To some extent, tax sovereignty is related to tax competition, as both include the right of the state to define the elements of its own tax system according to its needs and ideas. Similar to other countries that joined the EU after 2004, the SR can be classified as one of the states that supported tax competition rather than tax harmonisation (especially in the area of income taxation). These Member States are often referred to as 'new Member States', characterised by a transformation from a centrally managed economy to a market economy and a lagging GDP per capita compared to the original Member States or EU average. Therefore, it is logical to expect their efforts to catch up (e.g. through tax competition with a lower tax burden). Usually, affirmations of competition are based on arguments that it preserves fiscal autonomy (since taxes are a natural stabiliser for regulating fluctuations in the economic cycle), increases competitive advantage by attracting investors through reducing corporate income tax (which usually leads to higher economic growth, especially in smaller countries), and contributes to the overall reduction of the tax burden in the EU.²⁵ Such a description corresponds to the SR's situation when it joined the EU, since, in 2004, a large-scale tax reform was adopted (including the introduction of a flat income tax of 19% with a very complex and broad tax base without a larger spectrum of various exceptions or special regimes).

Meanwhile, the main argument against tax competition is the inefficient allocation of resources (in the case of taxes, the market cannot ensure the efficient allocation of resources between Member States and the subsequent allocation of

²⁴ Bujňáková et al., 2015, pp. 101–102.

²⁵ Teplická and Daubner, 2013, p. 173.

public expenditures).²⁶ For example, Babčák²⁷ states that in EU documents, the term ‘tax competition’ is much more often used in a negative context (e.g. ‘harmful tax competition’) than in a positive one. He further notes that the very fact that certain unilateral measures in the field of taxation are considered by the Commission to be manifestations of harmful tax competition may discourage states from giving up part of their tax sovereignty to the EU. Further, research by Teplická and Daubner²⁸ on a sample of 27 EU states for the period between 1998 and 2008 confirmed that tax competition leads to higher economic growth; however, this research also observed that reducing the tax burden on capital, corporate income, labour, or consumption deepens the budget deficit. Therefore, tax competition cannot continue over the long-term and cannot lead to the so-called ‘race to the bottom’ without increasing the deficit. It is necessary to determine the right balance.

In step with the above, the SR’s position on the issue of tax competition was particularly visible during negotiations on the CCCTB concept (see the next subsection). The rejection of the harmonisation of direct or corporate taxes, in addition to other stated political reasons (including the loss of sovereignty), was significantly economically conditioned. The Minister of Finance at the time, Ivan Mikloš, stated, ‘if the proposal of the European Parliament were to be put into practice, the efficiency, neutrality and stability of our tax system would deteriorate’; meanwhile, the executive director of the Business Alliance of Slovakia, Róbert Kičina, also negatively evaluated the proposal of the CCCTB, according to which ‘the enforcement of a tax base other than the Slovak one would once again bring a number of different exceptions, from which only certain groups of people would benefit, who are basically not entitled to such benefits’.²⁹ Malová, Láštík, and Rybár³⁰ considered this position logical in view of the economic policy of the government, which, in 2004, introduced a large-scale reform of the tax system with lower direct taxes and a simpler method of calculation (and therefore, also control) than those used in the vast majority of Member States. According to Mikloš, at that time, Slovakia had ‘one of the broadest tax bases in the EU, which means that it had few exemptions in taxation’; additionally, he advised that while ‘harmonization would force various exceptions, as is the case in other EU countries – the tax reform was the most significant reform of the previous Government and is also the biggest competitive advantage of Slovakia’.³¹ Harmonisation was, therefore, seen by Vladimír Palko as a ‘limitation of the competitive advantage of the new EU Member States’.³² In 2006 and 2007, a group of members of the National Council repeatedly submitted proposals to adopt the Declaration on Tax

²⁶ Teplická and Daubner, 2013, p. 173.

²⁷ Babčák, 2020, pp. 85–86.

²⁸ Teplická and Daubner, 2013, pp. 185–186.

²⁹ Jančík and Odkladal, 2005.

³⁰ Malová, Láštík and Rybár, 2015.

³¹ Palko: *Slovensko má slabnúci postoj k daňovej harmonizácii v EÚ*, 2007.

³² Ibid. Similarly, Peter Chrenko from Ernst & Young; Jančík and Odkladal, 2005.

Sovereignty in Direct Taxes³³ as the official position of the SR; however, this proposal was not approved.

Currently, the SR strives to maintain a certain degree of freedom in its potential application of elements of tax competition. From the SR's reactions to many EU and OECD initiatives, especially in the fields of combating the erosion of the tax base, fighting tax evasion, and let's call it a desire for increase of justice in the allocation of tax revenues between the EU Member States, it is noticeable that SR also strives for solidarity and contribution to the construction of a community of states with harmonised tax regimes to an extent when better results are achieved in the stated objectives of the common EU tax policy, but also in a wider context international community.

2. Tax harmonization and the sovereignty of Member States

2.1. View of direct tax harmonization in the EU

In accordance with the above-described process, Slovakia, as an EU Member State, transferred part of its competence to determine some elements of its tax system to the EU (or to accept its formation at the transnational level) with the subsequent (mandatory) acceptance of the result (in the creation of which, however, it directly participated). Nevertheless, it cannot be said that the Slovak supreme legislative body thus a priori waived the right to exercise legislative authority in tax matters in which legislative acts were also adopted by the EU. Despite the above-mentioned principle of the primacy of EU law over the laws of the SR, these acts are implemented in the national legal order by the legal regulations of the SR in a modified manner (according to the principle of legality, by adopting new or changing existing tax laws), thus the will of the national legislative body is also reflected in the process of adopting EU legislative acts in the tax field.

That is, on the formal side, members of the government represent the SR in EU bodies, and formally (and legally), their representation of the SR is regulated by national legislation. This legislation is designed to ensure the presentation of the positions held by the Slovak legislature, primarily the Constitutional Act No. 397/2004 Coll. on the cooperation of the National Council and the Government of the Slovak Republic in matters of the European Union, the Rules of Procedure of the National Council of the Slovak Republic, and in detail the System of Forming Opinions on Draft EU Legal Acts and the State of Coordination of the Implementation of EU Policies approved by the resolution of Government no. 627 of October 27, 2013. The purpose of the regulation was to maintain the position of the National Council in

³³ See: INESS, 2007.

line with a strong model of its control over the government. The regulation outlines the government's obligation to submit designated materials to the National Council. Additionally, it grants the National Council the authority to approve the SR's position on draft legally binding acts and other EU acts (which are decided by representatives of the governments of the EU Member States) as well as on other EU matters if requested by the government or at least one-fifth of the Members of the Parliament. Subsequently, a member of the government is bound by the approved position when presenting the positions of the SR to EU bodies. The National Council entrusted the Committee of the National Council for European Affairs with this work; further, in addition to approving binding mandates for members of the government, this committee has also been entrusted with other powers of the national parliament, such as assessing the compliance of draft EU legislative acts with the principle of subsidiarity, including approving reasoned opinions³⁴. Therefore, the SR applies the so-called 'mixed' system of monitoring EU affairs in the national parliament. Through this committee, the National Council can correct the way in which members of the government who hold official positions on the SR express themselves regarding proposals for EU legislation or other matters.

The SR places a high importance on the possibility to express its position on proposed legislative acts. Notably, it does not support the Commission's long-time call for changing the unanimous voting system to a majority voting system.³⁵ For example, the Report on the membership of the SR in the European Union for 2011 (p. 3) states that one of the Slovak priorities was successfully implemented in the agreement on the Euro Plus Pact; namely, the explicit mention that direct taxes remain within national competence. In 2019, when the initiative 'More effective creation of legislation in the field of taxes: determination of areas in which voting by qualified majority (QMV) would be adopted' was presented, the official position of the SR was that

the idea of changing the current voting procedure in tax matters to QMV and the procedure proposed by EC has no support of the SR. The phrasing of the procedure and the EC's arguments are not justified. Even now, in the case of initiatives where they see the need for joint action, Member States can reach a unanimous agreement. This is also evidenced by a series of approved legislative acts during the last three years (e.g. ATAD, DAC). On the other hand, the EC also needs to enforce the QMV for its initiatives that are currently criticized by Member States and are conflicting the need to maintain sovereignty in the given issues.³⁶

34 In the context of the early warning system on compliance with the principle of subsidiarity in draft EU legislative acts.

35 See, for example: Communication from the Commission: A Constitution for the Union COM(2003) 548 final, p. 24.

36 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2018, Annex I, p. 5.

For the same reason, the SR expressed a restrained attitude towards the work of the Committee for Administrative Cooperation in the Tax Area (in view of a possible deviation from unanimous decision-making in tax matters, as the Committee makes decisions on the basis of a qualified majority). Member States are clearly aware of the reason for changing the system (i.e. the effort to enforce certain proposals at the expense of individual members). Considering that the effort to change the voting system has not been generally accepted for a long time, one may ask to what extent negative harmonisation in the field of direct taxes by means of the CJEU's case law can be considered a quasi-way to circumvent the impossibility of the harmonisation of direct taxes.

Procházka and Káčer³⁷ state that the traditional process of making collective decisions in international organisations (through unanimity) is based on the principle of sovereignty, and the deviation to majority voting occurs only where states limit their sovereignty in favour of integration into higher units; that is, to create communities (which allows them to feel like part of a whole). However, we do not see such a state (unity) in the current EU, which is characterized by different opinions and attitudes.³⁸ Kruková and Skalická³⁹ advise that states voluntarily take on limitations to their sovereignty. Member States evaluate decision-making by a qualified majority and the associated loss of the right of veto as a partial loss of their sovereignty, given that they can be overruled by other Member States – an element almost absent in traditional international relations.⁴⁰ Member States also guard their sovereignty. Furthermore, Kruková and Skalická draw attention to the issue of the legitimization of autonomous political power in transnational political systems. Non-unanimous voting would be a fundamental blow to questioning the exclusive legitimization of the decision-making processes at the EU level; specifically, this would enable the overriding and thus the negation of national wills. Additionally, there is also the problem of the implementation of indirectly valid secondary EU acts, which must be transposed into national law but with which the given state did not agree – in such cases, the national parliament would actually be forced by an international obligation to accept a certain vote; however, this goes against the principle of prohibition of the imperative mandate. According to Babčák,⁴¹ Member States defend the necessity of unanimity with the possibility of exercising the right of veto; notably, the EU does not have a mandate to harmonise direct taxation, which would be enshrined in the founding treaties – that is, the EU's tax powers are limited directly through the founding treaties. There is no interest in changing anything in this regard – Member States are not interested

³⁷ Procházka and Káčer, 2013, p. 39.

³⁸ There are directly opposing views on the future direction of tax legislation in the EU, one pole of which begins with an image of the complete unification of tax systems, and the other pole ends with a clear rejection of common tax policy and legislation. Babčák, 2015.

³⁹ Kruková and Skalická, 2011, p. 41.

⁴⁰ Novotný, 2006, p. 10.

⁴¹ Babčák, 2020, pp. 31–33.

in transferring part of their remaining tax sovereignty to the EU for the sake of harmonising direct taxes.

Nevertheless, since the beginning of its membership in the EU, the SR has maintained a positive attitude towards most solutions to tax issues at the EU level. This includes those issues related to indirect taxes and – above all – the fight against tax fraud. The SR supports international assistance, administrative cooperation, and the exchange of information for tax purposes, which significantly contribute to reducing the tax gap, and other measures that in principle also related to partial adjustments (initial coordination of tax systems) in direct taxes to eliminate double taxation, tax evasion, profit shifting and aggressive tax planning. Notably, exceptionally negative attitudes have been expressed to individual initiatives. For example, negative attitudes were expressed towards the CCCTB concept of 2006,⁴² where the SR

on the basis of the progress of work and partial outputs [...] has not yet acquired the conviction of the usefulness of the project, which should lead to the simplification of the situation of multinational companies doing business within the internal the EU market. The SR continues to hold the opinion that work on the CCCTB proposal should not receive political support [...] until the final proposal presented by the European Commission, in terms of its technical side and detailed evaluation of the impacts, convinces the Member States of the advisability of its consensual adoption.⁴³

Among other things, the SR criticised the proposed redistribution mechanism.⁴⁴ It more or less maintained this position even after the re-submission of the CCCTB proposal in 2016,⁴⁵ at which time

the SR announced at the working meetings a reservation of the review of the submitted draft C(C)CTB directives [...] From the Slovak perspective, an essential feature of a competitive EU corporate income tax system in relation to the rest of the world should be mainly an aspect of the uniformity of the rules in the territory of the Member States Another important element is stability, predictability and certainty in the application of common rules and the achievement of a common standard, which

42 Communication from the European Commission to the Council, the European Parliament and the European Economic and Social Committee – on the implementation of the Community's Lisbon Program – Progress to date and further progress in the area of the Common Consolidated Corporate Tax Base (CCCTB) – COM(2006) 157 final, p. 17.

43 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2007, p. 44.

44 The SR, as a smaller Member State, can rightfully feel concerned about not meeting its budget expectations and the total amount of the redistributed part of the tax base. Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2018, p. 50.

45 European Commission, Proposal for a Council Directive on the Common Corporate Tax Base COM(2011) 121 final; European Commission, Proposal for a Council Directive on the Common Consolidated Corporate Tax Base (CCCTB) COM(2016) 683 final, p. 45.

would simplify the system from the point of view of the legislative solution, as well as the application by tax subjects. SR is open to further negotiations on the drafts of the mentioned directives.⁴⁶

In the following period, however, the statements were not so categorical (in the sense that the SR ‘supports the study of the draft directive’).⁴⁷ However, according to Babčák,⁴⁸ the adoption of this concept would not contribute to the elimination of national sovereignty; on the contrary, it would facilitate cross-border trade and support trade and investment more broadly.

Additionally, the SR also demonstrated a negative attitude towards negotiations on the proposal for a Council Directive amending Directive 2006/112/EC as regards the introduction of the detailed technical measures for the operation of the definitive VAT system for the taxation of trade between Member States – COM(2018) 329 final,⁴⁹ the Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax COM(2018) 20 final,⁵⁰ and the Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax with as regards the special scheme for small enterprises COM/2018/021 final.⁵¹ The SR presented several reservations and questions regarding the new EU resources system. The SR also had a somewhat restrained attitude towards some elements of the proposal for a Council directive amending Directive 2006/112/EC on the common system of VAT, as regards the treatment

46 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2017, Appendix, p. 35.

47 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2018, Appendix, p. 42.

48 Babčák, 2019b, pp. 21, 831–832.

49 Where, in the opinion of the SR, ‘the definitive regime should be such that it does not weaken the existing system with new types of fraud, does not increase the administrative burden on businesses and tax administrations, which the proposal in question does not meet, and thus the SR does not support a definitive regime based on the fact that VAT collection will be dependent from other Member States. It is necessary to focus the discussion on the definitive regime on a system that would mainly eliminate tax fraud.’ Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2019, Appendix, p. 54.

50 This contains a proposal to remove restrictions in the area of reduced rates and proposes the mandatory application of the base rate through the so-called ‘negative list of goods and services subject to the basic VAT rate: ‘Given the fact that the said proposal deviates from a certain degree of harmonization that currently exists in the area of reduced rates, the SR does not support the path of the so-called ‘negative list’. The SR prefers to maintain the current status with the possibility of using existing exceptions that are applied by other MSS’. Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2019, Appendix, p. 55.

51 The SR supports this initiative, but has reservations about certain aspects of the proposal, where it sees the potential for an increased risk of tax fraud. Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2018, p. 23.

of insurance and financial services COM(2007) 0747; specifically, the SR preferred conventional measures to combat tax fraud and thus called for amending the existing legislation rather than completely changing the VAT system as such.⁵² The SR demonstrated a similar attitude toward the part of the Proposal for a Council Directive on administrative cooperation in the field of taxes COM(2009) 29 final (which was to replace Council Directive 77/799/EEC of 19 December 1977), namely to the proposed extension of the directive's scope of action to all types of taxes and mandatory social security contributions due to the practical aspect that in the SR levies are not part of taxes.⁵³

By contrast, the SR welcomed the vast majority of initiatives in the tax field, such as efforts to address the taxation of the digitised economy or aggressive tax planning with a greater scope of information exchange. The SR also supported some projects even more enthusiastically than other Member States; for example, while a financial transactions tax failed at the EU level, the SR worked to solve the issue within the framework of enhanced cooperation. The SR currently supports the Proposal for a Council directive implementing enhanced cooperation in the area of financial transactions tax COM(2013)71 (as of 2019), but only the original objectives of the directive and with reservations. The SR presented these attitudes through its fundamental national positions on certain elements of the proposal, the taxation of which would lead to distortion and negative consequences for the Slovak financial market.⁵⁴ However, this tax was highly criticised in the media and by some political entities.⁵⁵

In essence, the SR demonstrates a consistent attitude towards harmonisation in the area of taxes. Notably, it does so despite the considerable fragmentation of the opinions of individual political parties, which can be attributed mainly to the fact that more radical opinions appear more often among minority parties that are not part of the government or parliament,⁵⁶ even if some parties are exceptions.⁵⁷ This statement can also be applied to situations and topics of extraordinary consensus across the political spectrum, such as the rejection of tax harmonisation before the 2014 elections.⁵⁸

52 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2008, pp. 53–54.

53 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2009, p. 43.

54 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2019, Appendix, p. 54.

55 See, for example: Karlík, 2016.

56 Štrkolec, Vartašová, and Sábó, 2022.

57 See, for example, the 'Sloboda a Solidarita' party, which has long been a parliamentary party that was against the increase of the European Financial Stabilization Mechanism, the introduction of the European Stability Mechanism (ESM), and deeper integration that could threaten the sovereignty of Member States. Mesežnikov, 2014, p. 149.

58 Mesežnikov, 2014, p. 150.

2.2. *Current initiatives*

Regarding the Communication of the European Commission to the European Parliament and the Council ‘Taxation of enterprises in the 21st century (BEFIT)’, the SR has so far presented its preliminary position⁵⁹ in a very diplomatic tone. In general, the SR supports the goals and vision of the framework presented by the Commission, welcomes the stated measures, and is ready to discuss these measures. However, at the same time, the SR is aware that only the presentation of the relevant outputs from the proposed measures will be the subject of investigations and in-depth evaluations of the potential effects of the proposed output of the Commission for the SR. Regarding the proposed measures, the SR approaches all of them with an open mind and is ready to examine them from the viewpoint of their impact on the system of corporate taxation at the national level and on financial administration, as well as on their feasibility and justification from its own perspective.

Another very recent piece of regulation is the Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, which was implemented in the Slovak legal order with effect from 31 December 2023 in step with the expected deadline for the directive’s implementation. Since previous Slovak legislation has not covered the rules for the minimum taxation of taxpayers’ income, this regulation required the SR to create a new legal regime. The 500 Club and the Slovak Employers’ Union were involved in consultations on the preparation of the draft law, given that it would mainly affect entities from the business environment.⁶⁰ Even before its adoption, in March 2022, the Institute of Economic and Social Studies (INESS)⁶¹ expressed a negative opinion on the draft of the directive itself, stating that it ‘may weaken the competitiveness of smaller countries (which have fewer opportunities to attract investors) and increase the bureaucratic burden (for both states and companies) and legal uncertainty (endangering contracts concluded under current conditions). These consequences would be felt most by smaller Member States, which have less means to cope with additional costs. Notably, the directive overrides states’ sovereign power to determine tax rates. INESS underlined that no assessment of the impact of the directive from the perspective of EU competitiveness was carried out because the proposal was based on the OECD’s assessment, which was based on different conditions.’

The SR’s position was presented in the draft directive in 2022, and the interdepartmental comment procedure was completed on 11 May 2022. It contained a list of identified irregularities in the text of the directive and clarifications that must be accordingly made to ensure that the directive can be effectively applied and to reduce

59 LPEU/2021/271: Record of position on the draft EU act.

60 Preliminary Information on the Draft Law on Ensuring the Global Minimum Level of Taxation of Multinational Enterprise Groups and Large National Groups (PI/2023/23).

61 INESS, 2022.

the administrative burden on all affected entities while maintaining the same goals. In terms of the effects of the directive, both positive and negative effects on the public administration budget and the business environment were identified. According to the Ministry of Finance of the SR ('Ministry'), the SR had a stable tax system that did not contain the harmful preferential tax regimes used by some states. At the same time, the SR was not perceived as a tax haven. The SR has introduced some preferential regimes or adjustments, such as the patent box mode or the so-called 'super-deduction' for science and research; however, these were not harmful adjustments in the context of the Code of Conduct for Business Taxation within the EU Council or regimes evaluated within the Forum on Harmful Tax Practices. Based on preliminary estimates of the Ministry processed from the available data, additional taxation of Slovak companies in the SR belonging to groups with a consolidated revenue of more than EUR 750 million was not expected, as these companies were not anticipated to have effective tax rates below 15%. Additionally, there was no domestic group operating in the SR at that time with a consolidated group revenue of more than EUR 750 million and core entities within the scope of the directive. A significant positive impact on the budget of the public administration was also not expected considering that there were only potentially two main parent entities of a multinational group in the SR with a consolidated income above EUR 750 million; however, theoretically, it could be brought about by the application of the secondary rule Undertaxed Profit Rule (UTPR) to the basic entities of the group located abroad, mainly in third countries. The expected negative impact on the budget of the public administration was connected with the need to modify the information system of the financial administration of the SR. The impact on the business environment was presented briefly and primarily included (as a negative impact) an increase in the administrative burden and potential additional taxation in the case of an effective level of income taxation below the minimum tax rate of 15%. However, this excessive brevity was criticised by the commission, which recommended the development of a more detailed opinion on the potential impacts on the business environment.

The draft implementation regulation itself – in the form of a special act on compensatory tax to ensure the minimum level of taxation of multinational business groups and large national groups (LP/2023/477) – was submitted by the Ministry to the interdepartmental comment procedure on 3 August 2023. The Act (No. 507/2023 Coll.) was adopted on 8 December 2023 and came into effect on 31 December 2023.

Due to the position of the so-called 'source state/importer of capital' (with relatively few parent entities and many subsidiary entities) and to avoid taxation of the income of the affected entities abroad, the SR decided to ensure minimum taxation in the form of a national compensatory tax. From the viewpoint of the extent of adoption of the directive's text, the SR used the exception according to Art. 50 para. (1), based on which it decided not to apply the income inclusion rule and the undertaxed profit rule for six consecutive accounting periods beginning 31 December 2023 (because it fulfilled the condition according to the cited article of the directive, as there were no more than 12 main parent entities within the scope of the directive).

Several provisions specific to the national tax systems of other EU Member States that are irrelevant from an implementation point of view (when taking over the national compensatory tax) for the SR (e.g. non-qualified refundable imputation tax, the regime of deductible dividends, and recognised distribution tax systems) were not included in the draft of the new law. The SR chose to implement a qualified national tax to ensure that in situations where the main parent entity of a multinational group is located abroad and only subsidiaries with an effective taxation rate below 15% operate in the SR, the subsidiaries are not subject to additional taxes abroad, with their tax revenues logically remaining in the SR.⁶²

While the state anticipated reduced competitiveness, the draft law's reasoning suggests that it may have a positive effect on competitiveness. Specifically, the regulation should limit corporate tax competition in EU Member States by introducing a minimum level of taxation. Additionally, the new taxation rules should ensure that multinational corporations pay their fair share of tax regardless of where they operate. By abolishing a substantial portion of the benefits associated with the transfer of profits to states with zero or very low taxation, the reform was expected to globally create fairer business conditions for business entities.

It was assumed that the new regulation would negatively affect entrepreneurs by increasing their administrative burden. In particular, this was because the regulation was set to introduce new obligations for entities within the scope of the law (specifically, the Ministry estimates that approximately 5,000 entities will be subject to this law) with expected costs of approximately EUR 300,000. The negative impact on the state budget in 2024 related to the adjustment of financial administration information systems in amounts less than EUR 0.5 million was also quantified. However, it was expected that the positive impact on state budget revenues after 2024 would exceed the budgeted costs.

Another proposal currently being developed is the Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU – COM(2021) 565 final (ATAD III), to which the SR has so far held a slightly restrained position in the sense of agreeing with the idea of the proposal. However, it did so with reservations especially regarding the vagueness and ambiguity of the proposed text of the directive, the insufficient time for its implementation, and the administrative complexity of the proposed measures for all affected entities (LPEU/2021/847). Reservations regarding the proposal have also been voiced by academics in the context of the continuous expansion of EU intervention in the sphere of direct taxes (if only because this proposal has not yet been approved and its extension to non-EU countries is already being prepared),⁶³ which may give the impression that these steps only obscure the EU's real intention and long-term goal of harmonising corporate taxes across EU countries.⁶⁴

62 Baláži, 2023, p. 53.

63 Hrabčák, 2022, pp. 61–62.

64 Bonk, 2017, p. 868.

3. The tools of the fight against tax avoidance (as an element of tax sovereignty) in Member States

3.1. National tax policy in the area of tackling tax avoidance and fraud

Efforts to reduce tax evasion have been part of the agenda of the SR for a long time. Indeed, the government has declared this intention its program statements, highlighting the importance of this issue. Over the past ten years, legislative activities aimed at addressing tax evasion have intensified significantly. In particular, 2012 was a landmark year when activities in this direction increased in terms of both quantity and quality.

The Action Plan for Combating Tax Fraud,⁶⁵ adopted in 2012, became a fundamental program document of the Government. This plan contained 50 measures gradually implemented between 2012 and 2014; specifically, these measures were not only of a tax nature but also concerned commercial and criminal law.⁶⁶ According to Štrkolec,⁶⁷ the following measures were the most significant: the introduction of the obligation to submit a financial guarantee by risk persons during VAT registration; the cancellation of the VAT registration of persons who do not communicate with the tax administrator or fulfil legal obligations; a mandatory monthly taxation period for new VAT payers (for a period of 12 months); joint and several liability for tax; provision of tax when importing goods from third countries; introduction of the obligation of non-cash payment in business transactions above a certain limit; and introduction of the obligation to submit data on domestic supplies of goods and services to the tax administrator in electronic form (summary report). In 2012, Act No. 394/2012 Coll. on the limitation of cash payments was adopted, which, in addition to preventing tax fraud and tax evasion, was also intended to contribute to fighting money laundering, corruption, and criminal activity. With this Act, a new body was created, the Criminal Financial Administration Office, which specifically focuses on the detection and investigation of economic criminal activity in the field of taxes and customs.⁶⁸ In 2012, 'Tax Cobra', a project for coordinating tax inspections in suspected cases of tax fraud and associated large-scale tax evasion, was established. Some of the most significant measures in the second stage of implementing the action plan include the introduction of an obligation for business entities to submit control statements and the subsequent introduction of a new information system to process these statements. In the third stage, a new module for automatic communication with bank systems was launched and the

65 Resolution of the Government no. 235 of 31 May 2012, Action plan to combat tax fraud for the years 2012 to 2016.

66 For more details, see: Huba, Sábo, and Štrkolec, 2016, pp. 123–124.

67 Štrkolec, 2017, p. 220.

68 Straka and Šimonová, 2014.

information systems were integrated.⁶⁹ Thus, the action plan prioritised indirect taxation.

In 2013, the state attempted to contribute to the improvement of discipline in the issuance of cash receipts, thus limiting undeclared payments, by amending Act No. 171/2005 Coll. on gambling by Act No. 135/2013 Coll., which came into effect on 1 September 2013 and enabled the implementation of the receipt lottery (the so-called ‘National Receipt Lottery’); however, the effect of these changes was ultimately assessed as questionable,⁷⁰ and the whole idea was abandoned in 2021. In general, this aspect of tax evasion and fraud was dealt with by legislation first regulating the introduction of electronic cash registers,⁷¹ which over time changed to online cash registers, the possibility of using a virtual cash register, and, from 2019, online connections between cash registers and the central financial administration database. Nevertheless, these changes were accompanied by several technical problems due to insufficient initial preparation for the full launch of this new regime.⁷² Another unsuccessful measure that may be pointed out was the above-mentioned obligation for risk persons to submit a financial guarantee during the VAT registration process. Notably, this measure was also implemented in 2012 as a preventive measure and potentially compensatory measure should the taxable entity not pay the due tax. The good idea was, however, so problematic in practice that it was abolished in 2019. The problem lay in establishing the risk taxable entities⁷³ and the sum of the guarantee, which ranged from EUR 1,000 to EUR 500,000, without making the criteria publicly available and thus unreviewable and breaching the principle of legal certainty.⁷⁴

The first action plan in 2012 was followed up with the Action Plan for Combating Tax Fraud 2017–2018,⁷⁵ which added other tax measures, such as expanding the legal measures of the Financial Administration Criminal Office to support the issuance of a decision on a preliminary measure; the introduction of the Tax Reliability Index; the issuance of a summary report from the tax inspection on interconnected transactions of tax subjects, in which a violation or circumvention of tax regulations was detected; and the shortening of the assessment procedure in order to prevent its abusive prolongation by tax subjects. The so-called ‘shortened assessment procedure’ was established in 2017 to accelerate decisions on cases in which the tax entity did not cooperate in removing errors in the tax return

69 Popovič, 2018, pp. 180–181.

70 Štrkolec, 2020, p. 183.

71 Act No. 289/2008 Coll. on the use of electronic cash registers and on amendments to Act No. 511/1992 Coll. on the administration of taxes and fees and on changes in the system of territorial financial authorities, as amended.

72 Štrkolec, 2020, p. 186.

73 Among which there were also persons not yet supplying goods or services at the time of filing the application for tax registration, but only performing preparatory activities for business, which might be frequent in situations where the person needs to be VAT registered since beginning their activities.

74 Dobrovičová and Štrkolec, 2013.

75 Resolution of the Government no. 206/2017 of 26 April 2017.

(the so-called ‘assessment order’) without the need to carry out a tax audit (which was required before the amendment). However, these action plans also contained measures in the areas of criminal and commercial law; this is essential, as Štrkolec⁷⁶ emphasises that ‘as a tax evasion, but rather in an economic sense, it is also possible to perceive the ordinary insolvency of a tax entity, or the absence of a property substrate, the enforcement of which could ensure the payment of the tax, which is the final purpose of tax administration’.

Efforts to limit tax evasion were therefore clearly focused first on VAT and partly consumption taxes, and only later on preventing the evasion of direct taxes. Notably, Hrabčák⁷⁷ perceives this delay negatively. Later activities were performed as separate measures or packages of measures rather than broad action plans, where, especially within the framework of direct taxation (i.e. income tax), amendments were predominantly induced by the adoption of European legislation. We deal with these components in more detail below.

Evaluating the established trend based on objective data, since 2012, when the SR reached the maximum values in these indicators, the estimated tax gap gradually decreased from 36.7% to 12.1% in 2021 for VAT⁷⁸ and from 50% to 10.9% in 2019 for CIT,⁷⁹ indicating that measures gradually taken to reduce the incidence of tax evasion and fraud have an effect. Furthermore, making risk management more effective and intensifying the fight against tax and customs fraud is one of the four strategic goals of the Financial Administration of the SR for 2021–2024. However, the need to understand the entire spectrum of tax legislation in which the potential for tax evasion arises cannot be neglected. As stated by Štrkolec,⁸⁰ the tax legislation and financial administration do not pay adequate attention to the impact of illegal work, the Švarc system, and related questions on tax evasion in the context of income from dependent activities.

3.2. The implementation of anti-tax avoidance measures in the EU

Although the anti-tax avoidance package was introduced only in 2016,⁸¹ Slovak tax legislation in the area of income taxation began to be amended in response to aggressive tax planning even sooner. Since 2014, Act No. 563/2009 Coll. on Tax Administration (Tax Procedure Code) was supplemented by GAAR, mainly under the influence of Art. 4 paras. (2) et seq. of the Recommendation of the European Commission from 6 December 2012 in connection with aggressive tax planning

⁷⁶ Štrkolec, 2020, p. 181.

⁷⁷ Hrabčák, 2022, p. 60.

⁷⁸ *OpenData (portal of Ministry of Finance of SR)* [Online]. Available at: <https://opendata.financnasprava.sk/mi/opendata/search> (Accessed: 10 June 2023).

⁷⁹ Ministry of Finance of the Slovak Republic, 2021, p. 17.

⁸⁰ Štrkolec, 2020, p. 188.

⁸¹ For more details, see: Bonk and Románová, 2018, p. 227.

(C(2012) 8806 final),⁸² which, even though ambiguous in interpretation,⁸³ can be considered ground-breaking in terms of addressing aggressive tax planning.⁸⁴ Newly introduced were an increased withholding tax rate and an increase in the amount of tax security (35%) for taxpayers from the so-called non-treaty states.⁸⁵ Additionally, this regulation also expanded the concept of the real employer to cover individuals performing work for an employer on his behalf and under his responsibility without being expressly obliged to comply with his instructions and orders – this configuration allows for the evasion of tax obligations by abusing the exception specified in Art. 15 para. (2) of the relevant double taxation treaty through the so-called international hiring of labour ('hiring-out of labour'). Since 2015, thin capitalisation rules have been introduced and in 2016 a new anti-abuse provision in relation to dividend taxation⁸⁶ was introduced as one of the 'post-BEPS' measures under Directive (EU) 2015/121 amending the Parent and Subsidiary Directive; moreover, for dividends, in the next period, the regulation was further tightened (e.g. by increasing the level of taxation in relation to non-contracting states from 2017). The business conditions of related entities (transfer pricing) also gradually tightened. The SR also became a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), resulting from Action 15 BEPS on 15 June 2017, which came into effect on 1 January 2019, and which was implemented in the SR through separate amendments to pre-existing contracts.

The ATAD I directive adopted in 2016 was implemented in the Slovak legal system ahead of the deadlines specified in the directive. The CFC rules came into effect in 2019 and the rest as early as 2018. Thus, new institutes entered the Slovak legal system, particularly exit taxation, CFC rules, and hybrid mismatches. The existing GAAR was revised, and as far as the thin capitalisation rules were concerned, these were left to the extent that they had been introduced in 2015. In the last case (the transposition of Art. 4), the option from Art. 11 para. (6) of the directive – namely, to keep existing national rules within the provisions of Art. 21a of the Income Tax Act – was communicated with the European Commission. This was due to minor differences between the directive's rules and the Slovak adaptation of the thin capitalisation rules. For example, the Slovak Income Tax Act has a slightly stricter fixed test than the one in the ATAD Directive (25% instead of 30% of EBITDA) and a narrower

82 Bonk and Románová, 2018, pp. 216–217.

83 Románová, 2015; Bonk, 2016.

84 Hrabčák, 2022, p. 61.

85 Some states are not listed on the so-called 'white list' maintained by the Ministry. This list contains states with which the SR has concluded a double taxation treaty or a treaty on the exchange of information related to taxes and states that are contracting states of a treaty containing provisions on the exchange of information for tax purposes. Bonk and Románová, 2018, p. 219.

86 'If the taxpayer obtains a share of the profit on the basis of a measure or several measures, which, taking into account all the related facts and circumstances, cannot be considered real for the purposes of this Act and their main purpose or one of the main purposes is to obtain an advantage for the taxpayer, which is contrary to the object or purpose of this Act, this share of the profit is subject to tax.' Art. 50a of the Income Tax Act.

scope of coverage (the Slovak rule applies exclusively to ‘credits and loans’, while the ATAD includes ‘all forms of debt’).⁸⁷

The Slovak legislator included exit taxation in the Income Tax Act by means of a special tax base in the sense of adhering to the ‘minimum standard of protection’ enshrined in the directive. Meanwhile, the national legislation thoroughly reflects Art. 5 of the directive and its individual paragraphs. As part of the consultations during the legislative process, the most serious questions emerged as to how fair value would be calculated, what would actually be taxed, and whether ‘tax security’ would be paid at the time of departure, as the tax could also be paid in instalments. In the case of the SR, the possibility of establishing a tax lien is preferred. In addition to the high interest burden, the inconsistency of the ‘special’ legal regulation of exit tax also lies in the inconsistent application of both the special regulation (deferral of tax payment) and the general regulation of the Tax Procedure Code (interests).⁸⁸

The most significant criticism⁸⁹ was directed at the revision of the existing GAAR (which was criticised even before this amendment), which came into effect on 1 January 2018; specifically, the wording of this revision⁹⁰ did not correspond to the recommended wording of the directive – it went significantly beyond its scope based on the fact that it is enough that tax evasion is at least one of the purposes of the transaction even if it is not a fundamental one. Such interpretive ambiguity strengthens the position of tax administrators when assessing borderline situations and, on the contrary, makes the position of the taxpayers more difficult when exercising their rights, as it significantly extends the interpretation of the purpose test.⁹¹ Kačaljak⁹² points out that there may be potential problems in the context of double taxation treaties (e.g. possible exclusion of the application of such a treaty).

As far as the implementation of the rules for hybrid mismatches is concerned, despite the fact that the second sentence of point 4 of the directive clearly states that it is not desirable to extend the scope of this directive to types of entities that are not subject to corporate income tax in the relevant Member State (as it also admits in the explanatory report), in the partial regulation of hybrid mismatches of Art. 9, this rule was implemented for all taxpayers who determine the tax base according to Art. 17 para. (1) of the Income Tax Act, including natural persons; however, it only applies to situations that arise between controlled persons (natural and legal persons) and its purpose is to prevent tax evasion.⁹³

87 Kačaljak, 2017, pp. 198–199.

88 Bonk and Románová, 2018, pp. 233–234.

89 See, for example: Bonk, 2018a, pp. 54–55.

90 ‘For a legal act or several legal acts or other facts performed without a proper business reason or another reason that does not reflect economic reality and at least one of the purposes of which is to avoid the tax obligation or to obtain a tax benefit to which the tax subject would not otherwise be entitled, shall not be taken into account in tax administration.’ Art. 3 para. (6) of the Tax Procedure Code.

91 Babčák, Sábo and Štrkolec, 2018, p. 136; Bonk, 2018b.

92 Kačaljak, 2017, p. 196.

93 Vartašová, 2020, p. 253.

Another new introduced rule was that for controlled foreign companies that functioned as a special rule against abuse.⁹⁴ During the implementation, the transaction principle was chosen and not the categorical one, although the definition of the mechanism which is not real used in the directive is ambiguous and complex, and Kačaljak⁹⁵ suggests evaluating the categorical approach as a simpler, more unambiguous and administratively less demanding criterion. The SR chose this option to prevent tax evasion, as it did not consider it appropriate to apply the exceptions specified in Art. 7 para. (4) of the directive, which allows foreign companies or permanent establishments to be excluded from this rule if they reach the amount of accounting profit established by the directive. The tax base of the taxpayer, a Slovak legal entity, will thus include the tax base of the controlled foreign company to the extent that it is attributable to the assets and risks related to the performance of significant functions by the taxpayer who manages and controls the controlled foreign company. The Ministry justified this, stating that the transactional approach is more suitable for promoting SR as an environment favourable to holdings.⁹⁶ In accordance with the objectives of the directive, this rule was also not applied to natural persons, despite attempts to go in this direction in the legislative process and a lack of negative evaluations of such an expansion.⁹⁷ This regime has changed since 2021, when the CFC rules were extended to natural persons; the latest development is the re-exclusion of the application of the CFC rules for natural persons, which came into effect on 1 August 2023.

As an amendment to the ATAD, the ATAD II extended the anti-avoidance rules to hybrid mismatches with third countries. As with ATAD I, the directive was transposed in the case of the SR early on 1 January 2022 as the ATAD II set a deadline of 31 December 2021 and planned for it to take effect on 1 January 2024. With this new amendment, taxation of the income of a domestic transparent entity was introduced; this taxation is in part attributable to the partner or recipient of this income, in which it is not taxed according to Slovak or foreign tax regulations if the domestic transparent entity is a reverse hybrid subject.⁹⁸

3.3. Information exchange and mandatory disclosure rules as tools for fighting tax avoidance and fraud

Tax evasion and avoidance represent a problem as a result of which individual states lose a substantial part of their revenue, as taxes represent the main revenue to the state budget.⁹⁹ The exchange of information is of paramount importance in taxation, and Slovakia's membership in the EU has increased tax revenues, at least initially. Between 2005 and 2008, the overall financial efficiency

94 Duračinská and Duračinská, 2017, p. 125.

95 Kačaljak, 2017, p. 202.

96 Kačaljak, 2017, p. 202.

97 See, for example: Kačaljak, 2017, p. 202; Bonk and Románová, 2018, p. 240.

98 For more, see: Vartašová, 2020, pp. 258–259.

99 Čunderlík and Szakács, 2023, p. 13.

of the information exchange carried out by the Slovak Tax Directorate grew by an annual average of almost 50% (from SKK 192 million in 2005 to SKK 740 million in 2008).¹⁰⁰

The history of modern international assistance and cooperation in the administration of taxes (in the EU context) began in 2012, when an eponymous act was adopted in Slovakia (Act No. 442/2012 Coll. on international assistance and cooperation in the administration of taxes) to implement the then-new Council Directive no. 2011/16/EU on 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC (i.e. DAC 1) in the SR. Its amendments, DAC 2 to DAC 7, were implemented between 2015 and 2022 under the newly adopted Act No. 359/2015 Coll. on the automatic exchange of information on financial accounts for tax administration purposes, amending certain acts,¹⁰¹ and amending Act No. 442/2012 Coll.¹⁰² and the Tax Procedure Code.¹⁰³ Čunderlík and Szakács discuss the main aspects of these regulations in detail.¹⁰⁴ What is important to note here for our purposes is that, together with the Convention on Mutual Administrative Assistance in Tax Matters, which was ratified by Slovakia in 2013 and has been effective in the SR since 1 January 2015, and the system of bilateral double taxation treaties and tax information exchange agreements,¹⁰⁵ these changes gave rise to a complex system of mutual cooperation among states in taxation matters.

Between 2012 and 2017, the direct financial effectiveness of the international exchange of information achieved by the Slovak tax administration, based on the amount of additional tax levied (or reduced entitlement to excessive deductions) and penalties determined based on information obtained through the international exchange of information, increased from EUR 21.88 million to EUR 155 million. Although there has been a slight downward trend over the last four years, the annual positive effects (approximately EUR 52 million, on average) indicate the power of international cooperation. Traditionally, the largest exchanges of information have occurred with Hungary, the Czech Republic, Germany, and Poland.¹⁰⁶ However, the presented data do not contain the effects of tax liability enforcement with the assistance of foreign authorities. Above all, the indirect and incalculable yet highly significant effect of international information exchange is its preventive effect and

100 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2006 and of 2008.

101 DAC 2 and the Foreign Account Tax Compliance Act (FATCA).

102 DAC 3, DAC 4, DAC 6 and DAC 7.

103 DAC 5.

104 Čunderlík and Szakács, 2023, p. 13.

105 Slovakia expressed a few reservations, especially towards social security contributions, local taxes, real estate taxes, gift and inheritance taxes, and other tax categories.

106 Financial administration of the Slovak Republic, Annual reports between 2012 and 2022. See: *Výročné správy FS* [Online]. Available at: <https://www.financnasprava.sk/sk/financna-sprava/vyroczne-spravy/1> (Accessed: 10 June 2023).

promotion of voluntary compliance with tax obligations.¹⁰⁷ Thus, the aim of fighting tax evasion and avoidance is achieved through both the direct and indirect effects of such regulations. However, the potential of automatic information exchanges has not yet been realized. As was concluded in the Report from the Commission to the European Parliament and the Council on overview and assessment of the statistics and information on the automatic exchanges in the field of direct taxation (COM/2018/844 final), the SR spent a large amount of money on systems ensuring the automatic exchange of information, but did not do enough with the information obtained; for example, it did not evaluate this information sufficiently and did not use it to verify the facts relating to the taxpayer's tax affairs.¹⁰⁸

The most effective tool for fighting tax evasion seems to be the automatic exchange of information in the field of taxation as a form of administrative cooperation.¹⁰⁹ The most recent DAC amendments (6, 7, and 8) were targeted at automatic exchanges of particular information (DAC 6 on cross-border reportable arrangements, DAC 7 on the income of active sellers achieved through digital platforms, and DAC 8 on taxpayers using crypto assets and electronic money).

DAC 6 was transposed into the Slovak legal system under Act No. 305/2019 Coll., which amended Act No. 442/2012 Coll. and took effect between 1 January and July 2020. It introduced automatic exchanges of information between competent authorities of EU Member States on cross-border measures subject to notification; that is, measures related to potentially aggressive tax schemes that could lead to tax evasion or fraud. Information about such cross-border measures, which meet at least one distinctive feature defined for this purpose (listed in Annex No. 1a), must be submitted by so-called 'obliged persons' – that is, an intermediary or a taxpayer; thus, these measures primarily affect tax advisers or lawyers.

In preparing for the fulfilment of the new obligations of financial administration resulting from the amended directive, the Ministry assumed that these obligations would have both positive and negative effects on the budget and the business environment. On the state expenditure side, in addition to new wage expenditures, there was a plan to build a system within the Financial Directorate of the SR that would receive information from obliged persons and send and exchange this information with competent authorities of other Member States. Capital expenditures of EUR 2.5 million and, as a potential benefit, sanctions for breach of obligations and limitations on aggressive cross-border tax planning were identified. The obligation to provide information on cross-border arrangements subject to notification was intended to deter intermediaries and taxpayers from using potentially aggressive tax

107 Financial administration of the Slovak Republic, Annual reports of 2014 and 2015. See: *Výročné správy FS* [Online]. Available at: https://www.financnasprava.sk/sk/financna-sprava/vyroczne-spravy/_1 (Accessed: 10 June 2023).

108 Koroncziová, Cibula, and Hlinka, 2019, p. 217.

109 Čunderlík and Szakács, 2023, p. 13.

planning practices, thereby achieving fair taxation and increasing tax transparency. According to official documents, this issue is a priority for the SR.¹¹⁰

Meanwhile, regarding, the legislation itself, it is a transposition of the law in which national legislation does not exceed the minimum requirements of the EU. As part of the consultations for the preparation of the draft law, the most significant comments concerned the preservation of the obligation to maintain the confidentiality of consultancy providers – that is, intransigence; in particular, these comments were raised by professional organisations, such as those of lawyers and tax advisors, and chambers of commerce.¹¹¹ Indeed, in accordance with the wording of the directive, each Member State can take the necessary measures on the basis of which intermediaries are granted the right to an exemption from providing information on a cross-border measure subject to notification if the notification obligation violates that of confidentiality under the national legislation of the given Member State and, at the same time, takes the necessary measures to obligate intermediaries to immediately inform every other intermediary (or relevant taxpayers) about their obligation to report information. Therefore, in Slovak legislation, the intermediary is not an obligated person if the notified measure is subject to the obligation to maintain confidentiality according to special regulations¹¹² or a similar obligation in another Member State. In such a case, it is obliged to immediately inform all intermediaries involved in the notified measure about their obligation to submit information about the notified measure, to the extent established by law, to the competent body of the SR. Ultimately, if all intermediaries involved in the notified measure are obliged to maintain the confidentiality of the notified measure, then the user (not the intermediary) becomes the obliged person. Similarly, Slovak legislation, in accordance with the mandate of the directive, enshrined that if several intermediaries who are obliged persons are involved in the same notified measure, all intermediaries are obliged to submit information about the notified measure to the competent authority of the SR.

DAC 7 was transposed by the SR and came into effect on 1 January 2023 with Act No. 250/2022 Coll., which amended Act No. 442/2012 Coll. This change also partially affected the Tax Procedure Code regarding the joint controls mentioned below. This change follows the previously discussed dynamic development in the field of the automatic exchange of information and introduces a new type of automatic exchange of information related to sellers' use of platforms to help tax administrators correctly calculate the taxable income of persons who make sales via digital platforms without a physical presence. Specifically, it introduces the obligation of required platform operators to collect and provide information about notifiable sellers, who actively

110 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2018, p. 22.

111 Explanatory report to the draft of Act No. 305/2019 Coll., p. 10.

112 See, for example: Act no. 78/1992 Coll. on tax advisors and the Slovak Chamber of Tax Advisors, as amended, Act No. 586/2003 Coll. about advocacy.

sell goods and provide services through platforms, whether the platform facilitates the sale of goods, the rental of means of transport and real estate, or the provision of various services (e.g. accommodation, transport, catering), to the competent authority of the SR.¹¹³ The goal of these changes is to increase tax transparency and improve the functioning of existing administrative cooperation tools in the context of economic digitalisation. The introduction of the Institute of Joint Control is also significant. When the directive was adopted, Slovakia supported these changes and provided a compromise. The SR supported the expansion of the substantive scope of the directive to include information on sellers and their platform-based income, considering it a valuable source of information to ensure the fulfilment of tax obligations. Further, the SR particularly welcomed the introduction of a new tool of closer cooperation between Member States in the form of joint controls.¹¹⁴

According to the explanatory report on the bill of Act No. 250/2022 Coll., national legislation does not go beyond the minimum requirements of the EU. This was a complete or minimal transposition of the EU legislation directive. The bill assumed both positive and negative effects on the state budget and business environment. This legal regulation should have a significant positive impact on the state budget because controlling taxpayers' fulfilment of their tax obligations was limited by the lack of information necessary to verify whether they also declared income obtained through digital platforms. A positive impact on the state budget can be expected both within the framework of the verification of received information (not only from abroad but also from platforms in the SR used by Slovak sellers) and within the framework of the voluntary fulfilment of tax obligations, as taxpayers will be informed that the financial administration will have information about their income earned through digital platforms and will declare and tax this income in its interest. The received information can also be used to check the declared and paid VAT, as well as to check local taxes.

Another source of increased income could be the revenue from the imposed sanctions. The expected cost of the changes in the relevant electronic systems was calculated to be over EUR 1.2 million. In relation to the business environment, the changes are expected to increase the administrative burden due to the expansion of information obligations, regarding which Priateľová¹¹⁵ emphasises the difficulty of the in-depth verification process. A positive impact on the business environment is expected in the form of increased legal certainty for platform operators (and sellers), as reporting rules in all Member States have been unified and unilateral reporting obligations, introduced by some Member States in the past, have been eliminated.

The last proposal is the DAC 8, which addresses the automatic exchange of information on taxpayers using cryptographic assets and electronic money. This proposal

113 See, for more detail: Priateľová, 2021.

114 Ministry of Foreign and European Affairs of the Slovak Republic, Annual report on the membership of the Slovak Republic in the European Union of 2020, Appendix, p. 65.

115 Priateľová, 2021, p. 299.

responds to the latest developments in the field of investments. This directive prioritises tax transparency, which is a basic condition for an effective fight against tax fraud, tax evasion, and avoidance of tax obligations, as well as tax equity, the creation of equal conditions, and better and more efficient tax collection in Member States.¹¹⁶

The SR published a preliminary opinion on the original proposal of the Council Directive, amending Directive 2011/16/EU on administrative cooperation in the field of taxes,¹¹⁷ on 16 March 2023 (LPEU/2022/729). According to this, the SR generally supports the goals of the directive and positively perceives the inclusion of the revision of the CRS in the draft directive, as well as the expansion of the scope of the standard to include electronic money; however, the SR also raised several concerns.¹¹⁸ On the one hand, it was in favour of harmonising the wording of the proposed directive with the international standard (OECD CARF) as much as possible to avoid excessively increasing the administrative burden of the financial administration and reporting operators of crypto asset services (due to the fundamental differences between the two frameworks), arguing that since the OECD rules represent a compromise reached at the international level, deviations from these rules would make international cooperation in practically implementing these rules inefficient.¹¹⁹ It preferred to leave the area of sanctions in the competence of the Member States, who would determine the amount of sanctions in accordance with national principles and adapt it appropriately to the financial situation in the economy, especially because the proposed minimum sanctions were significantly higher than those currently applied in the relevant (Slovak) legal regulations. Further, there were also reservations about the proposed definitions of the terms ‘wealthy individuals’ and ‘non-custodial dividend income’; specifically, critics argued that these terms were too general and must be clarified to enable their practical applications. The SR also requested that the automatic exchange of information about life insurance products not be mandatory (the Slovak Financial Administration currently does not have the required information on the increase in the administrative burden available). Additionally, the SR asked to keep the existing wording in Art. 8 so that Member States should strive to exchange data on VAT numbers, but not absolutely, since these are not always available. Regarding the proposed obligation for Member States to send a list of purposes to other Member States, the SR held a reserved position, since the introduction of the possibility to voluntarily send such a list is only valid from January 2023 and no information is yet known about its practical use by the Member States. The SR considers it a more appropriate solution to keep the existing wording of the DAC 7 directive, which includes the possibility for the Member State to send

¹¹⁶ For more details, see: Szakács, 2021.

¹¹⁷ COM(2022) 707 final, p. 54.

¹¹⁸ Several fundamental comments were raised by the Club 500 (all of which were accepted and incorporated into the opinion of the SR).

¹¹⁹ However, slight deviations can be considered given the close connection of the draft directive with the EU regulation (MiCA).

such a list of other purposes if it decides to do so after evaluating the benefits and costs. It also evaluated how the submission of efficiency evaluation reports would increase the administrative burden. The resulting costs for financial administrative and business entities were not specified; the SR only concluded that it expected the directive to increase the burden (e.g. state costs for computerisation, costs for entrepreneurs to fulfil their obligations, applied sanctions). Meanwhile, the SR did anticipate that the directive will impact competitiveness and productivity, as the introduction of automatic exchanges of information by service providers of crypto assets did not create barriers in the market.

In May 2023, the finance ministers reached a compromise on the wording of the draft directive, which implemented the OECD rules for reporting crypto assets, skipping the provisions on the harmonisation of minimum sanctions. Moreover, the disputed provision on the exchange of advance cross-border rulings in relation to wealthy individuals was replaced by rulings in relation to the transactions above the set limit and those that determine whether the given person is considered a tax resident (the time frame of the issued ruling was also changed). DAC 8 will go into effect on 1 January 2026 with a few exceptions, with these excepted elements coming into effect between 1 January 2028 and 2030.

3.4. Peculiarities in domestic legislation:

Rules that apply in addition to or that deviate from EU laws

Regarding the tools for the fight against tax avoidance, beyond the framework of EU law implementation, we highlight three types of measures. The first set comprises those that actually existed in the tax legislation or were added not only as special tools to fight against tax evasion but also to secure the general purpose of tax administration (levying and collecting taxes in an appropriate and timely manner). For example, these measures influenced tax auditing institutes, tax enforcement (which was extended in 2020 by the new method of withholding of driving licences), various security institutes (e.g. liens), the securing and forfeiture of property, interim measures,¹²⁰ assessment of tax by so-called ‘tools’, and the simplified assessment procedure implemented in 2017. The second set comprises those that were implemented following international initiatives like the BEPS Project,¹²¹ such as tightening transfer pricing rules or refining the definitions of permanent establishments (e.g. construction sites, agencies, digital PE) and taxing gains from virtual currencies. The third set comprises so-called ‘motivation measures’ or the pro-client approach towards taxpayers by which tax administrations not only sanction law-breaching taxpayers but also motivate taxpayers who are or may be willing to follow the rules. Here, we may mention measures such as the implementation of the Tax Reliability Index in 2018, which enables the assessment of tax entities based on their compliance

120 See: Štrkolec, 2017.

121 For more, see: Vartašová, 2020, pp. 264–265.

with their obligations to the financial administration (based on which they are entitled to preferential treatment, e.g. more favourable time periods, individualised payment of advance tax, preference of other means instead of tax enforcement, preferring local enquiry over tax audit). The list of reliable taxpayers has been made public since 2021; this may also have had a motivating effect. Another measure that may be mentioned is the reduction of sanctions in the case of filing a supplementary tax return after the start of a tax audit, applicable from 2016. As of 2024, a new regulation will enter into force, which will introduce a so-called ‘second chance for fines’; that is, tax authorities will first send taxpayers a warning about failing to fulfil their tax obligations instead of immediately sanctioning them.

4. Conclusions

Tax sovereignty is an important element of state sovereignty. A state’s tax sovereignty may be thrown into question when a state becomes part of a broader community – an organisation of more states. This is the case with the EU’s Member States. Based on the history of the SR’s membership in the EU, we conclude that the SR has generally supported EU activities. Regarding taxation, the SR has generally perceived EU initiatives with a positive attitude and thus largely supported EU tax-related proposals – more precisely, the SR’s attitude may be understood as ‘support with a bit of caution’, as the SR has also kept in mind the economic effects of the proposed/adopted legislation. This chapter discussed a few examples of the SR’s resistance to the EU’s amendments to the status quo (e.g. CCTB project). However, it must be made clear that the SR does not typically demonstrate this resistance and instead generally holds a welcoming attitude towards most of the EU’s legislative tax proposals, even in the sphere of direct taxes, which has attracted increased attention in recent years. Ultimately, the SR seems to hold the attitude that most EU activities do not hinder its tax sovereignty but represent coordinated collective steps in its exercise.

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SLOVENIA: CHALLENGES OF SOVEREIGNTY, LUKEWARM IMPLEMENTATION OF EU TAXATION RULES



RADO BOHINC – DUŠAN JOVANOVIČ

Abstract

This chapter provides an in-depth exploration of the intricate relationship between tax policy, national sovereignty, and competition in Slovenia, with a specific focus on relevant case law and court decisions. As an European Union (EU) Member State, Slovenia grapples with the dual challenges of harmonising its tax policies with EU directives and preserving its national sovereignty and economic competitiveness. Similar to other EU members, Slovenia is deeply influenced by supranational tax regulations that aim to create a unified market and prevent harmful tax practices. These regulations have led to significant national legal developments, with court decisions related to the interpretation and implementation of EU tax directives shaping the country's tax policy landscape. For instance, the Court of Justice of the European Union (CJEU) has rendered judgments that impact Slovenia's approach to tax policy, making it necessary for the country to navigate EU legal interpretations while preserving its national sovereignty. Furthermore, domestic courts in Slovenia have played a crucial role in shaping tax policy through their interpretation of national tax laws and alignment with EU principles. Case law on issues such as transfer pricing, cross-border taxation, and tax evasion has significantly influenced the way Slovenia frames its tax regulations. Court decisions often play a pivotal role in defining the extent to which national sovereignty can be preserved while adhering to EU directives. Simultaneously, the Slovenian government acknowledged the importance of tax competitiveness in attracting foreign investment and promoting

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domestic entrepreneurship. This chapter examines the multifaceted nature of tax policy in Slovenia by considering the roles of case law and court decisions in shaping the landscape. By examining relevant case law, this study aims to provide a comprehensive analysis of the legal dynamics that underpin Slovenia's tax policy, offering insights into the country's economic future and ability to navigate the challenges of EU membership.

Keywords: *tax sovereignty, tax competition, tax harmonisation, property taxes, income taxes, global minimum tax, corporate income tax*

1. Elements of Slovenian Tax Sovereignty

1.1. Theoretical foundations of Slovenian tax sovereignty

'Tax sovereignty' refers to a government's exclusive authority to levy taxes within its territorial jurisdiction.¹ This principle is crucial for a state's effective operation, enabling it to generate the requisite revenue to provide public services and goods. Tax sovereignty is usually firmly established within a state's constitution, forming a part of its broader sovereign rights.²

The basis of tax sovereignty in the Republic of Slovenia can be found in Arts. 146 and 147 of its Constitution (Ustava RS).³ The first paragraph of Art. 146 stipulates that both the Republic of Slovenia and local communities fund their obligations through taxes, compulsory fees, and income from their assets. Art. 147 mandates that Slovenia establish taxes, customs duties, and other obligations through legislation, with local communities enacting such measures within the confines set by the constitution and laws. These articles underpin Slovenia's tax sovereignty and serve as the legal foundation for key tax laws enacted under the authority of the Slovenian Constitution, including the Corporate Income Tax Act (Zakon o davku od dohodkov pravnih oseb – ZDDPO-2)⁴, Personal Income Tax Act (Zakon o dohodnini – ZDoh-2)⁵,

1 For more about tax sovereignty, see: Dagan, 2021, pp. 319–320; Mota Lopes and dos Santos, 2016.

2 Rocha and Christians, 2017.

3 Constitution of the Republic of Slovenia (Ustava Republike Slovenije), Official Gazette of the RS, no. 33/91–I, 42/97 – UZS68, 66/00 – UZ80, 24/03 – UZ3a, 47, 68, 69/04 – UZ14, 69/04 – UZ43, 69/04 – UZ50, 68/06 – UZ121,140,143, 47/13 – UZ148, 47/13 – UZ90,97,99, 75/16 – UZ70a and 92/21 – UZ62a).

4 Corporate Income Tax Act (Zakon o davku od dohodkov pravnih oseb), Official Gazette of the RS, no. 117/06, 56/08, 76/08, 5/09, 96/09, 110/09 – ZDavP–2B, 43/10, 59/11, 24/12, 30/12, 94/12, 81/13, 50/14, 23/15, 82/15, 68/16, 69/17, 79/18, 66/19, 172/21 and 105/22 – ZZNŠPP.

5 Personal Income Tax Act (Zakon o dohodnini), Official Gazette of the RS, no. 13/11, 9/12 – odl. US, 24/12, 30/12, 40/12 – ZUJF, 75/12, 94/12, 52/13 – odl. US, 96/13, 29/14 – odl. US, 50/14, 23/15, 55/15, 63/16, 69/17, 21/19, 28/19, 66/19, 39/22, 132/22 – odl. US in 158/22.

Value Added Tax Act (Zakon o davku na dodano vrednost – ZDDV-1)⁶, and Tax Procedure Act (Zakon o davčnem postopku – ZDavP-2).⁷ However, it is essential to consider Slovenia's tax sovereignty in the context of EU and international law. Although Slovenia has the authority to independently shape its tax policies and manage its tax system, its tax sovereignty is not absolute.

Art. 3a of the Slovenian Constitution lays the foundation for international engagement, such as EU or NATO membership. This article permits Slovenia to delegate sovereign rights to international organisations through ratified treaties, provided they uphold human rights, democracy, and the rule of law. More importantly, the third paragraph of the same article states that legal acts and decisions from these international bodies should be integrated into Slovenian law, respecting the regulations of these organisations. This arrangement implies that the extent of Slovenia's sovereignty is defined not only by its laws but also by international organisations, especially the EU, to which Slovenia belongs. In the EU, tax sovereignty balances the Member States' autonomy in shaping tax policies with the need for coordination to prevent unfair tax practices and facilitate a single market.

Within the realm of taxation, various EU regulations and directives aim to ensure fair competition and discourage harmful tax practices. Key examples include the VAT Directive 2006/112/EC and Directives 91/680/EEC, 92/111/EEC, 2008/8/EC, 2008/9/EC, 92/77/EEC, 2008/118/EC, 92/83/EEC, 92/84/EEC, 2011/64/EC, 2003/96/EC, and exceptions to directives 2004/74/EC and 2004/75/EC. Directives 90/434/EEC (now 2009/133/EC), 90/435/EEC (now 2011/96/EU), and 90/436/EEC pertain mostly to corporate income tax. These measures aim to prevent member states from using their tax policies to gain unfair advantages or to erect trade barriers. Recent discussions within the EU have revolved around enhanced tax coordination, including proposals for minimum effective tax rates, digital services taxation, and a common corporate tax base, all geared toward combating tax avoidance and ensuring equitable taxation across member states. In the future, as the EU looks to extend its tax law regulations, concerns about tax sovereignty, especially among smaller member states, are likely to arise.

Beyond the EU, tax sovereignty operates in the context of international agreements, treaties, and organisations, particularly in the field of double taxation.⁸ Nations often engage in international efforts to address tax-related issues, striking a balance between sovereignty and cooperation, while preventing harmful tax practices. In turn, these agreements impose constraints on states' tax sovereignty.

6 Value Added Tax Act (Zakon o davku na dodano vrednost), Official Gazette of the RS, no. 13/11, 18/11, 78/11, 38/12, 83/12, 86/14, 90/15, 77/18, 59/19, 72/19, 196/21 – ZDOsk, 3/22, 29/22 – ZUOPDCE in 40/23 – ZDavPR-B.

7 Tax Procedure Act (Zakon o davčnem postopku), Official Gazette of the RS, no. 13/11, 32/12, 94/12, 101/13 – ZDavNepr, 111/13, 22/14 – odl. US, 25/14 – ZFU, 40/14 – ZIN-B, 90/14, 91/15, 63/16, 69/17, 13/18 – ZJF-H, 36/19, 66/19, 145/20 – odl. US, 203/20 – ZIUPOPdVE, 39/22 – ZFU-A, 52/22 – odl. US, 87/22 – odl. US, 163/22 in 109/23 – odl. US.

8 Kostanjevec, 2014, p. 29.

1.2. Problems, peculiarities, and reforms of Slovenian tax law concerning tax competition

This subsection analyses the key problems and peculiarities of Slovenian tax law, considers tax competition, and highlights the key elements thereof, which are more or less the subject of most tax reforms but which have not yet been addressed by solid, long-term, and effective solutions.

1.2.1. Tax competition

In general, it is important to emphasise that tax competition is a question for which no definite answer has been given.⁹ Tax competition occurs when countries adjust their tax policies strategically to attract businesses, investments, and individuals. This involves reducing tax rates or offering tax incentives to make their tax policies more appealing than those of other jurisdictions. Tax sovereignty allows countries to adopt tax policies that they believe will best serve their interests. This includes implementing tax measures to attract investments, encourage business activities, and promote economic growth. Therefore, tax competition can be viewed as a manifestation of tax sovereignty.¹⁰

However, tax competition can challenge tax sovereignty. Intense tax competition among countries can lead to a ‘race to the bottom’, in which countries continuously lower their tax rates or provide excessive tax incentives to compete with each other. The most recognisable manifestations of Slovenia’s wish to develop a competitive tax system are its recent tax reforms, which were intended to address critical tax issues. The most important reforms are presented below.

1.2.2. Property taxes

One of the main issues with Slovenia’s tax system is its low property tax rates – put simply, it imposes minimal taxes on real property. Compared to other EU members, Slovenia has the fifth-lowest property tax rate as a percentage of GDP among the EU 27.¹¹ On average, property taxes in the EU account for 1.8% of GDP, with France having the highest rate at 4.0%. Slovenia’s rate is much lower, at 0.6% of GDP¹², which yield EUR 280 million annually. Most of this revenue comes from the Tax on the Use of Building Land (Nadomestilo za uporabo stavbnega zemljišča – NUSZ), which amounts to about 0.15% of a property’s value.¹³ Notably, this tax applies to all properties regardless of how they are used.

⁹ Wilson, 1999, pp. 269–304.

¹⁰ Genschel and Schwarz, 2011, p. 340–342.

¹¹ *Tax on Property* [Online]. Available at: <https://data.oecd.org/tax/tax-on-property.htm> (Accessed: 30 October 2023).

¹² Ibid.

¹³ Finančne Uprave Republike Slovenije, 2023.

International organisations such as the OECD,¹⁴ IMF,¹⁵ European Commission, and local businesses have been urging Slovenia to increase property taxes and reduce labour-related taxes and contributions for over 15 years. Accordingly, Slovenia has made several attempts to address its property taxation system. The first effort was the 2013 tax reform, which led to the Real Property Tax Act (Zakon o davku na nepremičnine – ZDavNepr)¹⁶. Unfortunately, the Constitutional Court of Slovenia declared this law unconstitutional.¹⁷ In late 2017, a new Real Property Mass Valuation Act (Zakon o množičnem vrednotenju nepremičnin – ZMVN-1)¹⁸ was introduced as a step toward implementing a real property tax again. Other regulations, such as the Real Property Registration Act, support this goal.

Until now, the only real property tax paid by property owners was the aforementioned Tax on the Use of Building Land. However, in the current system, some property owners do not pay for the use of building land, whereas others – mainly those in the business sector – pay excessively. Local communities have significant discretion in these matters, and their decisions often depend on local needs.

Even now, the question of the real property tax remains significant. The current government plans to implement tax reforms on real property by 2024. Interestingly, representatives of the Slovenian government plan to maintain existing taxes on building land use. This suggests that the upcoming regulations may not be sufficiently comprehensive.¹⁹ Some oppose the introduction of the tax, while others question its model; however, representatives of the real business sector support it.²⁰

Taxation affects not only real property but also corporate assets. Until the end of 2023, bank balance sheets were not subject to taxation. However, the taxation of bank balance sheets at 0.6% was proposed as a temporary measure to support the state budget during the period of high inflation and catastrophic floods that occurred in Slovenia in August 2023. This means that reform is not a strategic move but rather a move to improve and solve²¹ temporary budget problems.

Individual deposits are also tax-free, and interest on deposits is currently untaxed, especially when interest rates are 0%. Gains from securities are also not taxed as long as no profits are realised upon sale. When buying automobiles, a one-time motor vehicle tax (DMV) is imposed, and there is no further ongoing taxation.

14 OECD, 2014.

15 *Republic of Slovenia: Staff Concluding Statement of the 2022 Article IV Mission*, 2022.

16 Real Property Tax Act (Zakon o davku na nepremičnine), Official Gazette of the RS, no. 101/13 in 22/14 – odl. US.

17 Constitutional Court Decision about repeal of Real Property Tax Act and Real Property Mass Valuation Act, p. 2549, no. U-I-313/13-86.

18 Real Property Mass Valuation Act (Zakon o množičnem vrednotenju nepremičnin), Official Gazette of the RS, no. 77/17, 33/19, 66/19 in 54/23 – odl. US.

19 Kozorog Blatnik and Daugul, 2023.

20 *Gospodarska zbornica Slovenije*, 2023.

21 *Prispevek bank za obnovo Slovenije*, 2023.

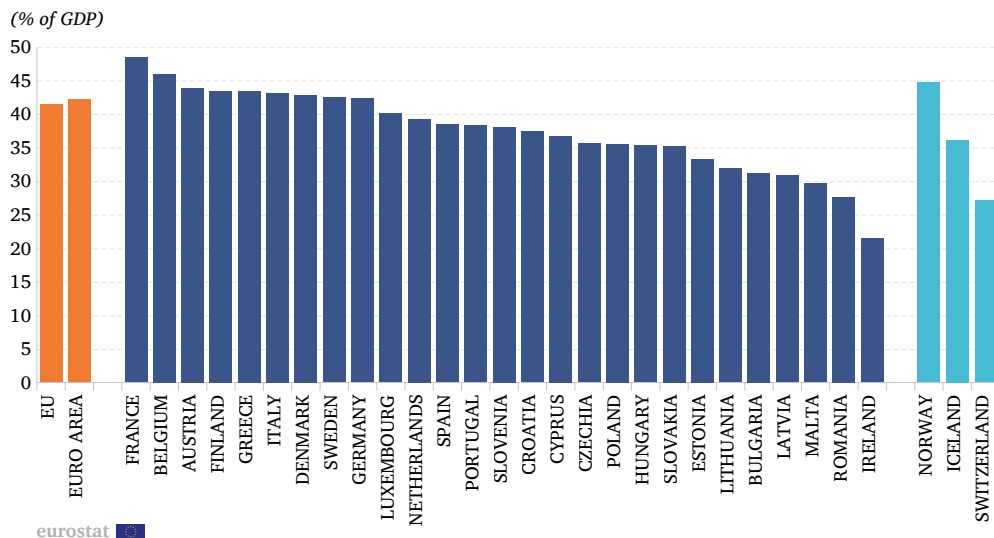
Overall, it is clear that Slovenia has no long-term strategy for property taxation, especially regarding real property – however, property taxation remains an important category for improving Slovenia's tax competitiveness.

1.2.3. Income taxes

1.2.3.1. A general overview of income taxes in Slovenia

In Slovenia, revenues from employment relationships in 2023 are subject to various contributions and taxes at rates of 6.36% for health insurance, 15.5% for pension insurance, 0.14% for unemployment, and 0.10% for parental care (22.10% in total). Additionally, wages are subject to income tax depending on the salary and a proportional progressive 5-tier tax scale (ranging from 16% for a net annual tax base of EUR 8,755 to 50% for an annual net tax base exceeding EUR 74,160). This calculation considers general tax relief, as well as personal and specific tax exemptions. Employers pay social, pension, and health contributions and taxes at a combined rate of 16.1%. Labour costs (from the 2022 table) will further increase in 2023, leading to an additional increase in the burden on labour.

Table 1: Revenue from taxes and social contributions in 2022²²



²² *Main national accounts tax aggregates* [Online]. Available at: https://ec.europa.eu/eurostat/databrowser/view/GOV_10A_TAXAG/default/table?lang=en (Accessed: 30 October 2023).

1.2.3.2. Income tax reforms in Slovenia

As we can see from the previous section, another challenge in Slovenia's tax competitiveness is its relatively high personal income tax burden, particularly concerning the taxation of personal income. Accordingly, the OECD has consistently urged Slovenia to reduce its personal income tax rate.²³

Consequently, personal income taxation has been a focal point in Slovenian tax reform efforts, with varying degrees of success. Specifically, over the past decade, Slovenia has revised its income tax regulations multiple times to establish a comprehensive and stable framework.²⁴ However, this work has faced the significant challenge of the susceptibility of tax regulations to shifting political landscapes. For instance, in 2021, the Slovenian government initiated a tax reform that encompassed changes in income tax rates; an increase in the general tax allowance; a reduction in the tax rate for the fifth income bracket (from 50% to 45%); and adjustments to tax-free allowances for business performance rewards, capital income, and income from property rents. However, after political changes resulting from elections the following year, the new Slovenian government revised the income tax system, reversing some of the prior adjustments; indeed, the government stated that its objective was eliminating or rectifying certain measures that were enacted in 2021 and 2022.²⁵

In 2023, the Slovenian government announced a third iteration of income tax reform, aiming to comprehensively address previous challenges and simplify the existing system, which has often been criticised for its complexity. Specifically, the government proposed a uniform system of tax deductions applicable to all taxpayers.²⁶ Notably, reforms of this style often affect tax stability and competition; accordingly, representatives from the real sector have consistently raised concerns about the adverse effects of such practices on Slovenia's tax competitiveness and reputation.

1.2.4. Other tax reforms

The third example of Slovenian tax reform is corporate income taxation. Specifically, the aforementioned tax reforms made in 2021 also involved reforms of the Corporate Income Tax Act. The primary goal of the amendment was to ensure stricter tax treatment in countries that promoted harmful tax practices or were unwilling to cooperate for tax purposes.²⁷ This was not meant to name and shame countries, but rather to promote positive changes through sustained and dynamic action.

It is also important to emphasise the latest changes and proposals made in late 2023. These included the introduction of an additional tax on salaries for long-term

²³ OECD, 2018.

²⁴ Slovenia has made few reforms to personal income taxes in the last five years.

²⁵ Simič, 2022.

²⁶ Kozorog Blatnik and Daugul, 2023.

²⁷ Bučar, 2021.

care, amounting to 2.94%; tightening taxation on legal entities; and implementing the aforementioned special taxation on bank balance sheets. There is also consideration, especially from the business sector, of revising the policies for asset taxation (the ‘thousandth tax’) based on warnings from the OECD. Some of these reforms were successful, such as reform of the Fiscal Validation of Receipts Act (Zakon o davčnem potrjevanju računov – ZDavPR)²⁸, which effectively solved issues with the grey economy.

Given these considerations, it is evident that Slovenia’s tax system requires comprehensive review and reform to align with international standards and ensure a fair and sustainable revenue structure. Over time, the country has made periodic adjustments to its tax system, albeit with varying degrees of success. Notable examples include the unsuccessful introduction of a real property tax, liberalisation of tax rates in 2022, and an increase in property taxes in 2023. The effectiveness of these changes often depends on the political landscape. Calls for reform from international bodies and the need for greater fiscal sustainability indicate that Slovenia’s tax system may evolve further in the coming years.

A stable and predictable tax environment is crucial for an economy. However, the current situation, with various fragmented and uncoordinated duties related to real estate, particularly compensation for the use of building land and frequent tax reforms on personal income, lacks stability and predictability. This uncertainty undermines trust in the Slovenian tax system and, consequently, Slovenian tax competition.

1.3. Relationship between national tax policy and EU law

Slovenia has largely adhered to the principles enshrined in EU tax policies. For the most part, the nation’s domestic tax system has aligned with EU directives. This commitment to implement EU tax policies underscores Slovenia’s unwavering dedication to the principles of the European Union and its single market.

Notwithstanding its overall alignment with EU tax policies, Slovenia has encountered challenges in effectively implementing certain directives, especially in the field of value-added tax (VAT). Several instances have arisen in which Slovenia has struggled to interpret and apply these directives in real-world cases, resulting in discrepancies and misunderstandings.

Meanwhile, Slovenia has also grappled with misinterpreting and misapplying EU tax directives. In some cases, Slovenian authorities inaccurately understood or implemented specific provisions, leading to conflicts with EU tax laws. For example, in Case *X Ips* 201/2016-23, a Slovenian court sought a preliminary ruling from the CJEU; the third question posed to the CJEU was, ‘Does the first paragraph of Article 90 of the VAT Directive have a direct effect, even in cases where a Member State’s

²⁸ Fiscal Validation of Receipts Act (Zakon o davčnem potrjevanju računov), Official Gazette of the RS, no. 57/15, 69/17, 3/22 – ZDDV-1M in 40/23.

legislator has exceeded the framework of permissible exceptions, as defined in the second paragraph of Article 90 [...] ?' The CJEU's response in Decision C-146/19²⁹ clarified that 'Article 90(1) of Directive 2006/112 must be interpreted such that a national court is obligated to interpret national law in accordance with this provision and should not apply any national provision that would yield a result contrary to this directive.'³⁰ This underscores that the Slovenian legislature did not correctly implement the VAT Directive, prompting the CJEU to intervene and prevent the use of Slovenian law in this regard.

Furthermore, misunderstandings of the terms derived from the directive have led to legal disputes within Slovenia's legal system, resulting in decisions from both the Supreme and Constitutional Courts. In the case of U-I-492/20-22, the interpretation of Art. 74 of the Tax Procedure Act (ZDavP-2) was disputed, and the Constitutional Court, in the aforementioned judgment, found that the article was inadequately regulated and consequently declared the entire Act unconstitutional. Meanwhile, in Case *X Ips* 61/2021, among other findings, the Supreme Court of the Republic of Slovenia concluded that the Financial Administration of the Republic of Slovenia misinterpreted the issue of impermissible tax avoidance. From the perspective of tax competitiveness, this situation poses challenges because it results in two state bodies interpreting EU law differently within a single member state. Both cases are explored in detail in subsequent sections. Therefore, we briefly summarize their impacts on tax competition here.

2. Tax harmonization and Slovenian sovereignty

2.1. A general overview of tax harmonization and Slovenian sovereignty

Slovenia has a tax system compliant with the EU, meaning that its tax laws are generally in accordance with EU tax directives; therefore, Slovenia has no open political or legal issues that may affect the harmonisation of tax law and tax sovereignty. This is most evident in the positions of the National Assembly of the Republic of Slovenia (the highest political body in the Republic of Slovenia in the majority of cases), which has not voiced reservations when providing opinions on proposals for EU acts related to tax policies.³¹

29 CJEU, 11 June 2020, C-146/19, *SCT d.d. v. Republic of Slovenia*, ECLI:EU:C:2020:464.

30 C-146/19.

31 *Zadeve Evropske unije v Državnem zboru* [Online]. Available at: <https://shorturl.at/roLOi> (Accessed: 30 October 2023).

2.2. The Slovenian approach to qualified decision-making in the field of taxes, global minimum tax, BEFIT, and ATAD 3

2.2.1. Qualified decision making

Qualified decision-making in the context of tax issues assumes a distinct character when viewed from the perspective of Slovenia as a smaller member of the EU. The viability of such decision-making mechanisms in the sphere of taxation is imbued with multifaceted considerations chiefly revolving around the preservation of Slovenia's tax sovereignty. Given their augmented economic prowess and consequential fiscal contributions, larger Member States tend to perceive qualified decision-making as an instrument that affords them greater leverage over tax policies. This argument also relates to the need for the EU to function efficiently in tax matters; however, this efficiency cannot be realized in exchange for the tax sovereignty of smaller countries.³²

Nonetheless, for Slovenia, adopting a circumspect stance is a requisite due to the conceivable ramifications that such decision-making mechanisms may have on the country's ability to exercise autonomous control over its tax regime. Slovenia's stance in this matter underscores the principle of equity within the EU framework, recognising the concomitant need to balance the interests of both larger and smaller member states.

As a smaller member state, Slovenia demonstrates a palpable affinity for the concept of voting by consensus on multiple occasions in the domain of tax-related decisions³³. This predilection aligns with the country's aspiration to preserve fiscal sovereignty and ensure that its unique economic circumstances are duly acknowledged. Voting by consensus acts as a mechanism through which smaller member states, such as Slovenia, can participate in the EU's policy formulation process while mitigating the risk of encroachment on their tax prerogatives.

Slovenia's predilection for a consensus-driven approach to tax-related decision-making reflects the nuanced legal framework within the EU and emphasises the imperative of harmonising tax policies across the EU while concurrently accommodating the idiosyncratic economic dynamics and interests of its smaller member states.³⁴ In this intricate interplay of legal constructs and pragmatic considerations, the EU continues its commitment to harmonise tax policies while preserving the sovereignty and distinct economic circumstances of its smaller member states.

³² Mintel and von Ondarza, 2022.

³³ Positions repeatedly expressed through public statements by Slovenian ministers and prime ministers.

³⁴ Luja, 2019, pp. 343–465.

2.2.2. *Global minimum tax*

On 12 December 2022, EU Finance Ministers adopted the Commission's proposal for the Council Directive to ensure a global minimum level of taxation for multinational enterprise groups and large – scale domestic groups in the EU with combined financial revenues of more than EUR 750 million a year.³⁵ Minimum corporate taxation is one of the two work streams agreed upon by members of the OECD/G20 Inclusive Framework, a working group of 141 countries and jurisdictions focused on the two-pillar approach to addressing the tax challenges of the digital economy.³⁶

Slovenia has not yet implemented the Global Minimum Tax Directive (GloBE), but has announced the final draft³⁷ version, from which we can see that the minimum tax will not affect all international corporate groups, but only those with revenues year exceeding EUR 750 million in the consolidated financial statements of the parent entity of the international group in at least two out of the four business years preceding the test business year. Based on the proposed law, it is possible to determine that Slovenia did not have specific objections to this directive, and that the issues it highlighted were mostly administrative in terms of the effective implementation of the law's provisions.

2.2.3. *BEFIT*

The Base Erosion and Profit Shifting Inclusive Framework (BEFIT), is a transformative initiative within EU tax policy. This framework was born out of a global effort to address the challenges posed by multinational corporations engaging in aggressive tax planning strategies that erode the tax base of individual countries and shift profits to low-tax jurisdictions.

The BEFIT framework is a collaborative endeavour in which EU Member States, along with other countries, work together to develop and implement measures aimed at preventing base erosion and profit shifts. This is a response to the recognition that in an increasingly globalised and digital economy, traditional tax rules often fall short of ensuring that companies are taxed fairly and equitably.

The primary objective of BEFIT is to establish a harmonised and coordinated approach to international taxation within the EU. This involves addressing issues such as transfer pricing, hybrid mismatches, and preferential tax regimes, which multinational corporations can exploit to reduce tax liabilities. The framework aims

³⁵ Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, OJ L 328, 22.12.2022, 1–58.

³⁶ OECD, 2020.

³⁷ *Predlog Zakona o minimalnem davku*, EVA 2023-1611-0064 [Online]. Available at: <https://e-uprava.gov.si/download/edemokracija/datotekaVsebine/622849?disposition=inline> (Accessed: 30 October 2023).

to protect the tax revenues of EU member states, ensuring that they can continue funding public services and infrastructure.

Moreover, BEFIT aligns with broader international efforts, including those led by the OECD, to create a fair and transparent global tax system. It acknowledges the need for a multilateral approach to tackle tax avoidance and improve the integrity of the international tax system. The EU's involvement in BEFIT reflects its commitment to these principles.

In summary, BEFIT is a crucial component of EU tax policy that addresses the challenges posed by multinational corporations' tax practices in an era of global economic integration. By fostering international cooperation and adopting comprehensive tax reforms, the framework seeks to ensure a fair and sustainable tax environment that benefits governments and the broader public interest.

Regarding Slovenia, in the public and academic spheres, we were unable to find any particular opinions or potential suggestions from their perspective. In the open debate ('have your say') about BEFIT on the European Commission's website³⁸, Slovenian stakeholders did not make any suggestions. Therefore, we can conclude that Slovenia does not currently have any specific opinion on the BEFIT and that the BEFIT will be implemented in Slovenian legislation.

2.2.4. ATAD 3

The European Commission, in its Communication³⁹ dated 17 June 2015 presented an action plan for the fair and efficient taxation of corporate income in the EU due to the need for fairer taxation. Based on this plan, the EU adopted Directive (EU) 2016/1164 on 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market – the Anti-Tax Avoidance Directive (ATAD) – which established five measures to prevent erosion of the tax base in the internal market and profit shifting from the internal market. These include the interest limitation, exit taxation, general anti-abuse, controlled foreign company, and hybrid mismatch rules, the latter of which was introduced by the ATAD 2 as an amendment to the ATAD 1.

ATAD 1 and ATAD 2 were implemented in Slovenia through changes to the ZDDPO-2 law, which has been revised several times in recent years. Most of these changes were necessary to implement rules for tax avoidance and evasion. While these rules make the system more complex, they align with Slovenia's goals and commitment to implementing and respecting them through their legislation.

The most recent changes to ZDDPO-2 were required for the implementation of reverse hybrid mismatches and were included in the ATAD 2 of the EU. Slovenia transposed all measures specified in the ATAD directive into its legal framework,

³⁸ European Commission, no date.

³⁹ European Commission, 2015.

except for the interest limitation rule for tax purposes.⁴⁰ The ATAD allows a deferral of the implementation of this rule until 1 January 2024 if a country has implemented equally effective targeted rules to prevent the erosion of the tax base and profit shifting. Slovenia is one of the Member States that exercised this deferral, as confirmed by the European Commission.

The interest limitation rule in the thin capitalisation rule focuses solely on limiting interest from loans, considering the taxpayer's debt-to-capital ratio, whereas the EBITDA rule restricts all types of interest based on the taxpayer's business performance. Slovenia has not chosen to include independent entities within the scope of interest limitations or to apply interest limitations at the level of international groups of companies. Additionally, Slovenia excluded regulated financial institutions and insurance companies from the EBITDA rule, following the provisions of the ATAD directive.⁴¹

The ATAD provides an option for EU Member States to exclude financial institutions or insurance companies from the interest limitation rules. This is because these entities operate in a sector with specific characteristics that may require a more tailored approach to addressing tax base erosion and profit-shifting risks.

Given that the ATAD 3 is still in the proposal stage, it can be inferred that there are no specific positions regarding its potential adoption and implementation in Slovenia. However, based on the previous implementation of the ATAD 1 and ATAD 2, we can also make assumptions about Slovenia's stance on the ATAD 3.

3. The tools of the fight against tax avoidance in Slovenia

3.1. Tax avoidance in Slovenia

Before we explain the harmonisation of the fight against tax avoidance, it is important to mention that in Slovenian tax law, the term 'tax avoidance' is not explicitly mentioned anywhere. However, when the term 'tax avoidance' is mentioned in the context of judicial practice, it is usually accompanied by the term 'illegitimate' or 'unfair'. This suggests that Slovenian legal practices generally accept the term 'legitimate tax avoidance'. In the context of tax law, the terms 'tax optimisation' and 'tax planning' are often used to describe actions taken to legally reduce taxable income.⁴² In addition, there is also the Slovenian implementation of the General

40 *Predlog Zakona o spremembah in dopolnitvah zakona o davku od dohodkov pravnih oseb, EVA 2020-1611-0129* [Online]. Available at: <https://e-uprava.gov.si/si/drzava-in-druzba/e-demokracija/predlogi-predpisov/predlog-predpisa.html?id=15481> (Accessed: 30 October 2023).

41 *Ibid.*

42 Kastelic, 2017, p. 11.

Anti-Avoidance Rule ('GAAR') introduced in Art. 74 para. 4 of the Tax Procedure Act; however, as mentioned, it was unconstitutional. Meanwhile, Slovenian tax law recognises the term 'tax evasion' as the illegal act of evading taxes by concealing income, earned either legally or illegally, from detection and collection by the tax authorities.

3.2. BEPS action plan and harmonization of tools of the fight against tax avoidance

Like many nations, Slovenia faces the challenge of ensuring that individuals and businesses contribute their fair share to public finances. In particular, as a member of the EU and OECD, Slovenia must implement key mechanisms to prevent tax avoidance.

One of the most important initiatives in the field of tax avoidance is the OECD's BEPS action plan, which resulted in 15 measures being adopted in 2015 and, at the EU level, encouraged the harmonisation of certain measures against tax avoidance in corporate taxation. As a member of the OECD, Slovenia committed to implementing BEPS measures in May 2013. The 15 BEPS measures represent a new tax regime. Some notable measures are related to limiting interest deductions (BEPS Action 4) and addressing the avoidance of abuse involving permanent establishments (PEs; BEPS Action 7). Some of these adopted measures have also been incorporated into EU legislation (e.g. rules on interest limitations, controlled foreign companies, and hybrid mismatches), with EU member states (e.g. Slovenia) subsequently transposing them into their national legislation.

Broadly, the objective of the BEPS Project was to create a different, globally inclusive tax policy to establish a stronger, more effective, and fairer tax framework; more specifically, the framework ensures that economic entities pay at least a minimum tax wherever they operate and that tax is paid where value is created.

The purpose of BEPS Action 7⁴³ is to prevent the artificial avoidance of PE status by expanding the definition of a commissionaire or dependent agent for a non-resident entity, thus preventing erosion of the tax base and profit shifting. Changes introduced by BEPS Action 7 have been incorporated as updates to Art. 5 of the OECD Model Tax Convention on Income and Capital, which defines a 'PE'. This measure addresses situations in which a non-resident company conducts sales in a specific jurisdiction through a commissionaire or dependent agent who does not officially conclude contracts in that jurisdiction, with the contracts concluded by the non-resident company. In this case, the non-resident company does not have a recognised permanent establishment for tax purposes in that jurisdiction, meaning that the income generated from the transaction is not subject to taxation in the jurisdiction where it originates. Other minor adjustments addressed by BEPS Action 7 relate

43 OECD, 2015.

to clarifying the treatment of auxiliary activities as permanent establishments and amending rules to prevent activity fragmentation.

The purpose of BEPS Action 4⁴⁴, which established the so-called ‘anti-abuse’ rule, is twofold: (i) To prevent taxpayers from diverting profits from higher tax jurisdictions to lower tax jurisdictions due to differing tax treatments of various income types (e.g. one jurisdiction treats income as interest, while another treats it as dividends); (ii) To protect the tax base (indirectly safeguard public revenue) by limiting the deductibility of interest for tax purposes (debt financing is generally more tax-favourable than equity financing because of the deductibility of interest expenses for tax purposes). The measure addresses all types of interest (not just loan interest) and all transactions (both related and unrelated), with riskier transactions in terms of profit shifting and tax base erosion typically involving related parties.⁴⁵

Some BEPS measures have been incorporated into the ATAD directive, whereas others from the OECD Action Plan have enhanced international double taxation avoidance agreements. Addressing the challenges of globalisation and digitalisation in the realm of taxation is an ongoing process, with intensive work taking place at the OECD level to develop further measures that address the allocation of taxation rights and the determination of minimum taxation levels. This work is part of a two-pillar global tax reform involving more than 140 jurisdictions.

3.3. The General Anti-Avoidance Rule and Slovenia’s Tax Procedure Act

In the Slovenian legal system, the general prohibition of tax avoidance arises in the fourth paragraph of Art. 74 of the Tax Procedure Act (ZDavP-2). It determines that one cannot circumvent the application of tax regulations through avoidance or abuse of other regulations. If such avoidance or abuse is identified, it is considered that tax liability has arisen, as it would have arisen had the relationships formed based on economic events been taken into account.⁴⁶ This provision was derived from the principle of material truth in tax matters from the second paragraph of Art. 5 of ZDavP-2 and can only be applied to the detriment of the taxpayer.⁴⁷

The provisions that serve as the basis for disregarding legal transactions constituting unlawful tax avoidance can be collectively referred to as the GAAR (and also known as the General Anti-Abuse Rule). This general rule is intended to be more than a procedural provision; it aims to establish different (or higher) tax liabilities.

Unlawful tax avoidance refers to legal transactions through which parties evade the tax consequences of the law. The ultimate effect of such transactions is illegal because they provide the taxpayer with an unjustified benefit using a different provision or allow the taxpayer to circumvent tax regulation. The legal consequences

44 OECD, 2016.

45 See: footnote 36.

46 See: footnote 7.

47 Constitutional Court of the Republic of Slovenia, Case no. U-I-492/20-22.

of unlawful tax avoidance vary; therefore, the tax authority must conduct an assessment of the economic and, above all, legal consequences of the concluded legal transaction and determine which legal transaction in specific circumstances would represent a reasonable way of conducting business events and be entered into by reasonable persons as well as what the tax liability would be in such a case. Therefore, the significance of the consequences of the identified tax avoidance is crucial for the practical application of it. As the name suggests, the general rule must be operationalised in practice; that is, in specific cases. A rule must have concrete effects on taxpayers when unlawful tax avoidance is identified.

The aforementioned article also brought many complications that, as mentioned earlier, even required intervention by the Constitutional and Supreme Courts of Slovenia. In the case U-I-492/20-22, the petitioner contended that ZDavP-2 contains an unconstitutional legal gap (in the context of Art. 2 of the Constitution of the Republic of Slovenia⁴⁸). The legislature did not constitutionally or clearly regulate the consequences of identified unlawful tax avoidance. In this regard, they believed that the legislator must, for the protection of constitutional and human rights as well as the public interest, regulate the prevention of tax abuse in a manner that complies with the principles of legality in tax regulations. Given the petitioner's claims, the Constitutional Court of the Republic of Slovenia conducted an examination of ZDavP-2 in light of Art. 147 of the Constitution and decided that the whole Tax Procedure Act was unconstitutional.

3.4. The Global Minimum Tax Act as a tool of the fight against tax avoidance in Slovenia

3.4.1. Introduction and foundations of the Global Minimum Tax Act

The income taxation system for legal entities in Slovenia has been based on and implemented international tax standards since its establishment, especially those adopted by the OECD. Slovenia, as a member of the OECD and of the inclusive framework of the OECD/G20, follows current OECD efforts to eliminate the tax practices of international corporate groups that allow them to shift profits to jurisdictions with very low or zero taxation.

The EU Tax Observatory, an independent research laboratory conducting innovative tax research, contributes to democratic and inclusive discussions about the future of taxation and promotes dialogue between the scientific community, civil society, and policy-makers in the EU and around the world. The Tax Observatory notably published a working document on tax avoidance and the complex structure of international corporate groups, which examines the impact of the complex ownership structures of international corporate groups on tax avoidance. They found that companies belonging to complex structures, where the parent company owns

48 See: footnote 1.

subsidiary companies through chains, predict lower profits than similar companies in the same country or sector.⁴⁹

Furthermore, only international companies with more complex ownership structures transfer profits from their higher-taxed units, whereas those with simpler ownership structures do not exhibit profit-shifting practices for tax purposes. In 2016, an important step was taken to obtain information on ownership structures by introducing country-by-country reports (CbCR). This measure was also implemented in Slovenia, with all international companies with consolidated revenues exceeding EUR 750,000,000 to disclose certain financial information for each country in which they have units; however, there is a gap in the disclosure of ownership information.⁵⁰

Subsequently, on 14 December 2022, the EU Council adopted Directive (EU) 2022/2523 concerning the establishment of a global minimum tax rate for international corporate groups and large domestic groups in the EU. States, including Slovenia, were required to transpose this directive into their national legislation by 31 December 2023. The goal of the directive is to establish a common framework for a global minimum tax rate in the EU based on the common approach outlined in the OECD model rules. All member states must achieve this goal through proper implementation, incorporation into national laws, and enforcement. This is crucial for member states to fulfil their commitment to achieving a global minimum tax rate.

According to the OECD's latest economic impact assessment, the implementation of minimum taxation rules is expected to result in approximately EUR 220 billion in additional annual tax revenue.⁵¹ Once the rules are implemented, the actual revenues will be influenced by the responses of international corporate groups affected by the rules and their adaptation, as well as the responses of jurisdictions. Most importantly, the responses of international corporate groups and jurisdictions affect the distribution of additional tax revenue among jurisdictions.

3.4.2. The Application of the Global Minimum Tax Act in Slovenia

Like other EU member states, Slovenia recently implemented rules and measures in its Corporate Income Tax Act (ZDDPO-2) to combat base erosion and profit-shifting schemes. These measures are currently in effect. However, it has become evident that these measures and provisions address specific situations and are ineffective. To effectively address and prevent inappropriate tax practices, a sustainable and comprehensive approach is necessary to tackle the root causes of base erosion and profit shifting.

Based on OECD and EU activities, the Minimum Tax Act (ZMD)⁵² was proposed. Taxation under this law applies above a certain threshold, regardless of the tax

49 François and Vicard, 2023, p. 23.

50 Ibid.

51 O'Reilly et al., 2023.

52 See: footnote 36.

regimes or incentives offered by individual countries or the business decisions of individual companies. If the threshold is exceeded, the rules for minimum taxation, which are the rules of the second pillar, come into effect. Their goal is to effectively address, prevent, or eliminate existing tax gaps.

The ZMD addresses the tax practices of international companies, which enable them to shift their profits to jurisdictions with very low or zero taxation. This proposal introduces a minimum tax rate to prevent competition in corporate income tax rates. By eliminating a significant portion of the advantages of profit shifting to low-tax or zero-tax jurisdictions, the new system will contribute to levelling the playing field for companies worldwide, preventing aggressive tax planning and allowing countries to better protect their tax bases and, consequently, their tax revenues.

The proposal represents a standalone law separate from that of ZDDPO-2. Transferring the directive's provisions to ZDDPO-2 would be much more complicated because the minimum tax is calculated differently from corporate income tax. Minimum taxation will not function as a tax calculated directly on a subject's income but will be applied to excess profits based on a standardised base and a special mechanism for tax calculation to identify low-taxed income within groups. Groups within the scope are those with annual revenues reported in the consolidated financial statements of the ultimate parent entity of at least EUR 750,000,000 in at least two of the four business years. The minimum rate is the internationally agreed-upon tax rate of 15%.

In the transfer of the directive's elements, including the scope, individual rules, technical details, and other aspects of new international tax rules, to domestic legislation, the ZMD proposal will closely follow the directive. This prevents the fragmentation of the internal market and enhances the efficiency of the new system owing to consistent implementation throughout the EU and potential global adoption. This approach simplifies compliance for taxpayers and tax authorities, especially in the early stages of implementing the new system, in line with the commitments of the international tax community for expected widespread global implementation.⁵³

As allowed by the directive, the ZMD proposal sets out the most permissible options. The most important is the use of the option to define obligations for domestic qualified excess profit taxes. This will allow Slovenia to benefit from the revenue generated by the excess tax collected from its low-taxed entities within the country. The ZMD proposal will also establish a transitional safe harbour CbCR regime. The directive generally provides a basis for member states to use the OECD model rules and explanations, as well as examples in the document 'Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)'⁵⁴ issued by the OECD/G20 Inclusive Framework on BEPS. The safe harbour

⁵³ See: footnote 36.

⁵⁴ *Global Anti-Base Erosion Model Rules (Pillar Two)* [Online]. Available at: <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm> (Accessed: 30 October 2023).

CbCR simplifies the use of data by using existing data to calculate the categories relevant to taxation. These safe-harbour rules apply to international corporations and large domestic groups.

Based on CbCR data, 412 international corporate groups with parent companies in Slovenia or abroad and subsidiary companies in Slovenia were identified in 2019, with global annual revenues of at least EUR 750,000,000. Of these, 144 international groups in Slovenia had effective tax rates of less than 15% in 2019. The average weighted effective tax rate was 8.72%.

3.5. The Common Consolidated Corporate Tax Base (CCCTB) as a tool of the fight against tax avoidance in Slovenia

The Common Consolidated Corporate Tax Base (CCCTB) is a set of rules proposed for calculating taxable profits in the EU. The CCCTB was first proposed by the European Commission in 2011, but is still not accepted. With the CCCTB, cross-border companies will only have to comply with a single EU system for computing their taxable income, rather than with many different national rulebooks. Companies can file one tax return for all their EU activities and offset losses in one Member State against profits in another. The consolidated taxable profits are shared between the Member States in which the group is active, using an apportionment formula. Each Member State taxes its share of the profits at its national tax rate.

In essence, the idea of the CCCTB is to improve the EU single market; however, the CCCTB is also a tool in the fight against tax avoidance. In other words, it is mandatory for the largest groups in the EU. This prevents companies with the greatest capacity from making tax plans by avoiding taxation. The CCCTB eliminates mismatches between national systems, preferential regimes, and hidden tax rulings that tax avoiders exploit. This eliminates the need for transfer pricing, which is the primary route of profit shifting. The CCCTB contains robust anti-abuse measures to defend Member States against base erosion and profit-shifting to non-EU countries.

However, Slovenia does not completely support this solution. For example, the opinion of the Slovenian parliament on the Proposal of the Directive of the CCCTB evidences a few reservations emphasised by parliamentarians. More specifically, Slovenia believes that the proposal presents significant challenges to implementation and execution, particularly for small economies. At a systemic level, the proposal has both positive and negative effects, depending on the eventual solutions that will be put in place. Slovenia maintains that its Proposal for a Directive on a CCCTB lacks clear and proven arguments for unconditional support. Nonetheless, Slovenia is willing to engage in discussions regarding the impacts of the CCCTB Directive and the effects of the Common Corporate Tax Base (CCTB), with special attention paid to how the CCTB is determined. Second, Slovenia emphasises that the financial impact of Slovenia in the case of the CCCTB is unclear. Companies would benefit significantly only in the case of consolidation, which is unlikely to be the final solution.

This proposal, particularly for small economies, poses significant challenges in terms of implementation and execution.⁵⁵

4. Conclusions

In conclusion, the Republic of Slovenia demonstrates its tax sovereignty within the boundaries set by its constitution while also considering how it transfers its sovereignty at the EU level. Consequently, it is of utmost importance to preserve Slovenia's tax sovereignty by interpreting EU rules on tax legislation harmonisation in a way that does not excessively encroach on the tax sovereignty of EU Member States. In pursuit of tax sovereignty, Slovenia seeks to regulate the taxation of assets and reduce the tax burden on labour income. It follows the rules of the EU and international organisations (BEFIT and ATAD 3) and, within the limits of its tax sovereignty, shapes tax regulations. Moreover, Slovenia prepared a proposal for a minimum tax law considering the requirements for combating and preventing tax avoidance; this aligns with its commitment to maintain a balance between EU directives and its own fiscal autonomy.

⁵⁵ See the Opinion of the Slovenian Parliament on the Directive on CCCTB: *Državni zbor, Ljubljana, 54924-12/2011/4* [Online]. Available at: <https://shorturl.at/NUWQf> (Accessed: 30 October 2023).

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PART IV

MONETARY POLICY

THE ‘ALMOST COMPLETED HOUSE’: AN INTRODUCTION TO THE ECONOMIC AND MONETARY UNION



GYÖRGY MARINKÁS

Abstract

The first part of this chapter will focus on the asymmetric nature of the Economic and Monetary Union and the lack of proper supervision in its initial form. The second part will elaborate on how an adequate supervision system – the Banking Union – was created after the 2010 Greek sovereign debt crisis. This chapter introduces the phases of the creation of the Banking Union and its already-functioning three pillars and examines their roles by analysing three main sources: the case-law of the Court of Justice of the European Union, the reviews of European Union institutions (or reviews completed under their aegis), and scholarly opinions. The third part focuses on three sets of crisis management strategies of the European Central Bank: those enacted in response to the Greek sovereign debt crisis, those enacted in response to the negative economic effects of the COVID-19 pandemic, and those enacted in response to the most recent issue, the consequences of the Russo-Ukrainian War. Regarding the Greek sovereign debt crisis, this section dispenses with introducing the related monetary measures in detail since very rich literature on this topic already exists; instead, the focus is on the legal disputes around the response, especially the Public Sector Purchase Program of the European Central Bank.

Keywords: *Economic and Monetary Union, Eurozone, European Central Bank, Banking Union, Single Supervisory Mechanism, Single Resolution Mechanism, Public Sector Purchase Program, COVID-19, Russo-Ukrainian War, ultra vires*

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1. The brief history of the creation of EMU and its initial weaknesses, with special regard to the lack of supervision

Despite the reforms seen in recent decades, the *Economic and Monetary Union* (EMU) is still far from being a so called *optimum currency area* (OCA), as described by Robert A. Mundell¹ and Béla Balassa.² It has always been a long way away from this state, and accordingly labelled the ‘half-built house’ by Fred Bergsten in 2012.³ It is not surprising that Milton Friedman, similar to most other contemporary US scholars,⁴ was very sceptical of the common European currency. Friedman identified structural weaknesses a decade before they became unambiguous in light of the 2008 crisis and predicted the downfall of the EMU before it was created. He argued that the chosen approach itself was a mistake;⁵ the creation of the EMU should have been preceded by the creation of a political union. Based on historic examples, Friedman concluded that only monetary unions established along with political unions had historically been successful.⁶ However, as Wolfgang Münchau stated, the Eurozone not only lacked the conditions to become an OCA, but also the political will to become one.⁷ Due to the lack of a ‘single European identity’, EU decision-makers consciously avoided any issues related to the political union, even though the establishment of the EMU was a political rather than an economic question.⁸ As a result of political dissent, the ‘founding fathers’ of the EMU gave up on creating a real economic and monetary union and instead created an asymmetric monetary union⁹ in which monetary sovereignty was transferred to the Union¹⁰ and the fiscal sovereignty of the Member States was left almost intact.¹¹ Besides this asymmetry, the EMU suffered from severe structural weaknesses: an appropriate supervision system was lacking. As the author of this chapter pointed out in a 2018 study, this was the ‘original sin’.¹²

When the founding fathers realised that it was impossible to create a fiscal union alongside with the monetary one, they secured the independence of the *European*

1 Mundell, 1960, pp. 657–665.

2 Balassa, 1961, p. 324.

3 Bergsten, 2012, pp. 16–22.

4 See: Quinn, 2023, p. 784.

5 Friedman, 1997.

6 Artner and Róna, 2012, p. 100.

7 Münchau, 2013, p. 539.

8 Friedman, 1997; Buti, 2017, pp. 56–57; Bod, 2012, pp. 695–698.

9 For more on the history and basic concepts of the monetary union, see: Angyal, 2009, pp. 109–119.

10 Some authors argue that the only country that lost its monetary sovereignty was Germany: during the *European Monetary System* era, most Member States followed the Bundesbank’s interest rates. Thus, these countries have gained influence over common monetary policy by participating in the ECB’s decision making. See: Goodhard, 1995, p. 457.

11 Dabrowski, 2009, pp. 6–7; Artner and Róna, 2012, pp. 83–84.

12 Marinkás, 2018, pp. 437–471.

Central Bank (ECB) to the extent that, based on the wording of the *Maastricht Treaty*,¹³ one could have regarded the ECB as a *sui generis* entity outside the EU institutional framework.¹⁴ This issue was finally settled in the *Lisbon Treaty*.¹⁵ In the meantime, the case law of the *Court of Justice of the European Union* (CJEU) sealed the leak, stating that the ECB is an integral part of the community, even if it has extraordinary independence.¹⁶

The founders of the EMU believed that on the long run the common currency would lead to convergence; that is, the negative effects of the lack of a common fiscal policy would be counterbalanced. In practice, however, the EMU did not facilitate real convergence among Member States and sometimes even caused their divergence.¹⁷ In addition, it covered up differences,¹⁸ which created the so-called 'moral hazard' issue or, in other authors' words, the 'free-rider' phenomenon.¹⁹ the common currency incited certain Member States to borrow in the common currency and, when they could not meet their debt service obligations, to ask for bailouts from other Member States – put differently, a 'beggar-thy-neighbour' policy emerged.

The Greek example clearly shows that this possibility is real: the government obtained cheap loans in Euros at an interest rate of 3% instead of 18% in the drachma era,²⁰ creating a temptation to obtain more loans.²¹ Friedman identified this as a factor that may enhance political conflict among Member States in the case of a future economic crisis. His prediction became true: when the crisis hit, it was hard to explain to the average German taxpayer why their tax should be spent helping Greek citizens,²² even if Germany was the main beneficiary of the Eurozone.²³

The founders of the Eurozone also foresaw the above issue and, in the absence of common fiscal policy, tried to avoid it by (i) adopting the *Stability and Growth Pact* (with all its deficiencies)²⁴ and (ii) enacting the 'no bailout' clause in Art. 125 of

13 Treaty of Maastricht, Treaty on European Union (Consolidated Version), 7 February 1992, OJC 325/5.

14 See: Angyal, 2008, pp. 116–131.

15 Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, signed at Lisbon, 13 December 2007, OJ C 306, 17.12.2007, 1–271.

16 CJEU, 10 July 2003, C-11/00, *Commission v. ECB*, ECLI:EU:C:2003:395, paras. 122, 186.

17 Gottfried, 2021, p. 118.

18 Tarafás, 2013, p. 362.

19 Quinn, 2023, p. 785.

20 Forgács, 2015, p. 42.

21 The Giovannini Group, an advisory committee to the European Commission on financial integration, proposed as early as 2000 that public debt issuance in the Eurozone should have been subjected to community level co-ordination. See: Giovannini Group, 2000.

22 As Kata Csankovszki and Júlia Mező pointed out, this clearly demonstrated why a successful monetary union should consist of equally developed member states as the original theorists of the OCA argued. Csankovszki and Mező, 2012, pp. 37–38.

23 Marján, 2014, p. 76.

24 See: Quinn, 2023, p. 785.

the *Treaty on the Functioning of the European Union*²⁵ (TFEU) as well as its monetary counterpart, the prohibition of monetary financing, in Art. 123 of the TFEU. In other words, unlike traditional central banks, the founders of the EMU did not provide the ECB with the mandate to act as a *lender of last resort* (LLR). However, it became one on the long run.²⁶

Even if the current decision makers were willing to provide fiscal policy tools for bailouts, in Friedman's view, the governing institutions of the EU would have lacked the room of manoeuvre the US Federal Government has, which disposes over a significant budget that enables it to counterbalance economic cycles.²⁷ On average, the US budget moved between 14% and 37% of GDP between 1945 and 2023.²⁸ In comparison, the EU budget reallocates 1% of the EU 27's GDP.²⁹ Friedman further argues that the US is not only a single market, where goods, labour force, services, and capital move freely, but also a single market, where – unlike in the EU – prices and wages are approximately identical in every state. Friedman believes that the latter two factors are the reasons for employee mobility in the US. Meanwhile, EU Member States exhibit serious differences in economic development.

Another weakness of the Eurozone, in its original form, was the lack of a proper supervisory system. The pre-crisis regulatory regime was based on minimum harmonisation, in which directives determined the minimum requirements at the EU level that could be surpassed by national legislators. This has led to divergent national rules that undermine legal certainty. It also incited, on the one hand, Member States to engage in regulatory competition to favour national banks and attract more businesses and, on the other hand, financial institutions to engage in regulatory arbitrage, exploiting national divergence to their advantage.³⁰ As Luigi Chiarella pointed out, the previous banking supervision and resolution framework – which was based on cooperation – failed during the crisis because domestic authorities were prone to turning a blind eye when it came to their '*national champions*'.³¹ In summary, the above-mentioned lack of proper political legitimisation and political union is the origin of the problems introduced below; namely, the asymmetric structure and lack of proper supervision.

25 Treaty on the Functioning of the European Union of 13 December 2007, OJ C 202, 7.6.2016, 47–360.

26 This will be further explored in the second and third parts of this chapter.

27 Friedman, 1997.

28 University of California: *Federal Budget Receipts and Outlays: Coolidge – Biden* [Online]. Available at: <https://www.presidency.ucsb.edu/statistics/data/federal-budget-receipts-and-outlays> (Accessed: 29 September 2023).

29 European Commission, 2023a.

30 Babis, 2018, p. 263.

31 Chiarella, 2016, pp. 41–46, 85.

2. The creation of the Banking Union and its elements established due to the 2010 financial crisis and the allocation of competences between the EU and its Member States

'Within our mandate, the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough' – Mario Draghi, President of the European Central Bank (2011–2019).³²

In October 2007, the ECOFIN Council acknowledged – though not *expressis verbis* – that the crisis in the US finance sector could possibly affect the single market. In conjunction with this, scholars,³³ think tanks,³⁴ and, in 2009, the expert group chaired by Jacques de Larosière,³⁵ suggested that the EU should create a community-level supervisory system. However, EU legislators and regulators were lagging behind;³⁶ it was not until 2011³⁷ that the EU, as a belated response to the crisis and to eliminate any possible threats that could jeopardise the stability of the financial systems of the EMU, established the *European System of Financial Supervision* (ESFS).³⁸

What happened next was extraordinary and unthinkable, even a few years earlier.³⁹ In the words of Rachel A. Epstein and Martin Rhodes: 'supranationalism had gained momentum'.⁴⁰ In their view, the creation of the Banking Union was a consequence of an array of interests – both national and supranational – and the ability of the European Commission and the ECB to manipulate the policy process against Germany, which would have preferred to keep competence at the national level.⁴¹ The world again witnessed the transfer of a significant amount of sovereignty to the supranational level – a level that could only be achieved under the exceptional

32 *Verbatim of the remarks made by Mario Draghi – Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London 26 July 2012* [Online]. Available at: <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html> (Accessed: 9 October 2023).

33 Dabrowski, 2009, pp. 17–18.

34 Lannoo, 2009, p. 59.

35 de Larosière Group, 2009, p. 86.

36 As advocate general Gerard Hogan wrote in his opinion in the *Landeskreditbank Baden-Württemberg v. ECB* case: '[...] legislators and regulators have struggled to come to terms with the enormity of this banking crisis and to understand how, in the face of what had previously seemed to be a perfectly adequate system of regulation, that system ultimately failed when it was put to the test in those dark days of 2008 onwards.' – CJEU, 5 December 2018, C-450/17 P, *Landeskreditbank Baden-Württemberg v. ECB*, Opinion of Advocate General Gerard Hogan, ECLI:EU:C:2018:982, para. 2.

37 To be more precise, in 2010 (before the ESFS), the Council called the *European Financial Stabilisation Mechanism* (EFSM) into being as a transitional solution. The aim was to provide credit for the Member States, which were struggling with problems. See: Council Regulation (EU) 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism, OJ L 118, 12.5.2010, 1–4.

38 See: Marinkás, 2018b, pp. 58–69.

39 Van Rompuy, 2014.

40 Epstein and Rhodes, 2016, p. 433.

41 Epstein and Rhodes, 2016, p. 433.

circumstances created by the sovereign debt crisis.⁴² This finding is affirmed by the above discussion of the lack of political will at the time of the EMU's foundation.

A change in the ECB's director in 2011 also gave an impetus for the already ongoing policy changes: while Jean-Claude Trichet insisted that the restrictive dispositions of the TFEU – namely, the 'no bailout',⁴³ 'no default'⁴⁴ assumptions – should be maintained under all circumstances, the new president, Mario Draghi, gave his 'whatever it takes' speech in 2012, giving the green light to the *Outright Market Transactions*⁴⁵ (OMT) and other programmes, which saved the Eurozone. The *European Stability Mechanism* (ESM) started to function in 2012⁴⁶ outside the framework of the EMU because, according to the original political compromise embedded in Arts. 123 and 125, the ECB would not act as a sovereign LLR to Member States. The ESM was created to provide the EU with an LLR, which – in case of necessity – could grant credits to the member states and financial institutions facing crisis. The aim was to avoid breaching the Treaties by converting the ECB into an LLR. By the end of the day, however the ECB became a de facto LLR within the Eurozone: during the global financial crisis, over a quarter of the Member States received bailouts and, arguably, monetary financing of some kind.⁴⁷ – As elaborated on later.

In addition to the above, EU legislators created the *Banking Union* (BU) based on Art. 114 of the TFEU. In accordance with the European Commission's proposal,⁴⁸ the BU should have been based on four pillars: the *Single Rulebook*, *Single Supervisory Mechanism*⁴⁹ (SSM), *Single Resolution Mechanism*⁵⁰ (SRM), and *European Deposit Insurance Scheme* (EDIS). Until now, only the first three pillars have been realised, with the EDIS still under development.

However, the creation of such a system was a huge step, the newly established measures and institutions had to tackle one final obstacle: withstanding the supervision of the CJEU. They did well in this regard until the '*PSPP-decision*'⁵¹ of the German Federal Constitutional Court (*Bundesverfassungsgericht*, BVerfG) as it will be elaborated in Chapter Three.

42 Howarth and Quaglia, 2016, p. 458.

43 Art. 125 of the TFEU.

44 Art. 9 of the TFEU.

45 See: Cœuré, 2013.

46 Treaty Establishing the ESM (signed on 2 February 2012, entry into force: 27 September 2017).

47 Quinn, 2023, p. 760.

48 European Commission: Communication from the Commission to the EP and the Council. A Roadmap towards a Banking Union, Brussels, 12.9.2012, COM(2012) 510 final, p.10.

49 Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, 63–89 (SSM Regulation).

50 Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [...], OJ L 225, 30.7.2014, 1–90 (SRM Regulation).

51 Bundesverfassungsgericht, 2 BvR 859/15 –, Rn. 1–237, Judgment of 5 May 2020 (PSPP).

2.1. *The Single Rulebook (2013–)*

The Single Rulebook, contrary to its name, is not a single document but comprises various sets of rules; namely, the *Capital Requirements Regulation* (CRR),⁵² *Capital Requirements Directive* (CRD),⁵³ *Bank Recovery and Resolution Directive*⁵⁴ (BRRD), and *Deposit Guarantee Schemes Directive* (DGSD).⁵⁵ The harmonisation model chosen for the Single Rulebook, which combines different layers of legislation – including directly applicable regulations and directives that need implementation – allows flexibility in making technical rules which can be changed to adapt to financial markets without the need to proceed with time-consuming EU legislation. However, it was a legitimate concern that flexibility could have led to divergence between Member States as seen in the former system, where some Member States engaged in so-called ‘gold-plating’ – that is imposing requirements beyond the common regulatory framework –, while others adjusted their regulations to attract businesses or promote national champions resulting in regulatory competition.⁵⁶ In the opinion of Valis Babis, the definition of capital is an ample example of how these fears are well-founded; while the delineation of capital is a fundamental principle of banking regulation and banks must hold adequate high-quality capital to absorb losses, the regulation does not provide a clear definition of the term.⁵⁷

2.2. *The Single Supervisory Mechanism (2014) and the national competent authorities*

While less significant credit institutions⁵⁸ fall under the supervision of national authorities, significant ones⁵⁹ fall under the direct supervision of the ECB.⁶⁰ It must

52 Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013, 1–337.

53 Directive (EU) 2013/36 of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [...], OJ L 176, 27.6.2013, 338–436.

54 Directive (EU) 2014/59 of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [...], OJ L 173, 12.6.2014, 190–348.

55 Directive (EU) 2014/49 of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast), OJ L 173, 12.6.2014, 149–178.

56 Babis, 2018, pp. 263–265, 269–272, 274.

57 Babis, 2018, p. 272.

58 The SSM Regulation does not contain the definition of credit institutions, instead it refers to Art. 4 para. (1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council, which defines credit institutions as follows: ‘credit institution means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account’.

59 The delimitation is to be made as contained Art. 6 para. (4) of the SSM Regulation.

60 The decisions of the ECB can directly affect individual credit institutions, which are subject to a two-fold system of review: an *internal administrative review* and an *external judicial review*. See: Chiarella, 2016, p. 70.

be pointed out that the notion of credit institutions is a concept of EU law that shall prevail.⁶¹ The ECB's Framework Regulation⁶² for the SSM – alongside with the *Court of Justice's* (hereinafter: CJ) case-law – further refined the rules on cooperation,⁶³ including (i) the methodology for determining the quantitative criteria for classifying banks as significant or less significant, (ii) the exercise of powers, and (iii) the relations between domestic regulators and the ECB.⁶⁴ The *General Court* (GC) also contributed to the clarification of certain definitions and interpretation of some of the provisions.⁶⁵

Based on Art. 32 of the SSM Regulation by 31 December 2015 and subsequently every three years thereafter, the European Commission shall publish a report on the application of this regulation. The Commission in its belated report hit a positive tone.⁶⁶ The *European Court of Auditors* (ECA)⁶⁷ and the *German Federal Ministry of Finance* (*Bundesministerium der Finanzen*)⁶⁸ evaluated the first three years of the SSM as a success, although it was also indicated that there is still room for further improvement. For example, the German Federal Ministry of Finance's reports highlighted that the ECB should put further emphasis on maintaining a strict separation between the ECB's monetary policy functions and its supervisory tasks as required by the SSM Regulation. Meanwhile, in a 2016 report, the *Bruegel* criticized the *black box nature*⁶⁹ of the SSM's decision making procedure (although the report also had a

61 Chiarella, 2016, p. 48.

62 Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities, OJ L 141, 14.5.2014, 1–50 (SSM Framework Regulation).

63 CJEU, 8 May 2019, C-450/17 P, *Landeskreditbank Baden-Württemberg v. ECB*, ECLI:EU:C:2019:372; CJEU, 19 December 2018, C-52/17, *VTB Bank (Austria) AG v. Finanzmarktaufsichtsbehörde*, ECLI:EU:C:2018:648; CJEU, 19 December 2018, C-219/17, *Berlusconi and Fininvest v. Banca d'Italia and IVASS*, ECLI:EU:C:2018:1023; CJEU, 13 September 2018, C-594/16, *Buccioni v. Banca d'Italia*, ECLI:EU:C:2018:717.

64 For a more detailed analysis, see: Marinkás, 2018a, pp. 437–471.

65 CJEU, 16 May 2017, T-122/15, *Landeskreditbank Baden-Württemberg – Förderbank v. ECB*, ECLI:EU:T:2017:337; CJEU, 13 December 2017, T-712/15, *Crédit Mutuel Arkéa v. ECB*, ECLI:EU:T:2017:900; CJEU, 24 April 2018, T-133/16, *Caisse régionale de crédit agricole mutuel Alpes Provence v. ECB*, ECLI:EU:T:2018:219; CJEU, 13 July 2018, T-751/16, *Confédération nationale du Crédit mutuel v. ECB*, ECLI:EU:T:2018:475; CJEU, 13 July 2018, T-745/16, *BPCE v. ECB*, ECLI:EU:T:2018:476; CJEU, 13 July 2018, T-757/16, *Société générale v. ECB*, ECLI:EU:T:2018:473; CJEU, 13 July 2018, T-758/16, *Crédit agricole SA v. ECB*, ECLI:EU:T:2018:472; CJEU, 13 July 2018, T-768/16, *BNP Paribas v. ECB*, ECLI:EU:T:2018:471.

66 European Commission, Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation, Brussels, 11.10.2017, COM(2017) 591 final, pp. 18–19.

67 European Court of Auditors, 2016, p. 136.

68 Federal Ministry of Finance (*Bundesministerium der Finanzen*): The Single Supervisory Mechanism: Lessons learned after the first three years, January 2018, pp. 4–5.

69 The lack of transparency was also a key point of the Transparency International report: Braun, 2017, p. 77.

positive tone at times). The Bruegel, just like the ECA⁷⁰, suggested streamlining the decision-making procedure and delegating decision-making.⁷¹ The SSM related case-law of the GC – each of the judgments⁷² delivered after the Bruegel’s report – supports these findings: the pleas-in-law presented by the financial institutions were mostly based on the insufficiency of the ECB’s reasoning, incorrect interpretations of EU law, and an excess of power. With regard to the latest CJEU judgments and scholarly reviews of the SSM Regulation and its implementation, one can argue that a scheme like the SSM requires clear relationship of accountability between the ECB and the national competent authorities (NCAs); however, such a relationship is not fully fledged in the current legal framework, as pointed out by Karagianni and Scholten.⁷³

In its second evaluation under Article 32 of the SSM Regulation – published in April 2023 –, the European Commission concluded the following:

The SSM has developed into a mature organisation that is functioning well. More than 8 years since its inception, the SSM has proven to be a respected supervisory authority capable of delivering on its mandate as set out in the SSM Regulation. [...] The SSM has also shown to be capable of rapidly adapting to emerging supervisory challenges as well as to unexpected adverse events. The review found that the SSM was generally praised, including by industry stakeholders, for its swift and agile approach to addressing the challenges posed by the COVID-19 crisis.⁷⁴

Other opinions support the idea that the SSM has had positive effects on the banking system; however, some effects, such as enhanced profitability, were unintentional.⁷⁵

2.3. The Single Resolution Mechanism (2016-) and the responsible national authorities

As mentioned in Section One, the SRM covers the same scope as the SSM. The purpose of the SRM Regulation is to provide a framework for the resolution of failing banks within the BU with minimal costs for taxpayers and the real economy. The banking sector finances this resolution procedure through a single resolution fund. The SRM Regulation gave rise to the *Single Resolution Board* (SRB), a new EU agency

⁷⁰ European Court of Auditors, 2017, p. 68.

⁷¹ The Bruegel referred to the more transparent US system as an example to be followed. See: Schoemaker and Véron, 2016, pp. 4–6.

⁷² T-122/15; T-712/15; T-133/16; CJEU, 13 July 2018, T-733/16, *La Banque postale v. ECB*, ECLI:EU:T:2018:477; T-745/16; T-751/16.

⁷³ Karagianni and Scholten, 2018, pp. 185–194.

⁷⁴ European Commission, Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism Established Pursuant to Regulation (EU) No. 1024/2013, Strasbourg, 18.4.2023, COM(2023) 212 final, p. 23.

⁷⁵ Avgeri et al., 2020, p. 34.

that started functioning in 2015, and *national resolution authorities*⁷⁶ (NRAs). If a financial institution falls within the competence of the SRB, it adopts the resolution scheme under Art. 18 para. (1) of the SRM regulation if (i) ‘the entity is failing or is likely to fail; or (ii) having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures [...] would prevent its failure within a reasonable timeframe.’ The SRB also adopts the resolution scheme if (iii) ‘a resolution action is necessary in the public interest pursuant to Article 18(5)’.

Art. 18 para. (7) states, ‘Immediately after the adoption of the resolution scheme, the Board shall transmit it to the Commission. Within 24 hours from the transmission of the resolution scheme by the Board, the Commission shall either endorse the resolution scheme, or object to it with regard to the discretionary aspects of the resolution scheme [...]’ The Commission within 12 hours from the transmission of the resolution scheme by the Board, may propose to the Council: (i) ‘to object to the resolution scheme on the ground that the resolution scheme adopted by the Board does not fulfil the criterion of public interest referred to in paragraph 1(c)’, or (ii) ‘to approve or object to a material modification of the amount of the Fund provided for in the resolution scheme of the Board.’ Based on this regulation, the Council acts according to a simple majority. The regulation requires the Council or Commission to provide reasons for exercising its power of objection. If no objection has been expressed by the Council or the Commission within 24 hours after its transmission by the Board, the resolution scheme enters into force.

The first nine SRM-related cases tried by the GC – even if eight out of nine cases⁷⁷ were dismissed as inadmissible for various reasons⁷⁸ – showed that the financial institutions did not evaluate the procedure of the SRB as transparent; in their applications,⁷⁹ they frequently claimed that (i) the SRB should have notified them of their decisions (not only the NRAs) and that (ii) the SRB should have disclosed more details on the grounds of its decision.

⁷⁶ For details on the Hungarian regulation and domestic supervision system, please see: Nagy and Csiszár, 2016, pp. 157–163.

⁷⁷ T-645/16, *Vorarlberger Landes- und Hypothekenbank v. SRB*, Order of the GC, 6 February 2017; T-661/16, *Credito Fondiario v. SRB*, Order of the GC, 19 November 2018; T-14/17, *Landesbank Baden-Württemberg v. SRB*, Order of the GC, 19 November 2018; T-42/17, *VR-Bank Rhein-Sieg v. SRB*, Order of the GC, 19 November 2018; T-494/17, *Iccrea Banca v. Commission and SRB*, Order of the GC, 19 November 2018; T-618/17, *Activa Minoristas del Popular v. ECB and SRB*, Order of the GC, 18 September 2018; T-281/18, *ABLVB Bank AS v. ECB*, Order of the GC, 6 May 2019; T-283/18, *Bernis et al. v. ECB*, Order of the GC, 6 May 2019; T-158/18, *Scaloni and Figni v. Commission, EP, Council*, Order of the GC, 9 July 2019.

⁷⁸ T-661/16, Order of the GC, paras. 49, 55; T-14/17, Order of the GC, paras. 33, 51; T-42/17, Order of the GC, paras. 24, 51; T-494/17, Order of the GC, paras. 24–26, 69; T-618/17, Order of the GC, paras. 15, 23–27.

⁷⁹ T-661/16, *Credito Fondiario v. SRB*, Application, 19/09/2016; T-14/17, *Landesbank Baden-Württemberg v. SRB*, Application, 12/01/2017; T-42/17, *VR-Bank Rhein-Sieg v. SRB*, Application, 25/01/2017; T-494/17, *Iccrea Banca v. Commission and SRB*, Application, 28/07/2017; T-618/17, *Activa Minoristas del Popular v. ECB and SRB*, Application, 08/09/2017.

Two novel judgments, both delivered on 1 June 2022, revolving around the resolution of the *Banco Popular Group* (the sixth-largest banking group in Spain at the time of the resolution) also show issues around clarity many years after the SRB was implemented, such as who should be notified. In the T-510/17 *Antonio Del Valle Ruíz v. European Commission and Single Resolution Board* case,⁸⁰ in their first plea-in-law,⁸¹ the applicants claimed that the SRB’s procedure under Art. 18 of the SRM Regulation contradicted Arts. 41 and 47 of the *Charter of Fundamental Rights of the EU* (Charter).⁸² Emphasis was placed on the right to an effective remedy and a fair trial under Art. 47 of the Charter, since, in their view, the fact that shareholders and creditors are not heard during the procedure infringes on this right.⁸³ The GC reiterated that while no provision of the SRM Regulation expressly excludes or restricts the rights of shareholders and creditors of the entity concerned to be heard during the resolution procedure, such a hearing procedure, which would be lengthy in the case of thousands of shareholders and creditors, is contrary to the very purpose of the procedure and may jeopardise its effectiveness,⁸⁴ since the decision procedure under Art. 18 of the SRM Regulation is aimed at:

[...] ensuring the continuity of the critical functions of the entity concerned and [...] protecting the stability of the financial system of that Member State and, therefore, preventing contagion to other Member States of the euro area would have been exposed to serious risks.⁸⁵

This risk is real, as the background of the case proves: on 31 May 2017, *Reuters* published an article entitled ‘EU warned of wind-down risk for Spain’s Banco Popular’; the publication was based on the allegations of an EU official, whose identity remains unknown. As a result, Banco Popular faced massive liquidity outflows during the first few days of June 2017.⁸⁶ Regarding the infringement of Art. 47 of the Charter, the GC stated that:

It is sufficient to note that the applicants’ argument is based on a misinterpretation of the scope of the right to an effective remedy enshrined in Article 47 of the Charter, which guarantees a right to an effective remedy against an act which adversely affects a person and not before the adoption of the act.⁸⁷

80 CJEU, 1 June 2022, T-510/17, *Antonio Del Valle Ruíz v. European Commission Single Resolution Board*, ECLI:EU:T:2022:312.

81 The applicants submitted nine pleas-in-law. The author introduces only the first and the ninth as the most relevant ones.

82 Charter of Fundamental Rights of the European Union, OJ C 326, 26.10.2012, 391–407.

83 T-510/17, para. 113.

84 T-510/17, paras. 124, 151, 165.

85 T-510/17, paras. 152, 161.

86 T-510/17, paras. 42–44.

87 T-510/17, para. 190.

Therefore, the GC rejected the first plea-in-law as unfounded.⁸⁸

In the ninth plea, the applicants claimed under Art. 277 of the TFEU that Arts. 18 and 22 of Regulation No. 806/2014 contradict the principles relating to the delegation of power set out by the CJEU in its 1958 *Meroni v. High Authority* judgment.⁸⁹ In the applicants' view, '[...] the provisions of Article 18(7) of [the SRM Regulation], according to which the Commission is to endorse the resolution scheme within 24 hours [...] it is the SRB which decides on the resolution policy, with the Commission simply carrying out a 'rubber-stamp' function'.⁹⁰ The GC first reiterated that the Founding Treaties do not elaborate on the issue of conferring powers on an EU body, office, or agency. As highlighted by Advocate General Niilo Jääskinen,⁹¹ in *United Kingdom v. Parliament and Council*:⁹²

[...] no mention is made of agencies in either Article 290 TFEU, which provides for delegation of rule-making in legislative acts to the Commission, or Article 291 TFEU which confers implementing powers on the Member States, the Commission, and in some limited circumstances the Council.⁹³

It is therefore the case law – in particular, *Meroni and the United Kingdom v. Parliament and Council* – that elaborated on the issue of the autonomous powers of EU agencies. In the latter case, the CJEU updated the *Meroni* doctrine and expanded the scope of powers delegable to agencies to include discretionary powers as long as adequate controls were in place.⁹⁴

In the GC's view, the EU legislator avoided an 'actual transfer of responsibility' within the *Meroni* judgment. First, the SRM Regulation states that the resolution scheme may enter into force only if no objection has been expressed by the Council or the Commission regarding the discretionary aspects of the scheme within 24 hours of its transmission. Thus, to produce legal effects for the resolution scheme, it is necessary for an EU institution to approve it. This finding is supported by pre-ambulars 24 and 26 of the SRM Regulation.⁹⁵ Second, under Art. 14 of the SRM Regulation the Commission is also obliged to make the assessment under Art. 18 when it has to endorse the choice of a resolution tool and comply with the public interest criterion. Under Art. 43 para. (3), the Commission is entitled to designate a permanent observer, who is entitled to participate in meetings of the executive

⁸⁸ T-510/17, para. 203.

⁸⁹ CJEU, 3 June 1958, C-9/56, *Meroni v High Authority*, ECLI:EU:C:1958:7; On the issue of the applicability of the *Meroni* case in the current institutional context, see: Ferran, 2012.

⁹⁰ T-510/17, paras. 204–205.

⁹¹ CJEU, 12 September 2013, C-270/12, *United Kingdom v. Parliament and Council*, Opinion of Advocate General Niilo Jääskinen, ECLI:EU:C:2013:562.

⁹² CJEU, 22 January 2014, C-270/12, *United Kingdom v. Parliament and Council*, ECLI:EU:C:2014:18.

⁹³ Opinion of Advocate General Niilo Jääskinen, C-270/12, para. 75.

⁹⁴ Babis, 2014, pp. 266–270.

⁹⁵ T-510/17, paras. 215–219.

and plenary sessions of the SRB as well as the debates and who has access to all documents; consequently, the Commission becomes aware of the resolution scheme before it is transferred by the SRB and has sufficient time to assess its discretionary aspects during the preparation of the scheme. Therefore, in the GC’s view, the SRB does not have the autonomous power to decide on the resolution of an entity or the resolution tool pursuant to Art. 22 of the SRM Regulation.⁹⁶ Accordingly, the GC rejected the ninth plea-in-law as unfounded.⁹⁷

The legal nature of the resolution scheme was also one of the core issues in the T-481/17 *Fundación Tatiana Pérez [...] v. SRB* case.⁹⁸ In its intervention⁹⁹, the Commission claimed that the action was inadmissible because the resolution scheme was an intermediate measure, which did not produce legal effects. It submitted that, by its decision, it approved the resolution program, made its own, attributed binding legal effects to it, and that, therefore, the action brought solely against the resolution program was inadmissible. In the view of the GC, while there is no doubt that – as the Commission argued at the hearing –, the resolution program will only enter into force with its support, this does not mean that the Commission’s support extinguishes the autonomous legal effects of the resolution scheme. Contrary to the Commission’s assertion, respect for the principles laid down in the Meroni judgment concerning the delegation of powers does not mean that only the decision adopted by the Commission produces legal effects.¹⁰⁰ As Preamble (26) of the SRM Regulation states:

[...] The procedure relating to the adoption of the resolution scheme, which involves the Commission and the Council, strengthens the necessary operational independence of the Board while respecting the principle of delegation of powers to agencies, as interpreted by the Court of Justice of the European Union.

As the GC reiterated, the division of competencies between the SRB and the Commission, according to the SRM Regulation, does not support the Commission’s argument that it makes the resolution program its own by endorsing it. The Commission has its own power to assess the discretionary aspects of the resolution program and decide whether to endorse or object to it. On the other hand, it has no power to exercise the powers reserved for the SRB or to amend the resolution programme or its effects; that is, the Commission cannot object to or alter the technical aspects of the resolution scheme. Furthermore, it should be noted that Art. 86 of the SRM Regulation provides that all decisions of the SRB – with the exception

⁹⁶ T-510/17, paras. 227–228, 230–232.

⁹⁷ T-510/17, para. 234.

⁹⁸ CJEU, 1 June 2022, T-481/17, *Fundación Tatiana Pérez de Guzmán el Bueno and Stiftung für Forschung und Lehre (SFL) v. SRB*, ECLI:EU:T:2022:311.

⁹⁹ The applicants submitted ten pleas-in-law. The author dispenses with them and focuses on the intervention of the Commission.

¹⁰⁰ T-481/17, paras. 107, 127.

of decisions which may be called into question before an appeal body – may be challenged before the CJEU by means of an action under Art. 263 of the TFEU. In the GC's view, the resolution programme falls conceptually within this category of decisions, and no reservation in that article or any other provision of the [SRM Regulation] allows its exclusion.¹⁰¹ It must, therefore, be concluded that it follows from the wording of Art. 86 of the SRM Regulation – as well as from other provisions of the Regulation –, that the resolution scheme adopted by the SRB may be challenged individually without requiring the launching of a procedure against the Commission's decision to endorse it.¹⁰²

Based on Art. 94 of the SRM Regulation, the Commission shall publish a report on the application of this regulation by 31 December 2018 and every three years thereafter. The evaluation of the SRM's first years of functioning showed a somewhat mixed picture. While reports made by EU institutions¹⁰³ – including the first evaluation of the Commission under Art. 94 of the SRM Regulation¹⁰⁴ – or on behalf of EU institutions¹⁰⁵ seemed to hit a cautious tone,¹⁰⁶ some scholars concluded¹⁰⁷ that the member states of the EU had recognised the prevalence of the ECB's competencies. In their view, the SRM regulation leaves no room for national resolution tools. Contrary to this optimistic evaluation, the author of the current article, after examining the case law of the CJ and the GC,¹⁰⁸ concluded that the national central banks – quoting Chiarella – are still prone to protect the so-called 'national champions' by calling the SRM's competence into question. In addition, the SRM seemed afraid to use its competencies. As pointed out by Nicolas Véron,¹⁰⁹ its hesitation to order the liquidation of *Banca Popolare di Vicenza* and *Veneto Banca* cost the Italian taxpayers a significant amount. As *Martin Sandbu* noted, the ECB started to use its recent empowerment half-heartedly.¹¹⁰

Unlike the SSM, recent academic evaluations show that there are shortcomings and legal uncertainties in the functioning of the SRM,¹¹¹ as proven by the two judgments of 1 June 2022 introduced in this study.

101 T-481/17, paras. 132, 140.

102 T-481/17, paras. 143–144.

103 European Court of Auditors, 2017, p. 68.

104 See also: European Commission, The Report from the Commission to the European Parliament and the Council on the application and review of Directive 2014/59/EU (Bank Recovery and Resolution Directive) and Regulation 806/2014 (Single Resolution Mechanism Regulation), Brussels, 30.4.2019, COM(2019) 213 final p. 15.

105 Véron, 2019, p. 21.

106 On the negative side, the agency was understaffed and resolution planning was not completed within the deadline. However, these shortcomings were associated with the initial period and could be tackled in the future. European Court of Auditors, 2017, paras. 34, 55–56, 60, 63, 64–68, 103, 114, 125, 141.

107 Busch, Louisse and van Rijn, 2019.

108 For details see: Marinkás, 2018a.

109 Véron, 2018.

110 Sandbu, 2015, p. 313.

111 Culpepper and Tesche, 2021, pp. 134–150; Smoleńska, 2022, pp. 42–53.

2.4. The European Deposit Insurance Scheme

The Commission's 2015 proposal on the EDIS¹¹² alleges that the current framework of national *Deposit Guarantee Schemes* (DGSs)¹¹³ is vulnerable to external shocks. The EDIS could remedy this vulnerability and would increase the resilience of the BU against future crises. The Commission indicated that Art. 114 of the TFEU provided the legal basis for the proposed regulations. The Commission argued that, to be effective, legislation needs unified applicability within the participating Member States; that is, the legislation has to be approved in the form of a regulation, and the creation of a board representing all members of the BU is needed. The board would be the SRB, expanded to make it eligible to administer EDIS. Based on the proposal, participating Member States would be members of the Eurozone and those other Member States that have established close cooperation with the ECB under Art. 4 para. (1) of the SSM Regulation. The Board is fully financed by administrative contributions from credit institutions affiliated with the participating DGSs. This means that EDIS-related functions do not require contributions from the EU budget. The EDIS will be implemented in three successive stages: a reinsurance scheme for participating in national DGSs in the first three-year period, a co-insurance scheme for participating in national DGSs in the second four-year period, and full insurance for participating in national DGSs in the steady state. National DGSs would be eligible to gain financing from the fund if they are being built in line with a precise funding path and otherwise comply with essential requirements under EU law. The introduction of the EDIS would be accompanied by ambitious measures to reduce risk in the banking sectors of Member States.

Most academic analyses¹¹⁴ and a recent ECB study¹¹⁵ displayed a positive attitude towards the creation of the EDIS and supported the findings of the effect analysis conducted under the aegis of the Commission,¹¹⁶ emphasising its positive effect on the resilience of the BU; however, political opposition hindered its creation.¹¹⁷ The most explicit opposition to the EDIS came from the German government, as was the case with the Banking Union's other elements. The German government and the main political parties criticised the EDIS proposal as an unacceptable step towards debt mutualisation. The German finance minister, Wolfgang Schäuble, argued that it was unacceptable that the 'backstopping of depositors

112 European Commission (2015) 'Proposal for a regulation of the European Parliament and of the council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme', Strasbourg, 24.11.2015, COM(2015) 586 final, p. 69.

113 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast), OJ L 173, 12.6.2014, 149–178.

114 Fernandez-Aguado et al., 2022, p. 244; Cerrone, 2018, p. 237.

115 Eule, Kastelein and Sala, 2022.

116 *Effects analysis on the European deposit insurance scheme (EDIS)* [Online]. Available at: https://finance.ec.europa.eu/system/files/2017-02/161011-edis-effect-analysis_en.pdf (Accessed: 29 September 2023).

117 Howarth and Quaglia, 2018, pp. 190–209.

[could] become an excuse for banks to behave irresponsibly, potentially leaving German taxpayers to foot the bill'. Schäuble believed that measures that ensured banks had big enough buffers of capital and debt to absorb financial shocks and gave authorities the power to force losses on creditors without facing litigation should 'have priority'.¹¹⁸

However in its 2017 communication¹¹⁹ the Commission urged the creation of the EIDIS, it only submitted its legislative proposal on 23 April 2023.¹²⁰ While this time too, the ECB proved to be supportive,¹²¹ political opposition to an EU-wide deposit insurance scheme remains very strong.¹²²

3. The ECB's crisis management strategies

3.1. Crisis management programs related to the Greek Sovereign Debt Crisis and the creation of the Banking Union

The CJEU has always displayed an 'amicable attitude' towards the institutional framework of the ECB's crisis management¹²³ or, as Dawson and Bobic more bluntly put it, the 'answer to any question related to ECB activity (at least on monetary questions) seems to be known in advance'.¹²⁴ Scholars have also observed that the ECB and the CJEU were not in an easy situation: in the words of Yair Listokin: in the 'OMT-case'¹²⁵ these two institutions could have chosen either the functional 'amendment' of the Founding Treaties or taken the risk of the Eurozone's possible fall. They chose the first option.¹²⁶ Similarly, functioning of the *European Securities and Markets Authority* (ESMA)¹²⁷ and the ESM were stated by the CJEU as being conform to the Treaties.¹²⁸ The national constitutional courts displayed the same

118 *EU to strengthen management of banking crises*, 2023; See also: Brunsden, 2015.

119 Communication to the European parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on Completing the Banking Union', Brussels, 11.10.2017, COM(2017) 592 final, p. 20.

120 European Commission, 2023b.

121 *Opinion of the European Central Bank of 5 July 2023 (CON/2023/19)* [Online]. Available at: https://www.ecb.europa.eu/pub/pdf/legal/ecb_leg_con_2023_19.en.pdf (Accessed: 9 October 2023), para. 2.2.

122 *EU to strengthen management of banking crises*, 2023.

123 Angyal, 2015, pp. 129–143.

124 Dawson and Bobic, 2019, pp. 1005–1040.

125 CJEU, 16 June 2015, C-62/14, *Gauweiler and Others*, ECLI:EU:C:2015:400.

126 Listokin, 2019, p. 280.

127 CJEU, 22 January 2014, C-270/12, *United Kingdom v. EP and Council*, ECLI:EU:C:2014:18.

128 CJEU, 27 November 2012, C-370/12, *Thomas Pringle vs. Government of Ireland and Others*, ECLI:EU:C:2012:756.

attitude.¹²⁹ The first 'warning' from the BVerfG arrived in 2019, when it stated, 'in the current state of the Banking Union there is still a sufficient level of legitimacy feedback'.¹³⁰

In the words of José Luís da Cruz Vilaça,¹³¹ the BVerfG 'crossed the red line'¹³² with the so-called 'PSPP judgment' of 5 May 2020¹³³ when it stated that the ECB acted ultra vires, and in violation of Germany's constitutional identity by implementing the PSPP.¹³⁴ The judgment caused a major earthquake in legal scholarship¹³⁵ and heated public debates, since the BVerfG did it at the worst possible time, at the beginning of the COVID-19 pandemic in May 2020, which, based on the knowledge available at the time, threatened to have unforeseen health and economic consequences. During this time, EU institutions were eager to seek a legal basis for their work to tackle the economic consequences of the pandemic.¹³⁶

As the BVerfG argued, Member States are the Masters of the Treaties and, consequently, EU institutions are not allowed to establish powers for themselves not conferred on them by treaty provisions, and Member States are not bound by decisions of EU institutions in case these decisions contradict the principle of conferral.¹³⁷ Asset purchases by the German Federal Bank (*Deutsche Bundesbank*) within the framework of the PSPP fall under the competence of Member States based on the Founding Treaties. Thus, in the BVerfG's view, the PSPP is essentially an intervention in the economic policy of Member States and enables the ECB to pursue an autonomous economic policy, contrary to the provisions of the Treaties.¹³⁸

The ECB has taken note of the BVerfG's decision without commenting on its merits and has declared its intention to continue to use its powers to fulfil its purpose, as laid down in the Founding Treaties.¹³⁹ The CJEU, departing from its habit to never comment on a national court judgment, made the following statements in its press release:¹⁴⁰

129 Austrian Constitutional Court (*Verfassungsgerichtshof*, VfGH) *Verfassungsgerichtshof*, No. SV 2/12–18, Judgment of 16 March 2013 (ESM Treaty); *Verfassungsgerichtshof*, No. SV1/2013–15, Judgment, 3 October 2013 (Fiscal Compact); French Constitutional Court (*Conseil constitutionnel*), 2012–653 DC, Judgment, 9 August 2012 (Fiscal Compact); Bundesverfassungsgericht, 2 BvR 1390/12, Judgment, 12 September 2012 (ESM Treaty).

130 BVerfG, 2 BvR 1685/14, 2 BvR 2631/14. Judgment of Juli 2019 (Banking Union); See furthermore: Horváth et al. 2021, pp. 116–137.

131 Former Judge and Advocate General of the Court of Justice of the European Union, former President of the General Court.

132 da Cruz Vilaça, 2020; See also: Lenaerts, 2021, p. 11.

133 Bundesverfassungsgericht, 2 BvR 859/15 –, Rn. 1–237, Judgment of 5 May 2020 (PSPP).

134 Decision (EU) 2015/774 of the European Central Bank of 4 March 2015 on a secondary markets public sector asset purchase programme (ECB/2015/10), OJ L 121, 14.5.2015, 20–24. – No longer in force.

135 See: Metzinger, 2022, pp. 13–54.

136 Marinkás, 2022, pp. 71–96.

137 BVerfG, 2 BvR 859/15, paras. 111, 157, 234.

138 BVerfG, 2 BvR 859/15, paras. 135, 142, 163.

139 European Central Bank, 2020a.

140 Court of Justice of the European Union, 2020.

[the] Court of Justice has consistently held that a judgment in which the Court gives a preliminary ruling is binding on the national court [...] In order to ensure that EU law is applied uniformly, the Court of Justice alone [...] has jurisdiction to rule that an act of an EU institution is contrary to EU law. Divergences between courts of the Member States as to the validity of such acts would indeed be liable to place in jeopardy the unity of the EU legal order and to detract from legal certainty.

The CJEU has stated that it would refrain from communicating further on this matter. The President of the European Commission, Ursula Von Der Leyen,¹⁴¹ notably recalled three basic principles:

(i) that the Union's monetary policy is a matter of exclusive competence; (ii) that EU law has primacy over national law and that (iii) rulings of the European Court of Justice are binding on all national courts. The final word on EU law is always spoken in Luxembourg. Nowhere else.

The European Commission launched an infringement procedure against Germany some thirteen months later.¹⁴² According to *Federico Fabbrini*, this is no coincidence: these thirteen months were long enough to 'save the BVerfG from itself'.¹⁴³ The Bundesbank, the German government and the lower house of the German parliament (*Bundestag*) 'settled the matter' by conducting the proportionality assessment, when they inspected publicly unavailable documents provided by the ECB.¹⁴⁴ Referring to the above assessment and to some formal deficiencies, the BVerfG in its April 2021 Decision¹⁴⁵ rejected two applications for the enforcement of the judgment of 5 May 2020 under Art. 35 of the Law on the BVerfG (*Bundesverfassungsgerichtsgesetz, BVerfGG*).¹⁴⁶ This time was also sufficient to negotiate the package at the EU level to counter the economic crisis caused by the COVID-19 pandemic, without the Commission having to confront the German government during negotiations. As Fabbrini wrote in June 2021, the issue had effectively been resolved by the time the Commission responded to its merits, so there would be no real stake in the proceedings.

¹⁴¹ European Commission, 2020.

¹⁴² European Commission, 2021a.

¹⁴³ Fabbrini, 2021.

¹⁴⁴ See: Deutscher Bundestag, Drucksache 19/20621 (19. Wahlperiode). Antrag der Fraktionen CDU/CSU, SPD, FDP und BÜNDNIS 90/DIE GRÜNEN Urteil des Bundesverfassungsgerichts zum Anleihekaufprogramm PSPP der Europäischen Zentralbank (1 July 2020); See furthermore: *Bundestag: EZB hat Karlsruher Vorgaben zu Anleihekäufen erfüllt* [Online]. Available at: <https://www.bundestag.de/dokumente/textarchiv/2020/kw27-de-anleihekaeufo-703660> (Accessed: 29 September 2023).

¹⁴⁵ Bundesverfassungsgericht, 2 BvR 1651/15 –, Rn. 1–111, Order of 29. April 2021, paras. 82–88.

¹⁴⁶ 'Bundesverfassungsgerichtsgesetz in der Fassung der Bekanntmachung vom 11. August 1993 (BGBl. I S. 1473), das zuletzt durch Artikel 4 des Gesetzes vom 20. November 2019 (BGBl. I S. 1724) geändert worden ist'.

Unsurprisingly, the European Commission closed the infringement procedure against Germany in December 2021.¹⁴⁷

Some academics argued that launching the infringement procedure was not a wise move since, by the end of the day, the German Government could have been made to pay for the act of the independent judicial branch.¹⁴⁸ It is no coincidence that, until the 2018 CJEU decision in *European Commission v. French Republic*¹⁴⁹, no judgment had been delivered in which the Commission had invoked a breach of Art. 267 para. (3) of the TFEU. However, it is clear from previous cases that such infringements may lead to infringement proceedings.¹⁵⁰ Others argue that launching the infringement procedure was a necessary move: the European Commission – chaired by a German citizen at that time – could not dispense with the infringement proceedings against Germany, given that this omission could have served as a basis for other countries not to comply with the provisions of the Founding Treaties.¹⁵¹

According to Grégory Claey's, the BVerfG's judgment was logically flawed in the first place because its statement that the CJEU did not examine the proportionality of the ECB's decisions in sufficient detail leads to the conclusion that the BVerfG did not take into account that the ECB's primary objective under the provisions of the Treaty is to achieve price stability. Any other objective can only be taken into account afterwards. In other words, the ECB cannot arrange price stability and other objectives in arbitrary order; thus, the proportionality test required by the BVerfG cannot be carried out. In Claey's view, the PSPP judgment's only positive outcome was that it highlighted a fundamental problem in the Eurozone: namely, that twenty years after the establishment of the ECB, it is still not entirely clear what exactly does and does not fall within the ECB's mandate.¹⁵² Following this train of thought, it is worth mentioning David Quinn's opinion that the newfound role of the ECB as an LLR within the Eurozone, legitimated by the CJEU's case law, led to a growing gap between the formal and functional constitutional framework of the ECB: the governance structure of the ECB was not designed to house contested disputes over distributional choices. Even assuming utmost probity and technical competence, its decision-makers are not directly elected by European demos; thus, its decisions on the above-mentioned distribution choices suffer from a democratic deficit.¹⁵³

147 European Commission, 2021b.

148 Riedl, 2021.

149 CJEU, 4 October 2018, C-416/17, *European Commission v. France*, ECLI:EU:C:2018:811.

150 Fazekas, 2021, p. 278; See also: CJEU, 9 December 2003, C-129/00, *Commission of the European Communities v. Italian Republic*, ECLI:EU:C:2003:656; CJEU, 30 September 2003, C-224/01, *Gerhard Köbler v. Republik Österreich*, ECLI:EU:C:2003:513, para. 55; CJEU, 13 June 2006, C-173/03, *Traghetti del Mediterraneo SpA v. Repubblica Italiana*, ECLI:EU:C:2006:391, paras. 32, 43; CJEU, 12 November 2009, C-154/08, *Commission of the European Communities v. Kingdom of Spain*, ECLI:EU:C:2009:695.

151 Everson and Joerges, 2021.

152 Claey's, 2020, pp. 7–9.

153 Quinn, 2023, p. 76.

Nevertheless, as Isabel Schnabel¹⁵⁴ concluded the reforms that followed the 2008 global financial crisis made the financial system safer and more resilient. Tighter regulations and higher capital ratios have been key factors enabling banks to act as shock absorbers rather than shock amplifiers during the (COVID-19) pandemic.¹⁵⁵ Other scholars have arrived at similar conclusions.¹⁵⁶

3.2. COVID-19-related crisis management

‘Extraordinary times require extraordinary action. There are no limits to our commitment to the Eurozone’– As Christine Lagarde, President of the European Central Bank (2019-) stated in March 2020.¹⁵⁷

The *Pandemic Emergency Purchase Programme* (PEPP)¹⁵⁸ was one such answer to the shocks of the COVID-19 pandemic, with an initial envelope amounting to EUR 750 billion.¹⁵⁹ The PEPP was increased and extended twice in terms of its amount and duration, ultimately reaching EUR 1850 billion.¹⁶⁰ On 16 December 2021 the Governing Council of the ECB decided to discontinue net asset purchases under the PEPP by the end of March 2022.

While the CJEU has not scrutinized the PEPP, some scholars have matched this at the theoretical level. In his March 2020 paper, *Sebastian Grund* argued that, on the basis of the related case law of the CJEU, if such a procedure would have been initiated, the PEPP would pass the ‘test’ set by the CJEU as (i) the measures do not exceed the ECB’s mandate, (ii) the measures respect the principle of proportionality, and (iii) the programme does not breach the prohibition of monetary financing enshrined in Art. 123 para. (1) of the TFEU.¹⁶¹ Additionally, Yves Mersch, a member of the ECB’s Executive Board,¹⁶² also argued in November 2020 that the PEPP was in line with the Founding Treaties, and that the ECB had not exceeded its powers with the programme. Furthermore, he stressed that the CJEU consistently held that the ECB enjoys broad discretion in defining monetary policy within its mandate to pursue the objective of price stability. This discretion is not without limitations; on

154 Member of the Executive Board of the European Central Bank (Incumbent from 1 January 2020).

155 Schnabel, 2020.

156 Fernandez-Aguado et al., 2022, p. 243; Cerrone, 2018, p. 224.

157 *ECB’s commitment to the euro has “no limits”*, 2020.

158 Decision (EU) 2020/440 of the European Central Bank of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17), OJ L 91, 25.3.2020, pp. 1–4; For the ECB’s Summary, visit: *Pandemic Emergency Purchase Programme (PEPP)* [Online]. Available at: <https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html> (Accessed: 29 September 2023).

159 While the first response to the pandemic on 12 March 2020 included the announcement of an additional envelope of €120 billion under our regular asset purchase programme (APP), it quickly became clear that the APP was not an adequate tool to deal with the sudden and severe dislocations in euro area bond markets when the crisis hit with full force. Schnabel, 2021.

160 European Central Bank, 2020b.

161 Grund, 2020.

162 Incumbent: 15 December 2012 – 14 December 2020.

the one hand, the ECB's actions are scrutinised by the CJEU and, on the other hand, the ECB is bound to respect certain established legal principles. The ECB's measures must be proportionate to the ECB's legitimate objectives: they must not undermine the spirit of the 'no bailout clause' and its monetary policy counterpart, the prohibition of monetary financing. Mersch stressed that Art. 4 of the original PEPP decision – promulgated on 24 March 2020 – states *expressis verbis* that measures must comply with the requirements of necessity and proportionality.¹⁶³ As is clear from Mersch's speech, the proportionality requirement is to be met by considering economic analyses that show whether the measures (i) are capable of achieving the monetary policy objective pursued, (ii) do not go beyond what is necessary, and (iii) avoid any disadvantages that are manifestly disproportionate to the objectives pursued.

Collateral easing measures also played a key role in the ECB's monetary policy response to the COVID-19 pandemic. Temporary collateral measures were introduced in April 2020 to ensure that the banking sector could expand its access to central bank liquidity on favourable terms via targeted longer-term refinancing operations (currently, TLTRO III), allowing it to continue to cover the funding needs of the Eurozone economy. The three interconnected primary objectives were: pre-empting shortages of eligible collateral; adding flexibility to the collateral framework; countering adverse pro-cyclical feedback effects. These collateral easing measures were gradually phased out by March 2024, based on the ECB's March 2022 announcement.¹⁶⁴

Regarding academic evaluations, the ECB played a highly positive role in diminishing the economic impact of COVID-19 on its members.¹⁶⁵ In the words of co-authors *Lucia Quaglia* and *Amy Verdun*, the ECB–SSM is an 'understudied' supranational institution with a proven ability to make a considerable mark on policy development and to act quickly in the 'vacuum' left by other EU-level institutions. Summarising their thoughts, they argue that the ECB was entrepreneurial in responding to the crisis that required a response at the EU level: it took on supranational leadership as soon as it realized that national decision makers could not do so right away.¹⁶⁶

3.3. Russo-Ukrainian War

As Christine Lagarde stated in October 2023, we are in a state of 'permacrisis': a constant succession of serious and unprecedented crises. Still, the ECB's mandate, is price stability. As it has been in the last 25 years. It is the ECB's compass. In Lagarde's view, key ECB interest rates have reached levels that, maintained for a sufficiently long period, will substantially contribute to the timely return of inflation to the target. As Lagarde stated, the ECB has raised rates because it is the most efficient and

¹⁶³ Mersch, 2020.

¹⁶⁴ Bakker et al., 2022.

¹⁶⁵ Quinn, 2023, p. 790.

¹⁶⁶ Quaglia and Verdun, 2023, pp. 139–156.

effective tool currently enabling it to reduce inflation and ensure price stability.¹⁶⁷ In July 2022, for the first time in the previous six years, the ECB increased its fixed interest rate to 0.5 percent. In the next period, the ECB increased its interest rates almost monthly. By June 2023, the rate reached 4% – the highest level since the start of the global financial crisis of 2007.¹⁶⁸ The ECB's other tool for fighting inflation is the phasing out of net purchase programs.¹⁶⁹ According to statistical data, these tools seem to be working.¹⁷⁰

4. Conclusions

The first part of this chapter considered why the EMU was called a 'half-built house' in its original form that is, the introduction explored the EMU's initial asymmetric nature and lack of a proper supervisory mechanism. The second part turned to notable subsequent developments: first, the ECB successfully managed the Greek sovereign debt crisis by various purchase programmes and, with the consent of the CJEU, emerged as the de facto LLR within the Eurozone (without a de jure authorisation, as some scholars pointed out). Second, the crisis created a situation in which Member States were willing to transfer certain elements of their sovereignty to the supranational level – something that seemed unimaginable a few years ago. They created the BU's first three pillars: the Single Rulebook, SSM, and SRM. The fourth pillar, the EDIS, is still under construction due to political opposition over the last decade. While the European Commission's April 2023 proposal may provide new impetus for its creation, political opposition remains significant. The already-implemented regulatory and institutional measures proved to be effective in enhancing the resilience of the financial system, even if the functioning of the resolution mechanism still exhibits uncertainties. Nevertheless, by the time the COVID-19 pandemic and its economic consequences arrived, the ECB had already experienced crises and was well equipped to handle another one.

167 *Interview with Christine Lagarde, President of the ECB, conducted by Marie-Pierre Gröndahl on 2 October 2023, 2023.*

168 *Fluctuation of the European Central Bank fixed interest rate from 2008 to 2023* [Online]. Available at: <http://web.archive.org/web/20230224110544/https://www.statista.com/statistics/621489/fluctuation-of-fixed-rate-interest-rates-ecb/> (Accessed: 29 September 2023).

169 Panetta, 2022.

170 *Euro Area Inflation Rate* [Online]. Available at: <https://tradingeconomics.com/euro-area/inflation-cpi> (Accessed: 29 September 2023).

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CROATIA: THE EXPERIENCES OF OTHER COUNTRIES AS A GUIDE TO THE EURO AREA ACCESSION PROCESS



NATAŠA ŽUNIĆ KOVAČEVIĆ

Abstract

After short introduction author gives review and analyses experiences of Croatia in a process of euro area accession. It is pointed that the conditions for entry into the Euro Area remained unchanged, so Croatia followed the path to the euro based on the criteria set out in the Maastricht Treaty. This paper examined with an overview of the experiences of Croatia in a process of euro area accession by giving a review of Croatian National Bank with relation to European Central Bank with section explaining the process of acquiring experiences from other eurozone member states. After the section on outcomes related to the introduction of the Euro and banking union special focus is given to the participation in the exchange rate mechanism – ERM II with described process of established close cooperation between the ECB and the HNB. The role of the HNB in the unified supervisory mechanism with Single Resolution Mechanism and the Croatian responsible national authorities chapter is central part of the paper. It is emphasized that ERM II was important preparatory phase towards euro adoption in Croatia. Concluding remarks are about positive effects of adopting the euro in Croatia in a short-term, with message on the long-term effects that depend on the domestic capability for changes.

Keywords: *Croatia's euro area accession, HNB, ECB, exchange rate mechanism*

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1. Introduction

Euro area accession is an open and rule-based process. Specifically, it requires the fulfilment of four economic convergence criteria, sometimes referred to as the Maastricht criteria, regarding price stability, sustainable public finances, exchange rate stability, and nominal long-term interest rate convergence. A country's national legislation on monetary affairs must also align with the Treaty on the Functioning of the European Union (TFEU).¹ The latest assessment of the progress of non-euro Member States in converging towards adopting the euro was published in the Commission's 2022 Convergence Report on 1 June 2022. This assessment found that Croatia fulfilled all the convergence criteria, paving the way for the Council's decision on 12 July 2022 to offer the country membership in the euro area as of 1 January 2023. With its accession, Croatia became the 20th member of the euro area. This paper presents the key considerations underpinning Croatia's Eurozone accession process.² The Croatian economy is expected to benefit from the elimination of currency risk as well as lower transaction and borrowing costs. After accession to the EU in 2013, Croatia made significant progress in addressing macroeconomic imbalances and achieving convergence towards the Eurozone. It must continue these reform efforts to fully obtain the benefits of the euro and allow adjustment mechanisms to operate efficiently within the enlarged currency area.³

Since the conditions for entry into the euro area remained unchanged, Croatia followed the path to the euro based on the criteria set out in the Maastricht Treaty. According to these rules, the European Central Bank (ECB) and European Commission publish convergence reports once every two years for euro area candidate countries. The convergence reports published between 2014 and 2020 showed that, while Croatia met the inflation and interest rate criteria, it needed to make obvious efforts to meet the criteria related to public finances. Since 2018, Croatia has made additional efforts to meet these criteria and adopt the euro. It was ultimately accepted into the exchange rate mechanism (the ERM II), the forerunner of the Eurozone, in 2020, together with Bulgaria. This extended its accession by one year until 2024. The Convergence Report for Croatia, published by the European Commission in June 2022,⁴ specifies that the country meets the criteria for adopting a single currency, except for its high level of debt. At the end of June, the members of the European Council approved Croatia's entry into the eurozone, and this decision was confirmed on 12 July 2022 by the Council of the European Union. Croatia adopted the euro on 1 January 2023 when it entered the Schengen area.

1 Consolidated version of the Treaty on the Functioning of the European Union, OJ C 326, 26.10.2012, pp. 47–390.

2 Perić and Reut, 2022.

3 Falagiarda and Gartner, 2022.

4 European Commission, 2022b.

Generally, the adoption of different currencies in any country has a significant impact on the economy. Since 1994, Croatia has had its own currency, the kuna.⁵ Becoming a member of the European Union (EU) was Croatia's strategic goal; in particular, this goal was anchored in Croatia's desire to further its social development. Further, the adoption of the euro in the Croatian market was seen as a very important strategic decision. This has been discussed from different viewpoints of stakeholders, including the government, monetary policymakers, bankers, scientists, and the public. The period of Croatia's journey to join the European Monetary Union (EMU) and adoption of the new currency were used to research the impact of adopting the euro in countries that were already using this currency. This provided solid ground for policymakers to learn from their experience and make precise predictions.

Croatia, as a small and open EU member country, has its own specifics; however, it still learned from the experiences of other EMU Member States. Indeed, each country preparing to adopt the euro has an advantage because of its previous experience with similar countries; therefore, it is useful to recognize countries comparable to Croatia and their relationship with a single currency as special.⁶ For a long time, Croatia was defined as a country with a mostly 'euroised' economy.⁷ In the process of accession to the EMU, the most likely candidates to introduce the euro were Croatia, Romania, and Bulgaria. It is important to note that nations experience an increase in their gross national products after adopting the euro; for example, Austria, Belgium, Finland, Luxembourg, Germany, Spain, France, Ireland, Italy, the Netherlands, and Portugal, which introduced the euro in 1999, experienced an intensive rise in their GNPs after introducing it.⁸

As suggested above, euro area accession is an open and rule-based process that requires the fulfilment of the Maastricht criteria on price stability, sustainable public finances, exchange rate stability, and nominal long-term interest rate convergence. A country's national legislation on monetary affairs must also align with the TFEU. The latest assessment of progress made by non-euro Member States on converging towards adopting the euro was published in the Commission's 2022 Convergence Report on 1 June 2022. This assessment found that Croatia fulfilled all the convergence criteria, paving the way for the Council's decision on 12 July 2022 to make Croatia the 20th member of the euro area as of 1 January 2023. This paper presents the key considerations underpinning Croatia's Eurozone accession process.⁹ Achieving close

5 The modern kuna was introduced on 30 May 1994, launching a period of transition from the Croatian dinar, introduced in 1991, which ended on 31 December 1994. One kuna was equivalent to 1.000 dinars at a fixed exchange rate. The kuna was fixed to the German mark from the start. A long-time policy of the HNB was to keep the fluctuations of the kuna's exchange rate against the euro (or, previously, the mark) within a relatively stable range. Since the introduction of the euro in 1999, the exchange rate between the two currencies rarely fluctuated to a substantial degree. For more details, see: Mance, Drazenovic, and Nikolaj, 2019, p. 153.

6 Tokarski and Funk, 2019, p. 2.

7 For example, around 75% of assets and 67% of liabilities were denominated in euros.

8 Barbosa and Alves, 2011.

9 Perić and Reut, 2022.

cooperation between the monetary authorities, that is, central banks, like Croatia's Hrvatska Narodna Banka (HNB), and the ECB, was a prerequisite for entry into the ERM II – the first formal step in a nation's process to adopt the euro as its official currency. The process of Croatia's integration into the euro area is defined by two key events – Croatia's accession to the EU and its introduction of the euro as its official currency – which initiated a series of changes to the HNB and its operations.

This study summarizes and examines Croatia's experience of euro area accession. To clarify the distribution of powers within the HNB, its relationships with other national and international bodies, and its goals and available instruments, we must first define the structures of the supranational monetary authority, the HNB, and other relevant bodies. Subsequently, the chapter turns to the relationship between the HNB and the ECB.

2. Croatian national monetary authority in relation to the ECB

2.1. The legal and institutional framework of the HNB

The institutional framework of monetary policy that enables development is provided by the Croatian National Bank Act, which is characterised by a high degree of independence in line with world experience.¹⁰ The Croatian National Bank Act defines the Council of the HNB as the highest body of the HNB and as responsible for carrying out tasks within the scope of the HNB's competence and achieving its goals.¹¹ Composed of eight members, including the governor, deputy governor, and six vice-governors, who also represent the management of the HNB, it makes decisions at monthly meetings. These decisions are made by a two-thirds majority of the members present; therefore, to hold a valid meeting, it is necessary to meet the conditions for a two-thirds majority. HNB Council members hold six-year terms in office, subject to the fulfilment of prerequisites for appointment, such as the requirement that they be citizens of Croatia with a recognised personal reputation and professional experience in the financial, banking, monetary, or legal fields.¹² Members of the HNB Council are appointed by the Croatian Parliament based on the proposals of the Committee for Elections, Appointments, and Administrative Affairs and on the basis of the opinion of the Committee for Finance and State Budget.

¹⁰ Croatian National Bank Act, Official Gazette ('Narodne novine') No. 75/08, 54/13, 47/20.

¹¹ Croatian National Bank Act, Art. 4.

¹² For more details, see: Croatian National Bank Act.

The law also prescribes certain restrictions regarding the appointment of a person as a member of the HNB Council to ensure impartiality in the Council's work. Thus, some of the legal restrictions regarding the appointment of members of the HNB Council are reflected in the fact that a representative in the Croatian Parliament, a member of the Government of Croatia, or a person who performs some other duty to which he was appointed may not be appointed as a member of the HNB Council by the Government of Croatia or the Croatian Parliament. This restriction extends to persons holding positions in the bodies of trade union organisations, political parties, and local and regional self-government bodies. Furthermore, this restriction also applies to persons holding shares or management, functional, or ownership positions in legal entities for which the HNB issues work authorisations or whose operations it supervises. Moreover, for legal entities that require work approvals from HNB or are subject to its supervision, such as audit firms and other legal entities related to these entities at the management and ownership levels, a member of the HNB Council may not serve as a member of their governing bodies, external collaborator, employee, attorney, procurator, or person with special powers. The restriction also applies to performing the aforementioned functions in other legal entities where the access of a member of the HNB Council to information classified as a business secret could provide a specific advantage to said legal entities.

The purpose of such statutory restrictions, which are realised not only in the form of impartiality in the work of the highest body of the HNB, but also in the prevention of threats to institutional independence in the form of conflicts of interest, lies in the correlation of regulations governing the work of bodies and organizational forms of the HNB. Conflicts of interest, in addition to privileged information and the prohibition of receiving benefits, relate to the rules found in the Code of Ethics for employees of the Croatian National Bank. The provisions of Directive (EU) 2015/856 of the ECB for establishing the principles of the ethical framework of the unified supervisory mechanism (ESB/2015/12) were applied.¹³ At the same time, the HNB is included as a participant in the unified supervisory mechanism, with the consequent application of the ethical standards established by the aforementioned directive in relation to all central banks participating in the unified supervisory mechanism. The powers of supervision over the implementation of the rules prescribed by the Code of Ethics, as well as an associated educational and advisory role for the purpose of developing a stronger understanding of the implementation of the ethical principles themselves, belong to the Business Compliance Office, an organization within the HNB that reports directly to its governor.

The HNB governor is responsible for managing the HNB's operations and implementing the decisions of the HNB Council, which he also chairs. The governor also participates in the work of the bodies of the ECB; that is, he is a member of

13 Guideline (EU) 2015/856 of the European Central Bank of 12 March 2015 laying down the principles of an Ethics Framework for the Single Supervisory Mechanism (ECB/2015/12), OJ L 135, 2.6.2015, 29–34.

the General and Governing Council of the ECB. Furthermore, he is authorised to represent and present the HNB; appoint and dismiss persons with special powers and responsibilities in the HNB; pass acts regulating the functioning of the HNB; and pass bylaws, general acts, and decisions within the scope of the HNB, which are not placed under the jurisdiction of the HNB Council by law. The expansion of the governor's power refers to the area of macroprudential policy, along with the powers resulting from the HNB's participation in the Single Resolution Mechanism (SRM) and close cooperation with the ECB, which were achieved during the aforementioned period. According to the provisions of Art. 43, the governor of the HNB also has the right to implement macroprudential policy and pass bylaws, decisions, and recommendations in the same area. In addition to issuing decisions on the procedure of remedial supervision of credit institutions, the governor also prescribes the method of implementation and determines the conditions of remedial supervision in more detail. In the remedial supervision procedure, the governor is authorised to impose measures against credit institutions. In cases where there is no quorum of the Council of the HNB or if a certain decision is not made during the Council's decision-making, the governor has the authority to determine whether, due to the absence of the same, it is possible to ensure normal work in the HNB or the implementation of tasks. The established tasks and jobs of the HNB are distributed among sectors and offices that report directly to the governor, deputy governor, or vice governors in accordance with the established structure. The governor of the HNB, as the President of the Council of the HNB, is replaced by the deputy governor when absent. The deputy governor assumes the powers and duties of the governor prescribed by Art. 43 of the law in cases of temporary illness, death, absence, or expiration of the governor's mandate until his return or the appointment of a new governor.

2.2. The HNB as part of the European System of Central Banks and the Eurosystem

The European System of Central Banks (ESCB) consists of the ECB and the national central banks (NCBs) of all EU Member States. The parallel presence of these two systems will be in effect as long as there are EU Member States that have not introduced the euro – that is, as long as these states remain outside the Eurozone. As one of the institutions of the EU, simultaneously representing the core of the Eurosystem and the ESCB, the ECB was established along with the ESCB based on the Statute of the European System of Central Banks and the European Central Bank on 1 July 1998.¹⁴ The headquarters of the ECB are located in Frankfurt am Main, Germany. In accordance with international public law, the ECB has a full legal personality. Notably, its decision-making authority belongs to three bodies: the Governing Council, Executive Board, and General Council. These bodies also manage the ESCB and Eurosystem.

¹⁴ Ioannidis, 2020.

The bodies of the ECB and other organizational forms are complex. The Governing Council, Executive Committee, and General Council are the bodies of the ECB responsible for decision making. These bodies receive expert support from the committees, sub-committees, and working groups of the ESCB and Eurosystem. Each of the aforementioned organizational forms is characterised by specialisation in relation to a specific ESSB activity, and their members are experts from the ECB and NCMs. The scope of the aforementioned decision-making bodies also includes the management of the ECB with the participation of other organizational forms, which are reflected in the level of internal and external control and participation of the Audit Committee.

The Governing Council of the ECB is the main decision-making body, consisting of six members of the Executive Board and governors of the NCMs of the Member States that introduced the euro. The Governing Council makes decisions at meetings, which are usually held twice a month at the ECB's headquarters. Specifically, these decisions are related to monetary goals, guidelines for their implementation (i.e. the monetary policy of the euro area), and guidelines necessary for the performance of duties established by the ECB and the Eurosystem.

The Executive Board of the ECB consists of the president of the ECB, the vice-president of the ECB, and four other members who have been appointed for a mandate period of eight years based on the decision of the European Council (passed by a qualified majority). It is not possible to renew members' mandates after their expiration. Furthermore, as an operational body of the ECB and Eurosystem, the Executive Board is responsible for the implementation of decisions made by the Governing Council of the ECB – that is, the implementation of the monetary policy of the euro area. In addition to managing the day-to-day affairs of the ECB, the Executive Board is also responsible for preparing meetings for the Governing Council.

The General Council of the ECB consists of the president and vice-president of the ECB as well as the governors of the NCMs of all EU Member States. The possibility of participating in General Council meetings is also open to other members of the Executive Board of the ECB, one member of the European Commission, and the President of the Council of the EU, under the condition that the aforementioned persons do not have the right to vote in the decision-making process. The General Council is a transitional body of the ECB and will be dissolved based on the Statute of the European System of Central Banks and the European Central Bank at the time of the introduction of the euro as the official national currency in all EU Member States. Some functions of the General Council are reflected in its contributions to the advisory functions of the ECB, compilation of the ECB's annual report, collection of statistical information, and establishment of the rules necessary for standardising accounting records and reports related to the work of NCMs.

The HNB independently performs tasks and does so in accordance with joint procedures in cases where the same are foreseen within the framework of the Eurosystem. Namely, the HNB was included in the ESSB with Croatia's accession to the EU, and became a component of the Eurosystem on the day of the introduction

of the euro as Croatia's official national currency on 1 January 2023. The HNB participates in the definition and implementation of the EU's common monetary policy based on the TFEU, Statute of the European System of Central Banks and the European Central Bank. Furthermore, the HNB is responsible for ensuring the smooth functioning of the payment system, its improvement, and the execution of foreign exchange transactions in accordance with Art. 219 of the TFEU.¹⁵ Existing regulations include a series of legislative regulations for the functioning of payment transactions. A payment system is a key element of a country's financial system, along with other elements such as the national currency, financial markets, financial institutions, and institutions that act as regulators and supervisors of the work of the aforementioned elements. Price stability is the fundamental goal of monetary policy, and the independence of NCMs is a necessary precondition to achieving the same, as per Art. 130 of the TFEU.

Central bank independence is manifested in emerging forms of financial, institutional, personal, and functional independence. Financial independence is reflected in the determination of income and expenditure according to the nature of the monetary policy; that is, it excludes cases in which the influence is reversed. Institutional independence implies that the central bank is independent in the decision-making process; put differently, its decisions must not be influenced by other bodies and institutions. Personal independence includes the exclusion of conflicts of interest; the guarantee of protection for HNB employees in relation to potential external pressures; and a clear definition of the conditions for appointing and dismissing members of the HNB Council, including the governor. Functional independence reflects a precisely defined goal and autonomy when choosing the instruments and measures necessary to achieve it. The HNB submits reports on its work to the Croatian Parliament.

The stability of the entire state economy, as the purpose of the tasks under the auspices of determining and implementing monetary and foreign exchange policies, certainly places this task at the top of the HNB's scope of work. However, the day of the introduction of the euro also marked Croatia's entry into the Eurosystem and the transfer of its authority in monetary policy. With this transition, Croatia has the authority to make decisions as a member of the Governing Council of the ECB and implement them through its NCB as a Member State that uses the euro within its territory. The introduction of the euro also marked Croatia's transition to the ECB's minimum reserve system from the HNB's previous mandatory bank reserve system – a monetary policy through which the regulation of the amount of money in circulation is achieved through the prescription of mandatory bank reserves, which represent a part of bank funds expressed as a percentage intended to be allocated to a special account managed by the central bank. In case of irregularities during allocation, an obligation to pay a certain fee to the central bank arises. Setting a higher reserve requirement ratio reduces banks' potential to generate

¹⁵ See: Art. 219 of the TFEU.

loans and simultaneously reduces the money available to legal and natural persons. This is one of the means to which central banks resort, for example, in periods of inflation, which threatens the Eurosystem's basic goal for monetary policy, price stability.

The ECB's minimum reserve system is characterised by the allocation of a certain amount of funds from Eurozone banks as reserves on the accounts of NCBs during the reserve maintenance period. The duration of the reserve maintenance period extends from six to seven weeks, and the amount of allocated funds, called 'the minimum mandatory reserves', is calculated prior to the start of a particular maintenance period based on the respective balance sheets. That is, what is relevant is the average amount of reserves that the bank keeps in the account with the central bank within the reserve maintenance period – put differently, the average amount must meet the set amount of minimum mandatory reserves, which negates the need for the full amount to be kept in the NCB account for the entire period. This gives banks the agency to take certain actions in connection with short-term movements in the money markets, which can positively affect the market.

The HNB is authorised to issue and revoke approval and consent and to issue other decisions in accordance with the laws governing the operations of credit unions, credit institutions, issuers of electronic money and payment systems, payment service providers, payment transactions, operations of authorised exchange offices, foreign exchange operations, and issuance of electronic money. HNB approvals include granting loans to credit institutions and, in relation to credit institutions, the HNB is responsible for opening accounts, receiving funds from credit institutions, and making payments on these accounts. The HNB also performs tasks related to the rehabilitation and supervision of credit institutions within the SRM and SSM frameworks. The subject of HNB supervision includes the operations of credit unions, issuers of electronic money and payment systems, payment service providers, and payment transactions. Credit institutions represent the backbone of Croatia's financial system, as they are the most represented financial institutions according to the criterion of the share of an individual intermediary in the financial system's assets.

The HNB, like other NCBs of Member States that have introduced the euro, is responsible for matters of consumer protection and the supervision of national regulations for the prevention of terrorist financing and money laundering. Furthermore, the HNB issues euro banknotes and coins with certain restrictions to comply with the provisions of the TFEU, the Statute of the European System of Central Banks and the European Central Bank, and the limits established by the approval of the ECB when carrying out the aforementioned activity. The remaining activities covered by the HNB include the collection and processing of data to create official statistics, the management of its financial assets and international reserves, the adoption of bylaws related to the tasks under its jurisdiction, and the performance of the duties of the fiscal agent for Croatia, in addition to other tasks established by law and other regulations.

3. Outcomes related to the introduction of the euro and banking union

3.1. Introduction to the banking union

The creation of the European Banking Union (EBU) marks a significant step toward further integration in the euro area and is important for efficient supervision and resolution, especially for the legal differentiation of cross-border banks.¹⁶ Cooperation takes place according to two EBU pillars – the Single Supervisory Mechanism (SSM) and the SRM – with authorities of non-participating Member States and third countries in cross-border contexts. Cooperation is a prerequisite for functioning mechanisms, as it represents the foundation for further integration within the EBU, consolidating equivalence with third countries.¹⁷

The period of accession to the EU and the introduction of the euro as the official currency fulfilled the requirements for harmonisation with the *acquis* of the EU. Croatia became a member of the EU on 1 July 2013 following the conclusion of negotiations from 2005 to 2011. The introduction of the euro as Croatia's official currency was the ultimate goal of Croatia's integration into the EU.¹⁸ For this purpose, the Government of Croatia, in cooperation with the HNB, adopted a strategy for introducing the euro as the official currency in Croatia on 10 May 2018.

To achieve this goal, it was necessary for Croatia to first commit to joining the European exchange-rate mechanism.¹⁹ Croatia was committed to submitting an application for entry into the European Exchange Rate Mechanism (ERM II) with the additional condition of ensuring the close cooperation of the HNB with the ECB based on Art. 7 of Council Regulation (EU) No. 1024/2013 on the assignment of certain tasks to the ECB in connection with credit institutions' prudential supervision policies.²⁰ Croatia's official request to establish close cooperation was sent to the ECB on 27 May 2019. The decision to closely cooperate with the HNB was made by the Governing Council of the ECB on 10 July 2020. Furthermore, one of the requirements is the implementation of a single recovery mechanism in accordance with Regulation 806/2014 on the establishment of uniform rules and procedures for the rehabilitation of credit institutions and certain investment companies within the framework of a uniform rehabilitation mechanism and a uniform rehabilitation fund,

16 For more studies on the EBU, see: Gutiérrez-López and Abad-González, 2020; Howarth and Quaglia, 2020; Högenauer, Howarth and Quaglia, 2023.

17 Petit, 2023.

18 Published in the Official Gazette – International Contracts No. 2/12.

19 Government of the Republic of Croatia, Croatian National Bank, 2018.

20 European Central Bank, no date; Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, 63–89.

and on the amendment of Regulation 1093/2010.²¹ Croatia has been a participant in the SSM since 1 October 2020 and simultaneously became a participant in the SRM, according to Regulation 806/2014. Namely, the process of establishing close cooperation includes the detailed assessment of credit institutions, the implementation of which precedes participation in the unified supervisory mechanism, that is, the implementation of supervision. The aforementioned assessment procedure resulted in the supervision starting later on: Croatia participated in the SSM from 1 October 2020 in relation to the decision to establish close cooperation with the ECB, which was made in May of the same year. As already mentioned, in addition to recommendations and cooperation with the EU, it was necessary to harmonise national regulations, including activities under the jurisdiction of the HNB. Necessary changes were accordingly made to the Croatian National Bank Act²² in 2020.²³

3.2. Participation in the exchange rate mechanism: The ERM II

Participation in the ERM II is part of the convergence criteria derived from Art. 140, para. 1 of the TFEU and the Protocol (No. 13)²⁴ on convergence criteria. These criteria are used to limit particular economic risks for the Member State and the euro area during the Member State's transition to the euro; that is, to ensure the Member State is adequately prepared for the transition. The Eurozone includes the territories of EU Member States that have introduced the euro as an official monetary unit, and approximately 350 million citizens living in the 20 Member States.

Regarding the convergence criteria, we may distinguish between criteria for economic convergence and those for legal convergence. Economic convergence criteria are divided into four categories subject to more detailed regulation: price stability, healthy and sustainable public finances, exchange rate stability, and long-term interest rates. The price stability criterion assumes that the country's inflation rate does not exceed 1.5% of the rates of the three-Member States that achieve the best results. To meet the criteria of healthy and sustainable public finances, the state must not be in the process used in the case of an excessive deficit. The exchange rate stability criterion is met if a country participates in the ERM II, the aim of which is to demonstrate whether the country's economy can operate efficiently without excessive currency fluctuations. When a country that is not a member of the euro area joins the ERM II, its national currency is pegged to the euro at the central exchange rate agreed upon by the euro area Member States, the countries that do not belong to the euro area, but already participate in the ERM II and with the ECB, with the

21 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010, OJ L 225, 30.7.2014, 1–90.

22 Croatian National Bank Act, Official Gazette No. 47/2020.

23 For more information, see: Nieto and Singh, 2021b.

24 Mangiameli, 2021.

participation of the Commission in the same procedure. Regarding the criterion of exchange rate stability, it is necessary for the state to participate in the mentioned mechanism for a period of at least two years and achieve particular results. In other words, significant deviations from the ERM II central exchange rate are undesirable. Currency fluctuations within the standard limit of 15% above or below the set central exchange rate are permissible. The long-term interest rate criterion assumes that the country's interest rates do not rise above two percentage points of the rates of the three Member States that achieve the best results in terms of price stability. Legal convergence implies the harmonisation of the national legislation of the country that seeks to become part of the Eurosystem and the ECB's euro area. In several reports, called Convergence Reports, the ECB emphasised the need for Croatia to further harmonise certain legal provisions before introducing the euro to fully comply with the conditions of legal convergence; specifically, the ECB presented these views in reports from 2014, 2016, and 2018.

3.3. Establishment of close cooperation between the ECB and the HNB

The decision to establish close cooperation was made by the ECB at the request of a Member State whose official monetary unit was not the euro. The Member State requested drafts of relevant regulations to achieve close cooperation between the ECB and its own national competent authority (NCA).²⁵ The establishment of close cooperation is based on the adoption of a decision by the ECB under fulfilled conditions, with close cooperation achieved by supervising credit institutions through the SSM. A full assessment of credit institutions is one of the two important parts of the process of establishing close cooperation between the ECB and HNB. The second part of the process involves adjusting the regulatory framework. The evaluation of institutions, which usually lasts for six to twelve months from the completion of the adaptation of the relevant national regulations, includes credit institutions and branches of credit institutions based in countries other than Croatia that operate in Croatia. To fulfil the legislative prerequisite, that is, the adjustment of the regulatory framework as one of the components in the process of establishing close cooperation, Croatia submitted a draft of the proposed amendments to the legislation on credit institutions.

3.3.1. Fundamental pillars of the banking union

The SRM, the SSM, and the European Deposit Insurance Scheme (EDIS) are the three fundamental pillars of the EBU, which constitutes a unique system of bank reintegration and supervision at the EU level. The EBU includes all Eurozone

²⁵ 2014/434/EU: Decision of the European Central Bank of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro (ECB/2014/5), OJ L 198, 5.7.2014, 7–13.

Member States and EU Member States outside the Eurozone that decide to join. Member States that do not belong to the euro area are given the opportunity to join the EBU by establishing an agreement to engage in close cooperation. Such a financial framework in the territory of the EU was created as a reaction to the financial crisis that hit world markets in 2008 and 2009, which pointed to certain shortcomings in the euro area.²⁶ By 2015, the crisis had deepened in some European countries. In particular, this framework includes unified rehabilitation, supervision, and deposit insurance for all credit institutions operating in the euro area. Through these mechanisms, efforts are being made to more deeply integrate the banking system, given the special interdependence of euro area countries, which the financial crisis highlighted. In particular, efforts are being made to prevent – or at least limit – the future negative effects of financial crises in ways that increase the general level of banks' resilience. Specifically, this is being done by reducing market fragmentation by harmonising the financial sector rules, reducing the transfer of undesirable effects resulting from problems in the balance sheets of banks on public finances and vice versa, using a Single Fund for the rehabilitation of banks and financial burden-sharing among owners and creditors, and avoiding situations in which taxpayers' money will be used for the rehabilitation of failing banks.

A unique monitoring mechanism, the SSM, came into force on 4 November 2014 after the Regulation on the Single Supervisory Mechanism of the Council of the EU was adopted on 15 October 2013 following the conclusion of negotiations between the Council of the EU and the European Parliament. The SSM represents a common framework with regard to banking supervision in the EU. Through the establishment of continuous supervision, the SSM aims to raise the general level of credibility, security, and stability of the EU banking system. Participants include the ECB and relevant national supervisory authorities.²⁷ The ECB is responsible for the efficient and uninterrupted operation of the single supervisory mechanism. It performs its tasks through the direct supervision of significant institutions through its exclusive competence in relation to all banks in the Eurozone. Less significant institutions are subject to direct supervision by national supervisory bodies that cooperate with the ECB to perform tasks within their jurisdiction.²⁸

Within the framework of cooperation between the ECB and national supervisory authorities, joint supervisory teams are formed, composed of employees of the ECB and of certain national supervisory authorities.²⁹ Supervision by direct control teams involves individual risk areas, corporate governance, and internal control systems.

26 On shortcomings, see: Bańkowski et al., 2021; Bénassy-Quéré and Weder di Mauro, 2020.

27 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, 63–89.

28 Heldt and Mueller, 2021.

29 Chiaramonte, et al., 2022.

Due to the need to adopt important supervisory measures with a focus on areas such as liquidity risk, capital risk, and business model and internal management, the above-mentioned supervisory verification and assessment procedure is carried out.³⁰ The ECB continuously examines the institutions of the countries participating in the unified supervisory mechanism.³¹

3.3.2. The role of the HNB in the unified supervisory mechanism

In matters of supervision, the HNB has exclusive jurisdiction over areas regulated by the Credit Institutions Act³² and bylaws adopted by the HNB. These areas include provisions for exposure classification and accounting, consumer protection, methods of determining losses caused by credit activities and restrictions regarding investment in tangible assets. Additionally, as one of the supervisory bodies, along with prevention bodies and criminal prosecution bodies, it includes provisions for operating within the framework of the financing prevention system for terrorism and money laundering. In addition to the HNB, the competence to supervise within this system belongs to several other institutions. The jurisdiction of the aforementioned institutions derives from legal provisions that regulate their rights, duties, and mutual cooperation. The HNB cannot investigate potential offenders of criminal acts among the bank's clients; instead, such actions are completed by a criminal prosecution body, such as the police, the state attorney's office, or the judiciary. Within the framework of the system for suppressing such criminal activities, the HNB monitors whether banks implement all adequate measures to prevent the use of the banking system for money laundering in compliance with law. Banks, like brokers, currency exchanges, insurance companies, and organisers of games of chance, play the role of prevention bodies within the system for preventing money laundering and terrorist financing. Such a regulatory solution at the EU level will require Croatia to implement further regulations and manage risks that manifest themselves in areas under the jurisdiction of the HNB, which have proven to be important, especially during financial crises. The competence of the HNB for supervision in areas that are not covered by the SSM regulation is provided for in Art. 1.³³ The same article establishes the authority of the ECB to supervise credit institutions and thus at the same time limits and foresees competence in supervisory tasks that are not entrusted to the ECB by national supervisory authorities. The assessment of solvency is based on an exhaustive analysis of the balance sheet and other reports from the institution and includes analyses of past and future conditions.

30 Howarth and Quaglia, 2021.

31 Gortsos, 2020.

32 Credit Institutions Act, Official Gazette No. 159/13, 19/15, 102/15, 15/18, 70/19, 47/20, 146/20, 151/22.

33 Karagianni and Scholten, 2018.

3.3.3. *The Single Resolution Mechanism and the responsible Croatian authorities*

The SRM, one of the pillars of the EBU, includes national resolution bodies and the Single Resolution Board (SRB), whose task is to plan the resolution of entities under their jurisdiction. The SRB is the central resolution authority within the EBU, which currently comprises 20 Eurozone countries, including Bulgaria. Together with the national resolution authorities, it forms the SRM. The SRB works closely with the European Commission, ECB, European Banking Authority, and national authorities to ensure the orderly resolution of failing banks and protect taxpayers from state bailouts, which promotes financial stability. This mechanism seeks to adequately assimilate weakening banks and minimise consequences by preventing the effects of the implemented procedures from spreading to both taxpayers and the entire economy. Further, the SRM is designed to facilitate efficient and independent centralized remedial decisions, which are especially reflected in situations involving cross-border institutions that need to be remedied and those in which the coordinated action of numerous remedial bodies is necessary for remediation.

The fundamental goal of the unified reintegration committee is to ensure the continuous functioning of the SRM with simultaneous cooperation between resolution institutions at the national level and other institutions of an international character of the same nature. The board can be defined as an independent EU agency and regulatory body for the banking sector. Regulation 806/2014 established the SRM, which grants power to the SRB³⁴ in matters of resolution within the framework of the EBU. In addition to the general function of ensuring the smooth operation of the SRM, the SRB is authorised to dispose of the Single Resolution Fund, draw up resolution plans, and make decisions regarding the resolution of credit institutions or groups of credit institutions that have been assessed as significant or directly supervised by the ECB. The Board also makes remedial decisions related to ‘other cross-border groups’, which are defined as groups in which the parent credit institution and at least one daughter credit institution have headquarters in two different participating Member States. The SRB performs the aforementioned functions in simultaneous coordination with the ECB, recovery, and supervisory bodies at the level of participating countries, ministries, the European Banking Supervisory Authority, and many other institutions that perform activities of the same nature in the territory of the EU, as well as in third countries. The SRB assumes direct responsibility for certain credit institutions based in Croatia due to Croatia’s accession to the SRM, with the exception of institutions for which the SRB will cooperate with recovery bodies at the national level; that is, in relation to which it is not directly responsible.

³⁴ Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225, 30.7.2014, 1–90.

Resolution authorities at the national level are responsible for credit institutions that are not members of EU groups. An exception is provided for the direct responsibility of national resolution authorities in relation to credit institutions that belong to groups in the EU. However, the parent company of the group in which they are included is not located in a Member State of the EBU. The SRB became the competent resolution body for banks with headquarters in Croatia and which belong to groups of credit institutions in the EU, and in relation to which it performed the same function in the period before the accession of Croatia to the SRM.

The direct competence of the SRB includes actions related to the preparation of restoration plans, defining the minimum requirements for regulatory capital and liabilities for some of the largest banks in Croatia, and assessing the need for rehabilitation. To ensure the accuracy of the relevant data for the successful undertaking of the aforementioned actions and to assess the potential effects of actions undertaken to ensure Croatia's financial stability, representatives of the HNB and all other recovery bodies from the participating Member States, if they the relevant banking group conduct business.

The SRB makes decisions during executive and plenary sessions. Both types of meetings are attended by the same members; namely, the president of the SRB, four members of SRB management, and representatives of the national resolution bodies appointed by each Member State of the EBU. In plenary sessions, decisions are made by a simple majority, and each member has voting rights. In executive sessions, efforts are made to reach a consensus among all members, and if this is not possible, decisions are made by majority. In the event of a tie, the presidential vote is decisive.

The fundamental difference lies in the nature of the issues that are decided in each session. While plenary sessions make decisions on issues such as the annual work program, annual budget, investments, and use of the resources of the SRF in certain circumstances, executive sessions make decisions regarding rehabilitation issues. Thus, within the scope of the executive sessions, the rehabilitation plans are completed – that is, they are prepared, evaluated, and approved. Then, in the executive sessions, when certain conditions are met, decisions can be made on the establishment of simplified obligations, the minimum requirements for regulatory capital and acceptable obligations can be determined, rehabilitation programs can be incorporated, and the European Commission can be informed.

In Croatia, remedial powers are divided among the Croatian National Bank, Croatian Deposit Insurance Agency (HAOD), and Croatian Financial Services Supervision Agency (HANFA). Ensuring the continuous and efficient functioning of a single recovery mechanism is the goal, the realisation of which rests on the national recovery bodies in such a way that they harmonise with the SRB at the working methodological and political levels and achieve cooperation through the monitoring of guidelines, instructions, recommendations, and warnings issued by the SRB. This ensures the equal treatment and application of equal rehabilitation criteria to credit institutions in Croatia, over which the SRB does not have direct jurisdiction. Since

Croatian legislation has been gradually harmonising with EU regulations for years, after joining the SRM, there were no significant changes in the operation of the HNB as a recovery body. This may have been because a certain level of operations and communication had already been established. A more significant change lies in the fact that upon joining the aforementioned mechanism, representatives of the HNB will directly participate in the work and decision-making of the SRB in such a way that they will attend and have the right to vote in its sessions and participate in the work of working groups formed within the SRB framework.

The years leading up to the adoption of the amendments of the Croatian National Bank Act³⁵ and the introduction of the euro as the official currency of Croatia are marked by particular goals. These goals essentially shaped the direction of the HNB's consequential strategy and, more broadly, state policy. In the context of monetary policy, certain changes have been made to implement negative interest rates, which play an important role in the work of central banks due to their effects on the money market and liquidity. Negative interest rates were not used in the past because of the limitations of domestic legislation.

The new amendment to the law was also designed to align with the application of the Directive on the legal framework for accounting and financial reporting in the European System of Central Banks³⁶ (ESB/2016/34) (hereinafter: Directive of the ECB) and to support the introduction of the euro as the official currency through the improved presentation of relevant data in the financial statements submitted by the HNB. Simultaneously, this will bring about convergence with certain standards in the field of accounting similar to those of other EU members. The application of the ECB Directive was scheduled for 1 January 2021.

A series of requirements that had to be met in the mentioned period, including the introduction of the ECB Directive, resulted in the amendment of existing legal articles; that is, in regulatory adjustments on a wider scale. The introduction of the euro as the official currency in Croatia and the closing of one chapter in this European journey were preceded by the last phase, which included the implementation of a series of activities that began with the adoption of the Euro Act³⁷ in 2022. In June of the same year, the European Council supported the introduction of the euro in Croatia on 1 January 2023. This move followed the adoption of a recommendation by the Eurogroup and the Council of the EU on the issue. Furthermore, the Council of the EU adopted a decision on the introduction of the euro in Croatia and a regulation on a fixed conversion rate on 12 July 2022. This was followed by a series of activities to implement the same decision. Some of the included activities were the pre-supply of banks and other relevant institutions with euro banknotes and coins

35 Amendments of Croatian National Bank Act, Official Gazette No. 47/2020.

36 Guideline (EU) 2016/2249 of the European Central Bank of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), OJ L 347, 20.12.2016, 37–86.

37 The Law on the introduction of the euro, Official Gazette No. 57/2022.

and the beginning of the obligation of dual price reporting. The euro was scheduled to be introduced in Croatia on 1 January 2023.³⁸

4. The ERM II: The preparatory phase of Croatia's adoption of the euro³⁹

The Croatian kuna was included in the ERM II on 10 July 2020. This inclusion marked a milestone towards the enlargement of the euro area, highlighting the important role of the ERM II as a preparatory phase for the adoption of the euro. Participation in the ERM II may lead to a regime shift in the concerned countries; that is, it may alter the incentives of international and local investors and national authorities. Indeed, there is evidence that a 'regime shift indeed occurred in the central and eastern European countries (CEECs) that joined this mechanism between 2004 and 2005. If supported by sound economic policies, this shift may have positive consequences, such as accelerating the convergence process'. To fully reap the benefits of monetary integration and ensure smooth participation, countries need sound policies, governance, and institutions which allow them to address risks with adequate macroeconomic, macroprudential, supervisory, and structural measures.

Two Member States, Bulgaria and Croatia, joined the ERM II on 10 July 2020. The process began in 2017 and integrated lessons from the experiences of other countries.⁴⁰ For Bulgaria and Croatia, the ERM II served not only as an exchange rate arrangement but also as a preparatory phase for euro adoption.⁴¹ The ERM II acts as an arrangement for managing exchange rates between participating currencies. In addition, the purpose is to assist the convergence assessment provided for in the TFEU with regard to the adoption of the euro by non-euro EU nations; that is, the ERM II offers a testing ground before the adoption of the euro – it serves as a market and policy test.⁴² Looking back at the history of the exchange rate mechanism (ERM) brings to mind that the original ERM, which had been part of the European Monetary System since 1979, was replaced by ERM II with the introduction of euro on 1 January 1999.⁴³

The ERM II was established by the European Council Resolution of 16 June 1997, which provided that 'The euro will be the centre of the new mechanism'.⁴⁴ While the

³⁸ Falagiarda and Gartner, 2022.

³⁹ Dorrucci, et al., 2020; For more information, see: Nieto and Singh, 2022.

⁴⁰ Detken, Gaspar, and Noblet, 2004, p. 9.

⁴¹ See, for example: Kordić, 2023.

⁴² Lefterov, 2015.

⁴³ Eckert, Lindner and Nölke, 2020.

⁴⁴ Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union, Amsterdam, 16 June 1997, OJ C 236, 2.8.1997, 5–6.

ERM II is referred to in the Treaty as an integral part of the Maastricht exchange rate convergence criteria, its procedures and agreements are not based on the Treaty, as they are intergovernmental.⁴⁵ Decisions regarding participation in ERM II – in particular, whether a country's currency can be included in the mechanism with a certain central rate and fluctuation band – are made by mutual agreement between the finance ministers of euro-area countries, the ECB, and the finance ministers and central bank governors of non-euro-area Member States participating in the ERM II at any given time.

Participation in ERM II is a precondition for the eventual introduction of the euro. Further, there must be a consensus that the concerned Member State is pursuing effective stability-oriented policies consistent with smooth participation in the mechanism. The full benefits of euro adoption can only be enjoyed if adequate policy measures are in place, including those at the national level. A 'high degree of sustainable convergence', as established by Art. 140 of the TFEU, is the most important precondition for the successful adoption of the euro.

Notably, participation in the ERM II affects the expectations and economic incentives of international and local investors, as well as of local policy authorities.⁴⁶ Following the accession of selected CEECs to the EU, the countries that participated in the ERM II experienced a more noticeable international financial flow cycle than those that did not. At the same time, the results suggest that EU accession is not relevant to recorded financial inflows; specifically, differences in gross international financial inflows between the CEECs participating in the ERM II and other CEECs are largely driven by bank lending. After joining the mechanism, ERM II participants experienced a stronger expansion in domestic credit and lower real interest rates than CEECs that did not join the ERM II after their accession to the EU.

Regarding Croatia, it is notable that ERM II participants may benefit from the increased availability of capital but may also face an increased risk of a build-up of macroeconomic imbalances. Historical experience suggests that factors such as resilient economic structures, the quality of institutions, and governance reduce the risk of economic imbalances and enhance a country's capacity to cope with shocks. Therefore, a given currency's participation in the ERM II requires the proper framework and conditions at the national level.⁴⁷ Croatian authorities made several policy commitments in 2018 and 2019 in areas highly relevant to a smooth transition into and subsequent participation in the ERM II. After fulfilling prior policy commitments, Croatia entered the ERM II and the EBU simultaneously on 10 July 2020.

When Croatia first expressed interest in joining the mechanism, ERM II parties considered three fundamental issues.⁴⁸ During the informal phase, a dialogue was held between ERM II parties and Croatian authorities on potential risks and how to

45 Nieto and Singh, 2021a; Dorrucchi et al., 2021.

46 Kordić, 2023; See also: Jerković, 2022.

47 Deroose and Baras, 2005.

48 Gronkiewicz-Waltz, 2023.

mitigate them. After this phase, the last step in the roadmap was marked by formal requests for the inclusion of the Croatian kuna in the ERM II, which were sent the day before the decision was made.⁴⁹ Some policy commitments were completed by the time Croatia formally entered the ERM II as ‘prior commitments’. In line with past practices, other commitments had to be completed after joining the ERM II as ‘post-entry commitments’.⁵⁰ Adequate monitoring was established by the ECB and European Commission within their respective remits to verify compliance with both prior and post-entry commitments. The ECB focuses on commitments related to the banking sector, including banking supervision and macroprudential issues. Meanwhile, the Commission focused on commitments to structural policies. It is important for fiscal policies to be governed by the Stability and Growth Act. Prior commitments were made by Croatia in the summer of 2019 and completed before joining the ERM II on 10 July 2020. The completion of the ERM II policy commitments was related to structural policies, and in letters to the ERM II, Croatia⁵¹ committed to implementing several policies related to structural policies before joining. The European Commission was mandated by ERM II parties to monitor Croatia’s implementation of these prior policy commitments. Monitoring was facilitated by regular technical exchanges between the Commission and the Croatian authorities. The European Commission provided regular progress updates to the ERM II parties. Simultaneously, the ECB reported on the implementation of policy measures related to banking supervision.

Specifically, the Croatian authorities made commitments related to (i) the anti-money laundering framework, (ii) statistics, (iii) public sector governance, and (iv) the business environment. The final assessment reports were published together with the ECB Decisions to include the Croatian kuna in the ERM II. In June 2020, the Croatian authorities informed the ERM II parties of prior commitments and asked them to invite the Commission and ECB⁵² to assess their effectiveness. Both institutions confirmed that the policy commitments in their respective areas of competence were fully implemented.⁵³

Post-entry commitments were also made by Croatia – and Bulgaria – upon joining the ERM II. Specifically, the Croatian authorities made commitments to implement specific policy measures on the anti-money laundering framework, the business environment, state-owned enterprises and the insolvency framework. The inclusion of Croatian kuna in the ERM II was also subject to standard fluctuation margins.⁵⁴ When assessing the central rates of the Croatian kuna within the ERM II, it was

49 Ćorić and Deskar-Škrbić, 2017.

50 For details, see: Gronkiewicz-Waltz, 2023; Nieto and Singh, 2021b.

51 Nieto and Singh, 2021b.

52 See: Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, 63–89.

53 Nieto and Singh, 2021a.

54 Dorrucchi et al., 2021.

determined that Croatia maintained nominal exchange rate stability for more than two decades.⁵⁵ The HNB rarely intervenes in foreign exchange markets, with interventions historically focused only on supporting or weakening the currency. Until the COVID-19 shock, the HNB mostly intervened to counter appreciation pressures. The ERM II parties decided to set the central rate of the Croatian kuna at the prevailing market rate of 7.53450 HRK/EUR, corresponding to the level of the reference exchange rate (as published by the ECB based on daily consultations between European central banks) ahead of its inclusion.

Ultimately, joining the ERM II was a necessary step in Croatia's adoption of the euro. At present, 19 EU Member States have adopted a common monetary policy, with the euro as the common currency. Under the Treaty, all other EU Member States except Denmark are expected to introduce the euro once the necessary requirements have been fulfilled.⁵⁶ From a procedural perspective, decisions on euro adoption are made by the Council of the European Union in line with the relevant Treaty provisions, including the need to stay in the ERM II for at least two years.⁵⁷ From a policy standpoint, the adoption of the euro is an opportunity, albeit not a guarantee, to gain substantial benefits. The adoption of a global currency as legal tender fosters monetary stability, which in turn manifests itself in a low and stable real interest rate environment. Art. 140 of the TFEU states that a country should achieve 'a high degree of sustainable convergence' with the euro area before introducing the Euro; this means that the adoption of the euro should be sustainable in the long run. Resilient economic structures, financial stability, the quality of institutions and governance, and the progressive enhancement of the EU architecture play important roles in this regard.⁵⁸

When the ECB included the Croatian kuna in the ERM II in July 2020, it emphasised a 'firm commitment' by the respective authorities 'to pursue sound economic policies with the aim of preserving economic and financial stability, and achieving a high degree of sustainable economic convergence'. Commitments made by the Croatian authorities in recent years have spurred the introduction of important measures to mitigate risks under the ERM II. Although crucial steps have been taken to address macroeconomic imbalances, there is still significant work to do.⁵⁹ Finally, policy efforts need to include measures aimed at preventing the euro changeover from being used by firms and price setters as excuses for unwarranted price escalation. In this regard, national authorities, in cooperation with the European Commission and ECB, can benefit from past experiences with the euro changeover in other countries.⁶⁰

55 Vujčić and Presečan, 1999.

56 Deskar-Škrbić and Kunovac, 2020.

57 For more details, see: European Commission, 2022a.

58 Diaz del Hoyo et al., 2017.

59 Backé, et al., 2004.

60 Pufnik, 2017.

Along with the Commission, the ECB has been fully committed to supporting Croatian authorities in promoting campaigns to prevent the rounding of prices.⁶¹

5. Summarizing thoughts

On 1 January 2023, Croatia adopted the euro and became the 20th member of the Eurozone. The Croatian economy is expected to benefit from the elimination of currency risk as well as lower transaction and borrowing costs. After its accession to the EU in 2013, Croatia made significant progress in addressing macroeconomic imbalances and achieving convergence towards the Eurozone. It must continue these reform efforts to fully reap the benefits of the euro and allow adjustment mechanisms to operate efficiently within the enlarged currency area.

In light of Croatia's deep integration with the euro area and assuming that it pursues sound fiscal, structural, and financial policies going forward, it is expected to continue to benefit from adopting the euro. Since the Croatian currency has been tied to the euro for a long time, and before that, to the German mark, no significant changes were expected after its adoption. At the same time, a good part of the Croatian economy is 'euroised', which confirms the previous position. Among the effects generated by the transition to the euro are those already mentioned in the literature and in the previous sections of this chapter; namely, the reduction of currency risk and transaction costs, which diminish uncertainty and improve economic and financial stability. The euro can also facilitate trade between countries that use it. Notably, better integrated financial markets and improved economic stability can accelerate this development process. The simultaneous entry into the Schengen area also supported the Croatian economy. Meanwhile, the increase in inflation during the initial period of the transition to the euro is a common phenomenon. Still, the experience of the countries that adopted the euro shows that the actual effect of rounding prices when converting the national currency to the euro was significantly lower than the results of the simulations, which assume that all attractive prices are rounded up. In principle, joining the euro area will benefit Croatia because of the already consolidated economic and financial relations within this monetary union.

The ECB was mandated by ERM II parties to monitor the implementation of the two prior commitments related to banking supervision and financial stability that the Croatian authorities had to complete by the time they joined the ERM II. Specifically, there were two commitments: first, to establish close cooperation between ECB Banking Supervision and the NCA under the legal framework of the SSM and, second, to strengthen the macroprudential framework and borrower-based measures.

⁶¹ Dorrucchi et al., 2020.

Notably, Croatia was the first country to join the ERM II since the financial crisis. In addition, it marked the first time a Member State joined the ERM II after the establishment of the EBU. Given that the ERM II is a preparatory phase for euro adoption, joining the ERM II also meant preparing to enter a banking union. Therefore, countries aiming to adopt the euro were advised to closely cooperate with the ECB when joining the ERM II. Croatian authorities accordingly undertook many legislative amendments and measures to create a legal basis for close cooperation with the ECB. The ECB assessed the national legal framework for compliance with the relevant conditions for establishing close cooperation. The comprehensive assessment results for Croatian banks were published in June 2020 and did not indicate any capital shortfalls for the selected banks. In July 2020, the ECB decided to establish close cooperation with the HNB⁶² following the latter's fulfilment of all supervisory and legislative prerequisites.⁶³ The Croatian authorities have committed to broadening their macroprudential toolkit, which was completed through the adoption of relevant legislation in 2018 and 2020.⁶⁴ After completing prior commitments, Croatia joined the ERM II and the EBU.

On 1 October 2020, the ECB began to directly supervise significant Croatian institutions. Credit institutions that are closely cooperative are subject to the same supervisory standards and procedures as their equivalents in the Eurozone. Establishing close cooperation is an important landmark in the development of banking unions. This was the first time that banking unions had been enlarged with EU Member States outside the euro area. Croatia, like Member States in the European Union, adopted the euro as part of the process of Europeanisation. There was already a high level of euroisation, meaning that citizens independently decided to use the foreign currency as the dominant currency. Although adopting the euro should be followed by benefits for businesses and the economy, increased costs were confirmed as a negative effect for all countries, including Croatia, in 2023.⁶⁵ Although the effects of adopting the euro in Croatia might be positive in the short term, it is obvious that the long-term effects depend on Croatia's capabilities to endure change, especially in the fields of the economy and legal security.⁶⁶

62 Decision (EU) 2020/1016 of the European Central Bank of 24 June 2020 on the establishment of close cooperation between the European Central Bank and Hrvatska Narodna Banka (ECB/2020/31), OJ L 224I, 13.7.2020, 4–6.

63 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, OJ L 176, 27.6.2013, 1–337.

64 See: Croatian National Bank Act.

65 See: *Croatian Bureau of Statistics* [Online]. Available at: <https://podaci.dzs.hr/en/> (Accessed: 15 January 2024).

66 Čehulić and Hrbić, 2019.

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CZECH REPUBLIC: CZECH NATIONAL BANK'S ROLE IN THE MONETARY POLICY



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Abstract

This chapter deals with monetary policy in the Czech Republic, in which the Czech National Bank plays a crucial role. Broadly, the objective of monetary policy is to ensure price stability. Notably, Czech Republic has not joined the Eurozone – it is a member of the European System of Financial Supervision and cooperates with the European Systemic Risk Board and European Supervisory Authorities. While, prior to the COVID-19 pandemic, the Czech Republic met most of the Maastricht criteria for the euro, with the exception of compliance with normal exchange rate fluctuation margins, the situation has changed with the pandemic: currently, it only meets the criterion of the total general government debt-to-GDP ratio. Meanwhile, the most important factor for decision-making is the degree of alignment of the Czech economy with the Eurozone, which is key to outweighing the gains from the introduction of the euro over the losses from its own monetary policy. Presently, it is not possible to state that the Czech economy is significantly aligned with the euro area. As a non-member of the euro area, the Czech Republic is not obliged to join the European Banking Union. Important to note is that the Czech Republic regularly prepares a study that analyses all relevant aspects of its possible participation in the European Banking Union to help it make an informed decision on whether to join the European Banking Union before adopting the euro. These studies show that the banking sector in the Czech Republic is highly stable; therefore, it is increasingly advantageous for the Czech Republic to remain outside the European Banking Union. Notably, the Czech Republic used interest rates and foreign exchange interventions

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to ensure the stability of the economy during the pandemic and, subsequently, the Russo-Ukrainian war.

Keywords: *Czech monetary policy, Czech National Bank, euro, banking, monetary policy, COVID-19 pandemic, Russo-Ukrainian war*

1. The Czech National Bank as the leading monetary policy institution

In the area of monetary policy in the Czech Republic, the Czech National Bank is entrusted with a crucial role. The basic legal regulation of the bank is included in the Constitution,¹ which states that the Czech National Bank is the central bank of the state. In line with EU primary law, the same article defines the main objective of the Bank's activities as ensuring price stability.² The activities of the Czech National Bank may only be interfered with by law.³

Notably, the Czech National Bank is a part of the European System of Central Banks and contributes to fulfilling its objectives and tasks. It is also part of the European System of Financial Supervision and cooperates with the European Systemic Risk Board and European Supervisory Authorities. The supreme governing body of the Bank is the Bank Board, which consists of a governor, two Deputy Governors, and four other Bank Board members. All Bank Board members are appointed by the President of the Czech Republic for a maximum of two six-year terms.⁴

The Bank carries out its specific activities in compliance with the Act on the Czech National Bank.⁵ In addition to creating a low-inflation environment in the economy, the Bank fosters financial stability and supervises the operation of the financial system in the Czech Republic (e.g. the banking sector, capital market, insurance industry, pension funds, credit unions, electronic money institutions, bureaux de change). Its specific tasks are to issue banknotes and coins and manage and oversee currency circulation, payment systems, and settlements between banks.⁶

The independence of the Czech National Bank is guaranteed by the Constitution as its autonomy is *conditio sine qua non* and a prerequisite for effective monetary instruments conducive to price stability.

1 Act no. 1/1993 Sb., the Constitution of the Czech Republic, as amended.

2 Art. 98 of the Constitution of the Czech Republic.

3 Hulkó and Radvan, 2022, p. 62.

4 *About the CNB* [Online]. Available at: https://www.cnb.cz/en/about_cnb/ (Accessed: 24 August 2023).

5 Act no. 6/1993 Sb., on the Czech National Bank, as amended.

6 *About the CNB* [Online]. Available at: https://www.cnb.cz/en/about_cnb/ (Accessed: 24 August 2023).

The Bank's activities can be summarized as follows: (i) Broadly, in monetary policy, banks endeavour to keep inflation low, stable, and predictable; the Czech National Bank achieved its 2% inflation target by setting interest rates and using other monetary policy instruments. The Bank Board decides on which instruments to use and how to use them based on a macroeconomic forecast and an assessment of risks and uncertainties conducted eight times a year.⁷ (ii) The Bank sets a macroprudential policy by identifying, monitoring, and assessing risks to the stability of the financial system and, by preventing or mitigating these risks, contributes using its powers to the resilience of the financial system and the maintenance of financial stability.⁸ Banks define financial stability as a situation in which the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy while showing a high degree of resilience to shocks.⁹ (iii) The Bank is the supervisory authority of the Czech Republic's financial market. It lays down rules that safeguard the stability of the banking sector, capital market, insurance industry, and pension scheme industry. It regulates, supervises, and, where appropriate, issues penalties for noncompliance with these rules.¹⁰ (iv) The Bank is the exclusive issuer of Czech banknotes and coins. Circulating banknotes and coins are intended for cash payments. Commemorative banknotes and coins are designed for collection and investment purposes, and banks sell them through their contractual partners at prices different from their nominal values.¹¹ (v) The Bank contributes to preparing draft legislation regarding payments and clearing between banks, foreign bank branches, and credit unions. It promotes smooth and efficient payments, and contributes to the safety, soundness, efficiency, and development of payment systems.¹² (vi) The Bank declares the exchange rate of the Czech koruna against other currencies in the financial market in the form of foreign exchange market rates and the exchange rates of other currencies. (vii) The Bank is the resolution authority for banks, credit unions, and certain investment firms in the Czech Republic. 'Resolution' refers to the restructuring of an institution to ensure the continuity of its critical functions, minimise impacts on the economy and financial system, and restore the viability of all or part of that institution.¹³ (viii) In its area of competence, the Bank compiles and publishes statistics, particularly monetary and financial statistics, balance of payments statistics, supervisory statistics, financial accounts statistics, general economic statistics, and government finance statistics. The statistics are compiled in

7 *The Mandate of the Czech National Bank* [Online]. Available at: https://www.cnb.cz/en/about_cnb/mission/ (Accessed: 24 August 2023).

8 *Ibid.*

9 *Financial Stability* [Online]. Available at: <https://www.cnb.cz/en/financial-stability/> (Accessed: 24 August 2023).

10 *The Mandate of the Czech National Bank* [Online]. Available at: https://www.cnb.cz/en/about_cnb/mission/ (Accessed: 24 August 2023).

11 *Ibid.*

12 *Ibid.*

13 *Ibid.*

accordance with the international standards of the European Union (EU) and the relevant requirements of European supervisory authorities.¹⁴ (ix) The objective of the Bank's economic and financial research is to provide outputs that expand its knowledge base for its core activities.¹⁵

2. Introduction of the Euro: The Czech experience

Through the Act of Accession of the Czech Republic to the European Union, the Czech Republic committed to joining not only the EU, but also the euro area. The Treaty of Accession was signed over 20 years ago in 2003 and accession took place in 2004. Since the Czech Republic has not yet joined the euro area, its monetary policy is governed by Art. 130 and 131 of the Treaty on the Functioning of the European Union (TFEU) and the Statute of the European System of Central Banks and the European Central Bank. Art. 130 provides for the independence of the national central bank (NCB) in relation to the exercise of the powers and performance of the tasks and duties conferred on the NCB by the Treaties and the Statute of the European System of Central Banks and the European Central Bank. It also suggests that neither the European Central Bank (ECB) nor any NCB or member of its decision-making bodies may seek or take instructions from the institutions, bodies, offices, or other entities of the EU; from any government of a Member State; or from any other entity. Art. 131 requires each Member State to ensure that its national legislation, including the Statute of the National Central Bank, complies with the Treaties and with the Statute of the European System of Central Banks and of the European Central Bank.

2.1. The Maastricht convergence criteria

As mentioned above, the entry of a Member State of the EU into the Eurozone is subject to the achievement of a high degree of sustainable convergence, in addition to the compatibility of its legislation with Arts. 130 and 131 of the TFEU and the Statute of the European System of Central Banks and the European Central Bank. The convergence criteria were established in Art. 140 of the TFEU and elaborated in Protocol No. 13 of the Treaties.

Specifically, the convergence criteria are as follows: (i) Achieve a high degree of price stability; (ii) A sustainable government finance position in the long term; (iii) Compliance with the normal fluctuation margins of the exchange rate; (iv) Durability of convergence, as reflected in long-term interest rates.¹⁶

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ European Central Bank, 2023.

The price stability criterion measures the rate of consumer price inflation, which must not exceed 1.5 percentage points of the average price stability of the three best-performing EU countries. The Czech Republic will not meet this criterion by 2020, partly due to the low benchmark. High inflation in the Czech Republic in 2021 is driven by supply side factors, amplified by loose fiscal and monetary policies and a tight labour market. This is reflected in accelerated wage growth and input and energy prices. At the same time, the relaxation of anti-pandemic measures led to rapid growth in household consumption. In 2022, expansionary fiscal policy, previously loose monetary policy, and pandemic-induced low output began to take effect. Meanwhile, the economic consequences of Ukraine's invasion by Russian troops, which led to an energy and food crisis, were also negative. In 2023, price increases occurred – particularly in the energy and food sectors. In addition to supply side inflation, demand-side inflation also increased due to a tight labour market and high lending volumes, particularly housing-related lending, which, in turn, contributed to rising housing prices and the high contribution of imputed rents to inflation. In both years, the Czech Republic had one of the highest inflation rates in the EU.

In 2023, inflationary pressures gradually eased, both through a reduction in supply side factors causing inflation (problems with the supply of production inputs and oil prices) and through the effect of the Czech National Bank's interest rate hikes. The exchange rate of the CZK against the main world currencies, which is neutral, does not have an impact. Highly mandated expenditures are expected to contribute to an increase in inflation. Thus, the Czech Republic does not fulfil the criterion in 2023 and most likely will not fulfil the price stability criterion in 2024.

The public finance position criterion requires an EU country to maintain a sustainable public finance position in the long term. This criterion is formally met if a country does not have an excessive deficit. An excessive deficit procedure (EDP) is triggered if a country fails to meet one of its fiscal criteria. The first requirement is a deficit ceiling of 3% of GDP. The second requirement is a government debt ceiling of 60% of GDP. In these cases, an exception can be made in the event of an overshoot if the government debt ratio declines sufficiently towards this value. The Czech Republic has been in breach of the deficit maximum value since 2020, as the balance fell below -5% of GDP in 2020 and 2021 (a 2020 deficit of 5.8%, a 2021 deficit of 5.1%). The reason for this decrease was the decline in economic activity during the COVID-19 pandemic and the related government stabilisation, support, and redistribution policies. By 2022, the deficit was 3.6% of GDP. Thus, the deficit was reduced, but remained above the maximum value.

Owing to the application of the general escape clause, which allowed Member States to temporarily depart from common fiscal rules, the European Commission did not initiate the Excessive Deficit Procedure. Therefore, the Czech Republic still formally fulfils the criteria for government financing. The structural balance was measured against the medium-term budgetary objective of each EU Member State. The Czech Republic has so far set a target of -0.75% of GDP. However, the medium-term budgetary objective could be tightened to -0.5% of the GDP after joining

the Eurozone. According to the Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union, a structural balance threshold of -1.0% of GDP is only allowed if general government debt is well below 60% of GDP and long-term sustainability risks are low.

By 2023, the total general government debt is projected to increase to 44.1% and the level of total debt should remain below the reference value of the convergence criterion. An important factor behind the increase in debt is the rise in the general government deficit relative to GDP. However, under the current fiscal policy settings, despite economic recovery, the debt-to-GDP ratio is expected to continue to rise. Unfortunately, there is no deadline set for when the general government budget would stop falling against GDP; this will be marked by the generation of a budget surplus.

The interest rate convergence criterion requires yields on bonds with an average residual maturity of 10 years to be no more than two percentage points above the average bond yields in the three best-performing EU countries in terms of price stability.

This criterion has always been met, but since mid-2021, the Czech National Bank has sought to mitigate rising inflationary pressure by substantially increasing base interest rates. In contrast, the ECB maintained base interest rates at zero until July 2022, before gradually increasing them more significantly. Furthermore, the ECB's negative differential *vis-à-vis* the Czech National Bank is expected to remain this year, so it will not be met in 2023 either. A similar outlook has been assumed for the next few years.

Maintaining the national currency in the exchange rate mechanism (ERM; specifically, here, the ERM II) for at least two years is the fourth and final criterion. In the ERM, the exchange rate is assumed to move within a fluctuation band of $\pm 15\%$ without devaluing the central parity and without putting excessive pressures on the exchange rate. The fulfilment of this criterion can only be assessed after the entry of the Czech Republic into the ERM II. However, if one were to assess whether the Czech Republic would be able to fulfil this criterion at present, it can be concluded that meeting this criterion should not be problematic. The achievement of a stable exchange rate was supported by the Czech National Bank's intervention in the foreign exchange market in 2022. From 2021 onwards, an appreciating trend in the exchange rate can be observed, with the CZK exchange rate moving within a fluctuation band of $\pm 15\%$ over this two-year period. It is also possible to take into account the fact that even if the exchange rate were to appreciate more strongly and the fluctuation bands were to be slightly exceeded, there would be no immediate rejection of the country's entry into the Eurozone, as shifts of the central parity towards a stronger exchange rate have been tolerated in the past.

Based on the assessment of the above criteria, it can be concluded that the Czech Republic does not currently fulfil any convergence criteria. As noted above, the Czech Republic has one of the highest inflation rates in the EU, which is caused by both demand and supply side factors and fed by elevated inflation expectations. High inflation is subsequently reflected in the diverging monetary policies of the ECB and

the Czech National Bank, which negatively affect interest rates, and is therefore a consequence of the non-fulfilment of the next convergence criterion.

Specifically, the criterion for the state of public finances was also not fulfilled, except that the European Commission did not initiate an excessive deficit procedure against any country because of the COVID-19 pandemic. However, the European Commission's approach cannot be relied on to remain benevolent in future periods. Public finances in the Czech Republic are burdened by high structural deficits, and leading economists currently consider the impulses to reduce them insufficient. Although the Czech Republic technically meets the exchange rate fluctuation criterion, it does not truly fulfil it because it has not yet joined the ERM II.¹⁷

2.2. Pros and cons of being a part of the Eurozone: A Czech perspective

Over the past 20 years, the Czech Republic has taken the position of aligning its economic development with the Eurozone and trying to ensure that the economy itself minimises possible asymmetric shocks through other mechanisms. According to the Czech National Bank in 2023,¹⁸ the degree of alignment of the Czech economy with the Eurozone is key to outweighing the gains from the introduction of the euro over the losses from its own monetary policy. As reported by the Czech National Bank, the Czech economic level moved slightly away from the Eurozone average in 2021; however, compared to the situation associated with the onset of the external shocks listed above, price and wage levels have recovered. The absolute value, reflecting the distance from the Eurozone average, is still significant, discouraging the early adoption of the euro. In such a case, if the euro were to be adopted, inflationary pressures would increase significantly, and inflation above 2% would be expected with a high degree of probability. Examining the correlation between economic activity in the Czech Republic and the Eurozone reveals that the cyclical development of these economies is primarily aligned; this is again due to the economies' response to external shocks, which makes it impossible to conclude that there is a long-term alignment in terms of economic development. There are also significant differences in economic structure, with industry comprising a large share of GDP in the Czech Republic thanks to its automotive sector.

On the contrary, a high level of trade and ownership interdependence encourage the Czech Republic to join the Eurozone. Adopting the euro would remove exchange rate risk and reduce transaction costs in trade with Eurozone countries. The Czech Republic's position as an open economy leads to the synchronisation of economic shocks and cyclical alignment, which should lead to lower costs associated with the loss of an independent monetary policy. Meanwhile, 'ownership interdependence'

¹⁷ Ministry of Finance, Czech National Bank, 2022.

¹⁸ *Devizové rezervy a devizové intervence* [Online]. Available at: <https://www.cnb.cz/cs/menova-politika/vzdelavani/12-devizove-rezervy-a-devizove-intervence/index.html> (Accessed: 30 August 2023).

refers to investment by Eurozone countries in the Czech Republic. According to the Czech National Bank, financial cycle alignment between the Eurozone and the Czech Republic is gradually increasing. However, the Czech National Bank tightened its monetary policy in 2022, which increased the interest rate differential, particularly for short-term rates.

Although the Czech Republic is not in the Eurozone, its currency reacts to environmental changes in a similar manner to the euro. The correlation between the CZK and the dollar was similar to that between the CZK and the euro. Initially, the Russian invasion caused deterioration; next, owing to foreign exchange interventions to weaken the CZK against the euro, the correlation increased. Therefore, the exchange rate of the CZK against the Euro was the same as that of the other Central European currencies. According to the Czech National Bank, the alignment of individual segments of the Czech financial market with the Eurozone is moving away from the pre-pandemic levels. The level of private sector indebtedness and the depth of financial intermediation are relatively low in the Czech Republic and, according to the Czech National Bank's assessment, remain below the Eurozone level. However, it would be inappropriate to follow other Eurozone countries in this respect because the significant size of the financial sector and high private sector indebtedness may negatively impact cyclical fluctuations in the real economy. If private sector indebtedness increases, the scope of monetary or fiscal economic policies is reduced.

The structure of financial liabilities of Czech non-financial corporations with Eurozone corporations is still high, in contrast to the similarity in the structure of financial assets of Czech households with Eurozone households. The decline in other liabilities of Czech corporations (e.g. financing through bridge loans) contributes to the reduction of structural mismatch, as their share in total corporate liabilities is higher than that in Eurozone countries. Meanwhile, the structural similarity in financial assets between Czech and Eurozone households remains low; this is because Czech households prefer to hold cash, deposits, units, and shares while Eurozone households prefer insurance and social programmes. Thus, households' responses to interest rate changes and, hence, the use of interest rates as a monetary policy tool, may differ. Regarding the structure of loans according to the length of interest rate fixation, the trend is similar in the Czech Republic and Eurozone, with an increase in loans with longer fixations over the last decade. The largest volume of new loans to non-financial corporations (88%) has floating rates or rates with a fixation of up to one year.

Regarding nonfinancial corporate loans and overnight interbank market rates, client spreads remain lower than those in the Eurozone. The structure of client rate spreads is markedly different, as they have shown a significant increase in recent months due to monetary policy, and have emerged gradually and to varying degrees across interest rate segments. The evolution of the 10-year government bond yield in the Czech Republic only partially illustrates the evolution of monetary policy rates, as it is also influenced by factors unrelated to the evolution of

monetary policy rates (e.g. fiscal policy and market expectations in the long term). The spread of the 10-year bond yield to the overnight interbank rate is negative; that is, short-term money market rates are higher than the 10-year government bond yield. However, if we compare the client rate for loans to nonfinancial corporations with the yield on 10-year government bonds, the spread is positive. The most common fixation in the Eurozone is ten years, whereas in the Czech Republic, the most common fixation is five years. Different fixation lengths may imply varying degrees of sensitivity to changes in market or monetary policy rates.

Longer fixed periods may reduce the sensitivity of client interest rates to changes in financial market rates. Czech households are very conservative and the share of foreign currency loans and deposits is still very low, whereas the share of euro-denominated credit financing is increasing among businesses. This is because of the high degree of trade interdependence with the Eurozone and the desire to naturally hedge exchange rate risk. Notably, the high interest rate differential between the CZK and euro interest rates has exacerbated this increase, with the share of euro-denominated loans in total corporate loans now exceeding 40%. In this respect, there are no differences across enterprise sectors and sizes, and the share of euro-denominated loans in total loans is similar. This may increase further in the context of forthcoming changes to the Accounting Act,¹⁹ which would allow businesses to keep their accounts and pay taxes in euros. For this reason, however, the Czech National Bank's monetary policy can be expected to be less effective.²⁰

Based on the above, the Czech Republic's monetary policy stance is, in many respects, similar to that of the Eurozone. This conclusion is best supported by the fact that the CZK reacts to changes in a similar way to the euro. However, there are a number of areas in which the Czech Republic's situation differs from that of the Eurozone, such as the potential of monetary policy instruments, including the different impacts of these instruments on the business and household sectors and the profitability of the banking sector.

If the Czech Republic is committed to adopting the euro, its primary aim should be to align its economic development with that of the Eurozone and stimulate the economy so that it can respond independently to external influences without major government intervention. Although this has been declared, instruments are not always used, particularly in fiscal policy, to realize this objective. Currently, monetary policy efforts are focused on reducing inflation. The attitude of the Czech Republic towards the Eurozone could be appropriately expressed in the words of the current Minister of Finance, Zbyněk Stanjura: 'We are to adopt the euro when it is advantageous for the Czech Republic, and so far it is not.'²¹

¹⁹ Act no. 563/1991 Sb., as amended.

²⁰ Ministry of Finance, Czech National Bank, 2022.

²¹ *Přijetí eura se na čtyři roky odkládá. Podle vznikající vlády by to „nebylo výhodné“*, 2021.

3. The European Banking Union

The European Banking Union (EBU) was created in response to the 2008 financial and debt crises. Its aim was to increase the safety and soundness of the banking sector within the euro area and minimise the impact on the real economy in the event of bank failure. Put differently, this banking union is designed to strengthen economic and monetary unions. In general, joining a banking union involves cross-border risk and loss sharing and is clearly more beneficial for countries with relatively unstable banking sectors²² while likely disadvantageous for countries with relatively stable ones.

All Eurozone countries automatically participate in the EBU, but countries outside the Eurozone can also cooperate closely. The Czech Republic, which is not a member of the euro area, is not obliged to be a member of the EBU; however, it does have the option to do so. The Czech Republic regularly prepares a study containing all relevant aspects of its possible participation in the EBU in order to be able to make an informed decision on whether to join the EBU before adopting the euro or to wait. Specifically, these studies assessed the impact of the country's entry into the EBU according to several criteria.

The first criterion is the situation of the national banking sector; that is, its resilience, structure, size, extent of cross-border activities, intensity of ownership, and credit interconnectedness with banks in the Eurozone. The 2021 study confirms the conclusions of the 2015 Study and the 2016 Update, characterizing the Czech banking sector as follows: (i) Relatively high levels of capitalisation and profitability; (ii) Low levels of non-performing loans; (iii) High levels of bank funding through customer deposits; (iv) Low use of bank assets as collateral; (v) Very low importance of central bank funding; (vi) Low levels of household and nonfinancial corporate debt; (vii) Low levels of household foreign currency debt; (viii) Lower banking sector balance sheet relative to GDP; (ix) Dominant role of banking entities owned by parent banks in the Eurozone; (x) The banking sector is a significant owner of Czech government bonds.²³

These banking sector characteristics place the Czech Republic among countries with a more resilient and stable banking sector than many other EU Member States. From the analysis of these ten indicators, joining a banking union is not yet beneficial for the Czech Republic.

The EBU is based on a Single Supervisory Mechanism (SSM), which refers to the transfer of supervisory powers to the ECB. By joining the EBU, some supervisory and regulatory activities are transferred to the ECB; in the case of euro-area Member States, this transfer has already been made; in the case of countries not yet in the euro area, the central bank of that country would lose some of its activities. The Czech Republic's entry into the EBU would mean a significant reduction in the Czech National Bank's supervisory powers over major institutions and a weakening of the voting power of the

²² European Council, 2023.

²³ Ministry of Finance, 2020.

European Banking Authority and colleges of supervisors. These steps would mean that, in the event of the failure of a foreign bank, Czech subsidiaries could be at risk and the Czech National Bank would not be able to determine its own measures, which may be most effective given its knowledge of the Czech environment.

In the context of supervision and the general functioning of the SSM, assessments by the European Commission and the European Court of Auditors took place in 2016 and 2017. In its 2017 report, the European Commission positively assessed the first years of the ECB's functioning as a supervisory authority, but also identified areas for improvement. The European Court was more critical of the 2016 report; in particular, it was concerned with the supervisory structure, which is highly complex and requires a high degree of coordination and communication between ECB staff and Member States. There were also shortcomings in the IT and skills of the competent national authorities carrying out on-site inspections, which may affect the efficiency and effectiveness of decision-making. This factor also supports the Czech Republic's wait-and-see attitude, with the view that it should monitor the activities of the SSM, and, when more knowledge is available, re-evaluate its decision.

To make an informed decision on whether to join the EBU, the study published in 2021 provides a table containing individual criteria focusing on supervisory performance and financial costs, as assessed by the Ministry of Finance, the Ministry of Foreign Affairs, the Office of the Government, and the Czech National Bank. Consequently, the criteria relevant to informed decision making were divided into three areas. The first area contains factors in favour of the Czech Republic joining the SSM under current conditions; the second contains neutral factors or factors not assessable under current conditions; and the last contains factors against the Czech Republic joining the SSM under current conditions (see Table 1).²⁴

Table 1: Banking supervision, regulation, and financial stability (abridged)²⁵

	Factors for entry	Neutral factors	Factors against entry
THE EXERCISE OF SUPERVISION IN TIMES OF FINANCIAL STABILITY			
Supervision of significant institutions and their subsidiaries in significant groups			x
Supervision of minor institutions and their subsidiaries in major groups			x
Supervision of bank branches		x	

²⁴ Ibid.

²⁵ Ministry of Finance, 2020.

	Factors for entry	Neutral factors	Factors against entry
Prudential requirements (transfer of competencies from the Czech National Bank to the ECB, liquidity, limits on large exposures)			x
ECB approach to capital requirements		x	
Macro-prudential supervision and requirements		x	Czech National Bank
Licensing (from the perspective of the Czech market)			x
Assessment of acquisition of qualifying holdings (from the perspective of the Czech market)			x
Role of the EBA and dispute resolution between supervisors			x
The ECB as an active member of the college representing the Czech National Bank			x
The Czech National Bank and participation in the ECB Supervisory Board ²⁶	x	Czech National Bank	
Safeguard mechanisms for the participating countries of the Banking Union whose currency is not the euro ²⁷		x	x, Czech National Bank
The Czech National Bank's non-participation in the Governing Council of the ECB			x
Responsibility for supervision (ECB and Czech National Bank in relation to the Czech Republic)			x
Democratic control		x	
SSM regulatory supervisory framework			x
Rating		x	Czech National Bank

26 The Ministry of Finance, Ministry of Foreign Affairs, and Office of the Government took a neutral position regarding access to timely information and co-decisions on the supervision of institutions in the EBU.

27 Regarding membership in the European Banking Authority, the CNB was opposed to accession; regarding ending the close cooperation between the ECB and participating countries that do not use the euro as their official currencies, all interviewees were opposed to accession.

	Factors for entry	Neutral factors	Factors against entry
SUPERVISORY PERFORMANCE IN TIMES OF FINANCIAL INSTABILITY			
Prudential supervision			x
Macroprudential supervision		x	
Group supervisory performance		x	
Possibility of providing financial assistance to the parent institution		x	
Easier transmission of financial distress due to stronger links with the parent institution and group members			x
Lender of last resort		x	Czech National Bank
FINANCIAL COSTS ASSOCIATED WITH PARTICIPATION IN THE SSM			
Operating and other costs of the institution		x	
Financial contributions to ECB activities			x
Supervisory authorities			x

As stated in the 2021 study, based on the experience of the members of the EBU, the Czech Republic would have to increase its budget if it joined the EBU, mainly because of the increased administrative burden. Furthermore, the Bank's supervisory competencies would be transferred to the ECB, and the Czech National Bank would have to participate in the colleges but without voting rights. A shortcoming in the functioning of the SSM is the lack of differentiation of supervisory responsibilities within the SSM. Moreover, different legal frameworks are reflected in the ECB's supervisory activities, which negatively affect the performance of supervision. Additionally, the extent to which the ECB can influence the supervision of less significant institutions is not clearly predictable. Overall, in the context of supervision and regulation, it has been argued that it would be preferable for countries outside the euro area to join the banking union only when they decide to adopt the euro.

Crisis resolution in the banking sector was carried out under the Single Resolution Mechanism (SRM) regulation, which became effective on 1 January 2016 and applies to all countries with banking unions. According to previous studies, the measures set out in the SRM would be disadvantageous for a non-euro country. The primary concerns are the transfer of competencies to the ECB and the obligation to participate in financing future bank crises in other Member States. According to a 2021 study, the total amount of contributions paid by Czech-based banks to the

Single Resolution Fund (SRF) would be between CZK 17 billion and CZK 26 billion if they joined the banking union. Therefore, the Czech banking sector would contribute between CZK 7 billion and CZK 17 billion less than the current Resolution Fund; however, these funds would be used to finance the resolution of any entity in the banking union. If funds continue to be paid to the resolution funds, they will only be used to resolve domestic institutions. If the SRF were to be drawn down, the collection of contributions would resume, and it would be difficult to estimate the amount of this contingent liability. On the positive side, the number of entities contributing to the SRF is higher²⁸ than that contributing to the Resolution Fund. Given the good health of the banking sector in the Czech Republic, it can be assumed that additional contributions to the Resolution Fund were less frequent than those to the SRF.

In the wake of the COVID-19 pandemic, the EU has called on supervisory authorities to take measures to support the financing of households and businesses facing difficulties and that have had to temporarily reduce or minimize their activities; notably, it has been recommended that these measures be temporary. Under the SSM, the ECB reduced certain reserve ratios and liquidity coverage requirements. The Czech National Bank also took this recommendation into account, with the proviso that, in view of the greater resilience and stability of the banking sector, these were rather partial steps. For example, the countercyclical capital buffer for banks at the Czech National Bank was reduced from 1.75% to 1% and then to 0.5%, repo delivery operations were announced three times instead of once a week, and mortgage bonds could be included among the loans to be secured. Thus, the Czech National Bank was able, during the COVID-19 pandemic, to opt for measures that specifically helped the domestic market because it was not a member of the banking union. This also impacted the Czech Republic's attitude towards the banking union.²⁹

The EDIS is based on the harmonisation of deposit insurance rules and the creation of a common fund. Its aim is to: (i) Create a common deposit insurance mechanism separate from public budgets; (ii) Strengthen financial stability; (iii) Ensure citizens' confidence in protecting their deposits; (iv) Weaken the links between countries and banks within their territories, thus reducing the risk of contagion.

The EDIS is primarily based on a policy debate on whether progress in risk reduction has been sufficient, with some banking union Member States leaning towards the view that progress in risk reduction has been sufficient and others arguing the opposite; however, the COVID-19 pandemic has disrupted this discussion. In April 2023, the European Commission adopted a proposal that enabled authorities to organise an orderly market exit for failing banks. This process is not dependent on the firm's size or business model; therefore, it includes smaller players.

28 There are approximately 4.300 banking institutions operating in the euro area and only 34 insured banking institutions in the Czech Republic.

29 Ministry of Finance, 2020.

Under the 2023 reform, protection for owners and borrowers has increased and a deposit insurance scheme has been set up (before the reform, bank losses would have been paid by depositors). In banking unions, safety nets are financed by the SRF (EUR 80 billion) and Deposit Guarantee Schemes (EUR 55 billion). The reform should bring about higher incentives for smaller and mid-sized banks to choose a resolution, such as facilitating the transfer of deposits to another bank. However, because too little time has passed to effectively analyse the impact of this reform, it is not entirely relevant to the analysis of the potential effects of the Czech Republic's entry into banking unions.³⁰

4. Monetary aspects of crisis management

4.1. Eurocrisis

As suggested above, the primary goal of the Czech National Bank – enshrined directly in Art. 98 of the constitution – is price stability. In 1997, the Czech National Bank Board decided to change its monetary policy regime and, in 1998, opted to engage in inflation targeting, that is, to maintain inflation within predetermined bands. From 2002 to 2005, the target was set in the form of a linearly declining band, with a bandwidth of 3–5% in 2002 and a gradual reduction to 2–4%, to be reached in December 2005. In 2006, the Czech National Bank set an inflation target of 3%, with a further change in 2010. The inflation target has remained unchanged since 2010, with an annual increase in the consumer price index of 2%. The Czech National Bank expects this target to remain at the same level until the Czech Republic's accession to the Eurozone, in line with the targets of other central banks operating in advanced economies. The Czech National Bank regularly assesses whether its inflation target has been met.

As also noted above, monetary policy, which is intended to achieve and maintain price stability, is regulated by the Czech National Bank Act. Art. 5 lists the instruments of monetary regulation of the Czech National Bank; specifically, Art. 23 states that the Czech National Bank sets interest rates, frames, maturities, and other terms of transactions and determines the types of such transactions and its counterparties.

Therefore, interest rates are the primary monetary policy instruments. The board decides on where to set interest rates at regular meetings, and the rates applicable for the following period are published after each meeting. The most important interest rate is the two-week repo rate, which represents the marginal interest rate for repo operations (i.e. the withdrawal of excess liquidity from commercial banks against securities). Repo operations are usually executed thrice a week in the form

³⁰ European Commission, 2023.

of variable-rate tenders with a base duration of 14 days. Commercial banks tender their cash, with the Czech National Bank preferentially accepting bids requesting the lowest interest rate up to the amount of the estimated liquidity surplus for the day. The two-week repo rate influences short-term market interest rates. The Czech National Bank also announces the Lombard rate, which is the rate at which commercial banks can borrow liquidity from the Czech National Bank overnight against the collateral provided by the lending facility. The third rate announced by the Czech National Bank is the discount rate; this rate is the opposite of the Lombard rate, in which commercial banks deposit liquidity overnight with the central bank under the deposit facility.

The Czech National Bank has the option of using other monetary policy instruments; however, these are only used in specific situations when interest rates reach the effective lower bound and a more significant monetary policy instrument is needed. These monetary policy instruments include foreign exchange interventions. Foreign exchange interventions were used between 2013 and 2017, and their effect was notably greater than that of interest rate changes. The Czech Republic is characterised by a banking sector with a long-term liquidity surplus, and because of the zero lower bound on interest rates, the Bank Board decided in 2012 to use a more effective instrument. Between 2012 and 2013, the Czech economy was in a downturn, reflected in rising unemployment and declines in profits, business investment, and household income and consumption, and threatened to fall into a deflationary spiral. The Czech National Bank sought to reverse this development by lowering interest rates to near zero (0.05%) based on the understanding that interest rates would be kept at this low level for the necessary period. If a traditional monetary policy instrument was ineffective, another instrument was used. The anti-inflationary effects associated with the rise in unemployment and the cooling of investment and consumption were slow, and there was a further decline in commodity and energy prices. Inflation was forecasted to fall to zero in 2014; therefore, the Czech National Bank decided to implement its intention in 2013. Notably, the IMF also recommends the use of foreign exchange interventions.³¹

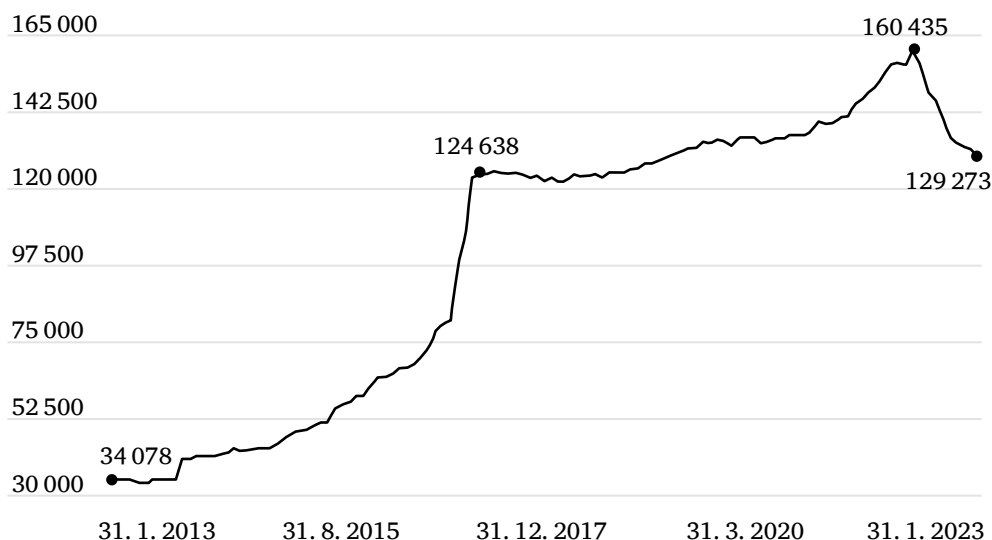
From November 2013 to April 2017, the Bank kept the exchange rate less than or equal to CZK 27 to the euro and spent over CZK 2 trillion on interventions. At the beginning of 2013, total foreign exchange reserves were approximately EUR 34 billion; in March 2017, they were four times higher. According to the Czech National Bank, the use of foreign exchange interventions was successful, as it not only prevented deflation but also contributed to overcoming the economic crisis. According to some economists, foreign exchange interventions lasted for too long and resulted in high exchange rate losses. However, the Czech National Bank defended itself, stating that these losses will be covered by future profits and will not burden the Czech state.

31 *Devizové rezervy a devizové intervence* [Online]. Available at: <https://www.cnb.cz/cs/menova-politika/vzdelavani/12-devizove-rezervy-a-devizove-intervence/index.html> (Accessed: 30 August 2023).

4.2. The COVID-19 Crisis

Further foreign exchange interventions began in March 2022 due to the significant weakening of the CZK and high inflation; specifically, the Czech National Bank began to sell off its euro reserves and buy domestic currency to strengthen the CZK (see Figure 1).

*Figure 1: Foreign exchange reserves of the Czech National Bank
(in billions of EUR)*



Thanks to high inflation, in 12 months, the Bank spent approximately EUR 26 billion – approximately 16% of its foreign exchange reserves. The CZK appreciated more than 6% against the euro for the entire year. Many economists view this step positively, arguing that interest rate operations in which higher rates lead to a decline in investment and consumption are relatively ineffective. However, because companies have started to demand loans in euros, they are not affected by the higher interest rates set by the Czech National Bank. A strong CZK has a negative impact on inflation, as Czech entrepreneurs cannot increase prices significantly because households would prefer goods from abroad. Furthermore, exports decline as they become more expensive abroad, which negatively affects employment, wages, and, ultimately, household demand. At present, foreign exchange interventions have not been terminated because the continuation of commitment acts has a psychological effect on markets; however, the Czech National Bank is not using these interventions because the CZK has strengthened. Economists believe that the Czech National Bank

would intervene again if the CZK entered the range of CZK 24.50 to 25.00 CZK/EUR.³²

Figure 2: CZK to EUR exchange rate³³



In addition to Art. 23, three other articles on monetary policy are listed in the Act on the Czech National Bank (the fifth section is devoted to monetary policy instruments). Art. 24 stipulates that banks, foreign bank branches, and credit unions must maintain mandatory minimum reserves in their accounts with the Czech National Bank; these reserves are kept in CZK and may or may bear interest. The minimum reserves may amount to a maximum of 30% of the total liabilities of the person required to maintain minimum reserves, less the liabilities of that obliged entity *vis-à-vis* other persons. The Czech National Bank also stipulates the possibility of setting minimum reserve requirements differently for individual obliged entities.

Mandatory minimum reserves were very important in the Czech Republic during the 1990s, when the money market was not yet fully developed. The level of minimum reserves and other conditions attached to them have since been adapted to contemporary needs. With the introduction of inflation targeting in 1998, their levels gradually decreased. Since October 1999, the reserve requirement rate has been 2% of banks' liabilities to non-banks, with a maturity of up to two years. In 2001, remuneration of reserve requirements at a two-week repo rate was introduced.³⁴

Art. 25 imposes sanctions when the debtor fails to maintain the required minimum reserves. In this case, the Czech National Bank is entitled to charge interest on the amount by which the minimum reserve requirements are not met. This

³² Voženílek, 2023.

³³ Ibid.

³⁴ Czech National Bank, 2021.

interest corresponds to the average Lombard rate for the period for which it should have maintained the minimum reserves, increased by five percentage points and at least 5%. Art. 26 sets out what the Czech National Bank establishes in its decree.

As mentioned, the Czech National Bank is trying to further stabilise the situation using interest rates; specifically, it increased interest rates to 6% during the COVID-19 pandemic (see Table 2).

Table 2: Discount rate of the Czech National Bank³⁵

Date	Discount rate
27 March 2020	0.05
1 October 2021	0.50
5 November 2021	1.75
23 December 2021	2.75
4 February 2022	3.50
1 April 2022	4.00
6 May 2022	4.75
23 June 2022	6.00

4.3. Russo-Ukrainian War

After the COVID-19 pandemic, the Russia–Ukraine conflict escalated, resulting in a substantial increase in energy prices. These inflationary pressures had to be solved by the Czech National Bank, which therefore continues to maintain high interest rates. The current situation shows that prices are decreasing very slowly; thus, it is expected that there will be no change in the Czech National Bank in the near future.

³⁵ *Devizové rezervy a devizové intervence* [Online]. Available at: <https://www.cnb.cz/cs/menova-politika/vzdelavani/12-devizove-rezervy-a-devizove-intervence/index.html> (Accessed: 30 August 2023).

5. Conclusions and Recommendations

Generally, the financial sector plays an important role in the economy's ability to absorb economic shocks. The banking sector in the Czech Republic is developing favourably and is highly resilient to potential negative shocks. The profitability of the banking sector in the Czech Republic has been high for a long time, and this was also the case in 2021, when it increased from pandemic levels. In 2022, the profits in the banking sector continued to grow owing to the higher margins associated with the Czech National Bank's policy rate hikes and increasing demand for loans. The banking sector is building a countercyclical capital structure that continues to increase its resilience; in particular, capital buffers ensure smooth lending to the economy and the stability of the banking sector in the event of negative external factors (e.g. economic downturns, geopolitical tensions). Moreover, the banking sector has a high proportion of liquid assets; thus, its liquidity should be high.³⁶

These aspects align with the conclusions of the Czech Republic's previous studies, which suggest that it should maintain a wait-and-see approach and not join the EBU or Eurozone. By not being a member of the euro area, the Czech Republic can effectively address the monetary policy situation according to the specifics of its domestic market. Further, in addition its relatively resilient and stable banking sector, the Czech Republic would have to consider the loss of its supervisory authority, especially over 'significant' banking institutions, their subsidiaries, and significant foreign banks with headquarters in its territory. Conversely, less significant entities (medium and small entities) would continue to be supervised by the Czech National Bank. The next study on the factors for or against entry into a banking union is expected to be published in 2024. The Czech Republic's entry into the banking union may indicate that it will seek to deepen integration with the EU, which may be reflected in its perception of future negotiations.

The actual determination of a specific date of entry is entirely within the competence of each EU Member State, although it should ideally be based on the State's level of preparedness. In addition to the undeniable positive benefits of being in the Eurozone, such as lower transaction costs and the elimination of exchange rate risk, adopting the euro means giving up an independent monetary policy and the exchange rate of the koruna as stabilising macroeconomic instruments. Therefore, an economy's readiness to join the euro area should be assessed in terms of its economic alignment and structural similarity with the monetary union, as well as its ability to absorb asymmetric shocks through other mechanisms, notably fiscal and labour market policies, after the loss of a separate monetary policy. Therefore, joining the EBU and Eurozone is primarily a strategic and political decision – one that is entirely up to the Czech Republic.

³⁶ Ministry of Finance, Czech National Bank, 2022.

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HUNGARY: NO EURO UNTIL 'MAASTRICHT 2.0 CRITERIA' ARE MET



GYÖRGY MARINKÁS

Abstract

The first part of the current chapter introduces Hungary's convergence data through convergence reports from years that the author deems milestones and, based on the relevant scientific literature, tries to answer why the Hungarian Central Bank took a cautious approach to the country's accession to the Eurozone and why academic literature adopted the 'real convergence' thesis as a basic principle. The second part introduces the constitutional and statutory framework of the Hungarian Central Bank's aims, functioning, and structure and presents certain academic debates on the chosen regulation. The third part of the book introduces the Hungarian Central Bank's monetary policy for crisis management in two parts: crisis management tools aimed at tackling the Euro crisis and tools aimed at mitigating the negative economic effects of the COVID-19 pandemic and the Russo-Ukrainian War. While tackling the first two crises required unconventional tools, such as near-zero interest rates and active refinancing, the latter required a return to old-school restrictive monetary policy, with high base rates and the phasing out of refinancing tools.

Keywords: *Hungarian Central Bank, monetary policy, convergence criteria, real convergence, Maastricht 2.0., Economic and Monetary Union, Eurozone, Banking Union, COVID-19, Russo-Ukrainian War*

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1. Lessons related to the introduction of the Euro: The positive and negative experiences of Member States within and outside the Eurozone with the common currency

1.1. Hungary and the Maastricht Convergence criteria

At the time of writing this chapter,¹ Hungary is a European Union (EU) Member State with a derogation under Art. 139 para. (1) of the Treaty on the Functioning of the European Union² (TFEU), which means that the provisions of the Treaties defined in para. (2) of said article shall not apply to Hungary. Based on Art. 140 para. (1) of the TFEU: ‘at least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council on the progress made by the Member States with a derogation’. Summarising the provisions of paras. (2) and (3), the Council shall, on a proposal from the Commission, after consulting the European Parliament and after a discussion in the European Council, decide whether the Member State with a derogation fulfilled the criteria set in para. (1) and abrogate the derogations of the Member States concerned. If it decides to abrogate the derogation, the Council shall, on a proposal from the Commission and after consulting the European Central Bank, irrevocably fix the rate at which the Euro shall be substituted for the currency of the Member States concerned and take other measures necessary to introduce the Euro. In doing so, the Council shall proceed with the unanimity of the Member States that use the Euro as their official currency and the Member States concerned. Notably, Hungary has never met the criteria set in Art. 140 para. (1); thus, the mechanism according to Art. 140 para. (3) has never been triggered. The following part of this chapter introduces certain convergence reports that were issued in the years the author of the chapter deemed milestones.

In 2004, the year when Hungary entered the EU, the price stability (inflation) rate was above the reference value of 6.5%. The government finance measures, namely the annual government deficit and the government debt-to-GDP ratio, were 6.2% and 59.1%, respectively. This means that the preceding value was above the reference value and the latter was below the reference value. Meanwhile, the long-term interest rates were above the reference value of 8.1%. Legal compliance was incomplete and the country did not participate in the ERM II.³

In 2010, when the currently governing party was elected into power, inflation (4.8%) was above the reference value. Annual government deficit (4%) and government debt (78,3%.) were above reference value. Long-term interest rates reached

¹ November 2023.

² Consolidated version of the Treaty on the Functioning of the European Union, OJ C 326, 26.10.2012, 47–390.

³ European Central Bank, 2004.

8.4%, rising above the reference value. Legal compliance was incomplete and the country did not participate in the ERM II.⁴

In 2014, one year after György Matolcsy became the governor of the Hungarian Central Bank (HCB), the convergence indicators improved. The inflation rate fell to 1%, dropping below the reference value. The annual government deficit rate was 2.2% and long-term interest rates were 5.8%, meeting the Maastricht criteria. Meanwhile, in terms of the government debt-to-GDP ratio (which was at 79,2%), legal compliance, and ERM II participation, the country did not fulfil the criteria.⁵

In 2020, before the negative economic effects of the COVID-19 pandemic kick in, the price stability indicator was 3.7% – somewhat higher than the Maastricht requirement. However, the annual government deficit was 2%, complying with the reference value. The government debt-to-GDP ratio was 66.3% that is, above the reference value. The long-term interest rate was 2.37% – that is, below the reference rate. However, legal compliance was incomplete and the country did not participate in the ERM II.⁶

According to a 2022 report, Hungary no longer complied with any of these criteria. The inflation rate was above 6.8% in April 2022,⁷ the annual government deficit had reached 6 %, and the government debt-to-GDP ratio was also above the reference value of 76,4%. The long-term interest rate was reported to be 4.1% – also above the reference value. Meanwhile, legal compliance was incomplete and the country did not participate in ERM II.⁸

As Menich-Jónás concluded, if we compare the former target dates for the introduction of the Euro with these data, it can be concluded that, in 2002, it was unrealistic to expect accession in 2007.⁹ As Péter Mihályi wrote in a 2012 study, fulfilling the Maastricht Criteria has dropped lower and lower down the list of priorities of successive governments.¹⁰ Instead, as Neményi and Oblath argue, short-term political considerations successively override medium-term stability-oriented macroeconomic policies – the instability and unpredictability of its economic and political policies have caused Hungary to lag behind other regions.¹¹ As Ákos Péter Bod summarised in 2007: 'The peculiarly Hungarian [...] story is that we were closer to meet the Maastricht criteria in 2000 than in 2006, which is (if I may say so) a laughing stock.'¹²

The author of the current article agrees with the above authors that, as made clear by the convergence reports, before 2014, Eurozone accession was rather wishful

4 European Central Bank, 2010.

5 European Commission, 2014.

6 European Central Bank, 2020.

7 This clearly does not indicate the extremely high inflation rate throughout the year after the Russo-Ukrainian War's economic effects peaked.

8 European Central Bank, 2022.

9 Menich, 2007, p. 70.

10 Mihályi, 2012, p. 918.

11 Neményi and Oblath, pp. 587–588.

12 Kenessey, 2023.

thinking due to the undisciplined fiscal policies of the former governments and the global financial crisis that started in 2007. However, in his view, somewhere between 2014 and 2020, Hungary had the opportunity to fulfil the Maastricht criteria and access the Eurozone with some extra effort. Nevertheless, doing so was not among the government's plans based on the 2017 statement of Mihály Varga, Minister of Finance, who explained that Hungary intentionally does not fulfil every criterion.¹³ Neszmélyi and Pócsik¹⁴ argued that, even in 2021, after the outbreak of the COVID-19 pandemic, we were not far from reaching compliance. However, based on the 2022 Convergence Report, Hungary's indicators started to deteriorate with the COVID-19 pandemic, and in 2022, the Russo-Ukrainian War affected the country's economic performance.

1.2. Pros and cons of joining the Eurozone

When examining the expected advantages and disadvantages of joining the Eurozone from a Hungarian perspective, it is worth examining the studies issued under the aegis of the HCB. In their 2002 study, Csajbók and Csermely¹⁵ emphasised that it is important to raise the question of whether a so called 'optimum currency area' (OCA) will come into existence between the Member State and the Eurozone. In their view, it is also important to determine whether a common monetary policy can be as efficient as a member state's monetary policy in countering economic cycles. Their main finding was that the introduction of the Euro may raise the long-term (20-year) average growth rate of Hungary's GDP by 0.6 to 0.9 percentage points. They identify and quantify three benefits and costs. The benefits include reduced transaction costs, expansion of foreign trade, and a drop in real interest rates. In their view, the costs are lower *seigniorage* revenue and the loss of independent monetary policy. Meanwhile, they also identified certain dangers of the accession. For example, if non-resident investors are confident that Hungary will join the Eurozone soon, it may trigger speculative capital inflows and start off a 'convergence play' similar to the ones that had involved other countries earlier in preparation for accession to the Eurozone. Additionally, the rapid fulfilment of the Maastricht criteria for inflation and the fiscal deficit may cause economic discrepancies. There is a danger that rapid disinflation and fiscal adjustment, aimed at a changeover in 2007, may entail an excessive sacrifice of growth. However, they summarised their cost-benefit analysis as follows: 'The quantifiable benefits arising from joining the Eurozone considerably exceed the costs entailed, resulting in higher economic growth and faster real convergence towards Western Europe'.¹⁶

13 MTI, 2017.

14 Neszmélyi and Pócsik, 2021, pp. 646–647.

15 Csajbók and Csermely, 2002, p. 208.

16 Csajbók and Csermely, 2002, p. 11.

Later studies were more cautious about the issue of accession. In their 2014 study, Kisgergely and Szombati argued¹⁷ that accession would mean loss of the country's monetary sovereignty. They also questioned whether the *Single Supervisory Mechanism* and *Single Resolution Mechanism* were more efficient than domestic supervision mechanisms and concluded that they were not.¹⁸ They argued that the competence between community and domestic authorities was not clear enough – that is to say, it was not clear who would have the last say; furthermore, the mechanism seemed to be bureaucratic and no clear rules existed on the burden of crisis management. As for the advantages, they argued that accession would secure our place at the 'core' and would also mean access to the crisis management fund (a sum of EUR 55 billion in 2014, an amount greater than Hungary could allocate alone). They also highlighted the professionalism of the ECB staff, which would contribute to enhancing the national staff's knowledge.

In their 2017 study, co-authors Nagy and Virág¹⁹ (who later separately revisited the concerns of the study²⁰) argued that while accession to the Eurozone does not result in 'automatic real convergence', failure is guaranteed if the country introduces the common currency before reaching a given level of real convergence. In order to avoid such a scenario, they elaborated the so-called 'Maastricht 2.0.' criteria; in their view, the following criteria should be met before accession: GDP per capita and wage levels should reach at least 90% of that of the Eurozone; synchronised business and financial cycles and an available, effective countercyclical political toolkit should be established; the economy should be close to full employment; an advanced, stable, and competitive financial sector (with 90% convergence) should be established; and structural balance should be achieved (based on government debt between 0 and -2% of GDP, with a debt target of 50%).

After introducing the HCB's points on this issue, one may introduce the opinions of the Hungarian academic community and practising economists. In the last 20–25 years, the basic thesis agreed upon by them became that, in the case of a premature, politically motivated accession without economic convergence, serious economic harm is inevitable.

The fulfilment of the Maastricht Criteria is necessary and, at the same time, insufficient to reach real convergence, as argued by Péter Mihályi.²¹ Zsolt Darvas argues that the Maastricht criteria are not proper tools for measuring a country's readiness for accession. Neither are the above cited Maastricht 2.0. criteria. In his

17 Kisgergely and Szombati, 2014, p. 30.

18 These findings on the BU's institutions were well-founded back in 2014: the chapter on European monetary policy, which also elaborates on the short comings of said institutions, support these findings. However, based on the developments of the recent ten years, most of these shortcomings were addressed.

19 Nagy and Virág, 2017.

20 Virág, 2020, p. 309; Nagy, 2020.

21 Mihályi, 2005, pp. 716–717.

view, the level of economic development is not that important.²² It is worth devoting a few lines here to the Greek example since it proved the importance of disciplined economic governance. As Darvas argued in 2017, it was not the introduction of a common currency that in itself induced serious problems in Mediterranean countries. In his view, the main problems were insufficient demand, poor budget structure, and wage increases in excess of productivity.²³ In 2008, Darvas and Szapáry concluded²⁴ that, due to certain characteristics of the Eurozone,²⁵ common monetary policy induced less-developed Member States to borrow excessively.²⁶ The Greek Sovereign Debt Crisis proved ‘once and for ever’ the dangers of premature, politically motivated accession since the accession in itself did not bring real convergence, as evidenced by Neményi and Oblath in their 2012 study.²⁷ In the author’s view, the Greek Sovereign Debt Crisis was also the turning point that made the ‘real convergence first’ thesis the most accepted among Hungarian scholars.

By contrast, the comparative study of Kutasi and Nagy²⁸ proves that pursuing a disciplined economic policy and reaching a level of real convergence is important, even if the country does not wish to access the Eurozone. In their study, they scrutinised the economic indicators of V4 countries; that is, they explored how the economic performance of Slovakia – the only V4 country that adopted the Euro – compares to the economic performance of countries with their own national currencies (namely, Hungary, Poland, and the Czech Republic). It is worth mentioning that while the Czech central bank chief seems to categorically refuse accession to the Eurozone, its Polish counterpart displays a more amicable attitude.²⁹

Based on the above-mentioned study by Kutasi and Nagy, the Slovak labour force became the most expensive in the region because Slovakia, which lacked sovereign monetary policy, was no longer able to devalue its own currency to keep the Slovak labour force cheap. Regarding price stability, they concluded that the Czech and Hungarian national currency inflation rates unexpectedly fit the Maastricht criteria better than the Slovak ones. From 2015 to 2016, Slovakia experienced deflation, similar to Hungary and Poland in the same period. Only the Czech Republic was not affected by deflation. Kutasi and Nagy further argued that only the Slovak debt-to-GDP ratio displayed growth during the examined period. Regarding the current account, they found that the common currency did not provide any advantage to Slovakia. Finally, they argued that data on the amount of foreign direct investment

22 Czalleng, 2018, p. 105.

23 Czalleng, 2018, p. 104.

24 Darvas and Szapáry, 2008, p. 873.

25 Artner and Róna 2012, pp. 83–102.

26 It is worth mentioning that the great availability of credit worldwide at the turn of the millennium would have induced the Greek government to obtain large amount of credit anyway, as Imre Tarafás argues. See: Tarafás, 2013, p. 362.

27 Neményi and Oblath, 2012, pp. 673–677.

28 Kutasi and Nagy, 2019, pp. 7–23.

29 *Central bank head: ‘Euro adoption could be considered by Poland within 8-10 years’*, 2023; *Czech central bank governor not betting on euro adoption in next decade*, 2017.

show almost the same trajectory in Hungary and Slovakia, whereas the Czech Republic and Poland performs better. Regarding the results of Kutasi and Nagy, the author of the current chapter only mentions that, based on his own findings, government debt-to-GDP ratios declined until around 2019/2020 in all V4 countries and started to grow in 2020³⁰ – a year outside the scope of the above co-authors' study.

Bod, Pócsik, and Neszmélyi in their 2020 study evaluated the results of the Slovak Euro more positively. Although they also mention the disadvantage of Slovak firms in terms of the wage share cost compared to producers in floating currency countries, they argue that since the price of imported materials and parts fell more than that of exported goods, the improvement in the exchange rate mitigated the effects of more 'expensive' wages. They also acknowledge that the actual benefits of Euro adoption have been somewhat lower than initially expected, which may be attributed to external factors, such as the global economic crisis and the prolonged crisis in the Eurozone. In their view, it can even be risky to state that the EMU and its strict fiscal rules protected the national economy from suffering greater losses as a result of these fiscal shocks. However, membership in the Eurozone is not in itself a guarantee of sustainable growth. Instead, it is the strong and longstanding commitment to the integration process and to obeying its rules that warrants growth: disciplined economy policy minimises the risk of economic policy 'slippage' and prevents costly forced adjustments.³¹

As an interim conclusion articulated by Darvas and Gottfried, one may state that a country may also be successful without the Euro. Similarly, in 2012, György Surányi stated that no country is immune to bad, irresponsible economic policies, either as a member of the EMU or an outsider.³²

Regarding the expected advantages, two additional facts should be emphasised. On the one hand, Hungary's import–export volume to the EU is already high, and it has almost reached its potential maximum.³³ In other words, accession to the Eurozone would not offer Hungary any room for improvement. However, some do not agree that accession to the Eurozone has any additional prestige value. As Gottfried argues, we are already devoted to the EU and NATO; accession to the Eurozone would not offer any additional value. However, Brexit has eroded the possibility of non-Eurozone members empowering their interests. In addition, every new entry to the Eurozone erodes the possibilities of those still staying out.³⁴ Vértés made a similar argument, stating that the main dilemma is the fear that missing out means being left behind.³⁵ It is also worth mentioning that Kisgergely and Szombati, in their 2014 study conducted under the aegis of the HCB, also emphasised that accessing the

30 Based on the data available at the following website: *Trading Economics* [Online]. Available at: <https://tradingeconomics.com/> (Accessed: 5 November 2023).

31 Bod, Pócsik and Neszmélyi, 2020, pp. 339, 343, 345–346.

32 Surányi: *kell a magyar euró, de nem túl gyorsan*, 2012.

33 Menich-Jónás, 2021, p. 72. See also: Virág, 2020.

34 Gottfried, 2021, p. 113.

35 Czelleng, 2018, p. 103.

Eurozone would mean belonging to the core. Brexit and its effect on the ‘outsiders’ ability to enforce their interests was also emphasised in György Surányi’s opinion, who, unlike Gottfried, thinks that accession offers prestige:

The financial and economic crisis, the crisis in the Eurozone, the influx of refugees, Brexit, the election of Donald Trump, all together and clearly push the European Union in the direction of deepening cooperation between member states. In this process, a country that is unable or unwilling to come into the inner circle could be marginalized or effectively left out of the European Union.³⁶

The loss of monetary sovereignty is maybe the most often cited argument against the introduction of the common currency, which is more often refuted by pointing out ‘the reality’; namely, that the Hungarian economy is small and open one, therefore, a fully independent monetary policy – in György Surányi’s words – is only an ‘illusion’. Thus, losing it is not an unacceptable sacrifice. For Székely, the devaluation tool is overestimated; he argues that it is only sufficient to buy time and only to a limited extent – specifically, only in order to facilitate other economic measures to solve the problem.³⁷

Finally, the issue of setting the target date must be addressed. As co-authors Bod, Pócsik, and Neszmélyi argue, no single date is absolutely perfect for accession from an economic point of view: all calculations are questionable. Furthermore, unpredictable circumstances can play a serious role; to put it simply, the outcome may depend on luck. While the decision on setting the target date should not be short-sighted, only political consensus over several government cycles can support the success of currency exchange and compliance with the resulting financial conditions.³⁸ In Mihályi’s opinion, the ‘original sin’ was committed by subsequent Hungarian governments, who repeatedly pushed the deadline, inducing unfounded expectations in economic operators and the population. The government should either manage the introduction of the Euro or tell us that we will not access the Eurozone in the near future.³⁹

As for the future, something has changed in 2023: both György Matolcsy, the current Governor of the HCB, and the finance minister, Mihály Varga, started to talk about the ‘Hungarian Euro’ even though it does not seem viable before 2030.⁴⁰ Although these discussions do not mean that Hungary has an official target date, this turn came somewhat out of the blue for two reasons: first, Hungary’s accession was off the agenda at such high levels for a while, and second, Matolcsy displayed a rather sceptical attitude towards the Euro early on.⁴¹ However, his recent thoughts suggest that this scepticism has since melted:

36 Surányi: *Euró nélkül kimaradunk az unió belső köréből*, 2017.

37 Czelleng, 2018, p. 105.

38 Bod, Pócsik and Neszmélyi, 2020, pp. 321, 323–324.

39 Mihályi, 2012, p. 918.

40 MTI, 2023.

41 Matolcsy, 2019.

Perhaps around 2030 or a bit later we could reach [...] 90% of the EU’s average in terms of development, then it is worth entering the Eurozone as the Euro has many advantages [...] Until then, it is worth using the extraordinary room for manoeuvre that having a national currency allows the Hungarian Central Bank to boost the economy.⁴²

2. The legislative framework of the HCB’s functioning and scholarly opinions

2.1. The legislative framework on the HCB’s aims, structure, and governance

The legislative framework of the HCB’s structure and functioning is set out in the Fundamental Law of Hungary⁴³ (FLH), which, in Art. 41 para. (6), states that the detailed provisions are to be settled in a so-called ‘cardinal act’.⁴⁴ The currently effective cardinal act is *Act 139 of 2013 on the Magyar Nemzeti Bank*⁴⁵ (the HCB Act).

According to the first sentence of Art. 41 para. (1) of the FLH, the central bank of Hungary shall be the *Magyar Nemzeti Bank* (hereinafter: *Hungarian Central Bank*,⁴⁶ HCB). According to the second sentence of Art. 41 para. (1) of the FLH, the HCB shall be responsible for monetary policy, as regulated by a cardinal act (the HCB Act). Art. 41 para. (2) of the FLH – enacted by the Fifth Amendment of the FLH in 2013⁴⁷ – doubled the HCB’s mandate, stating that the HCB shall supervise the financial intermediary system as well.

Meanwhile, Art. 3 of the HCB Act states that the primary objective of the HCB is to achieve and maintain price stability. However, the second paragraph of this article states that the HCB shall support the maintenance of the stability of the system of financial intermediation, the enhancement of its resilience, and its sustainable contribution to economic growth; additionally, it also outlines that the HCB shall support the government’s economic and environmental policy by using instruments at its disposal, provided they do not go against its primary objective.

The ‘Basic and other tasks’ of the HCB are set out in Art. 4 of the HCB Act. The HCB is entrusted with the task of implementing and defining monetary policy as well as issuing banknotes and coins in Hungary’s official currency, which shall be Hungary’s legal tender. To preserve the external stability of the economy, the HCB

42 Hungary central-bank chief sees chance for Euro adoption only after 2030, 2023.

43 The Fundamental Law of Hungary (25 April 2011).

44 In other words: organic law.

45 Act CXXXIX of 2013 on the Magyar Nemzeti Bank.

46 The author decided to use the terminology ‘central bank’ instead of ‘national bank’.

47 Fifth Amendment of the FLH, 16 September 2013.

is responsible for holding and managing official foreign exchange and gold reserves and is also entrusted with the task of conducting foreign exchange operations in relation to the management of foreign exchange reserves and the implementation of exchange rate policy. The HCB is entrusted as a supervisory authority, which oversees the payment and securities settlement systems and acts as a resolution authority.⁴⁸ The HCB shall collect and publish statistical information required for carrying out its tasks and fulfil its statistical reporting obligations to the ECB under EU law. The HCB is also mandated to establish a macro-prudential policy for the stability of the entire financial intermediation system. Further, the HCB must work to enhance the resilience of the financial intermediation system and ensure its sustainable contribution to economic growth. In doing so, the HCB contributes to the balanced implementation of the system of intermediation in financing the economy by stimulating and restraining lending in the event of excessive credit outflows. Last, but not least, the HCB is mandated to settle disputes out of court between consumers and entities or persons through the *Financial Arbitration Board*⁴⁹, a professionally independent body operated by the HCB.⁵⁰ Part Two of the HCB Act provides detailed rules on these duties.⁵¹

The HCB and its members shall be independent in carrying out their tasks and meeting the obligations conferred upon them under the HCB Act.⁵² Furthermore, they shall neither seek nor take instructions from the Hungarian government; from the institutions, bodies, and offices of the EU (with the exception of the ECB and the other exemptions described in the HCB Act); from the governments of Member States; or from any other organisations or political parties.⁵³

Arts. 5–7 of the HCB Act contain rules on the legal status of HCB. The HCB shall be a legal person seated in Budapest and should function as a company limited by shares.⁵⁴ The state owns shares of the HCB.⁵⁵ Shareholder establishes the statutes of

48 This is detailed in the following point.

49 See: Arts. 96–130/B of the HCB Act.

50 Art. 4 para. (10) of the HCB Act: ‘The MNB shall settle disputes out of court – via the Financial Arbitration Board – between consumers and the entities or persons covered by the acts defined in Art. 39 relating to the establishment and performance of legal relationships for the use of services.’

51 Chapter III, Arts. 16–30, contains rules on the ‘Certain Basic Tasks of the HCB’, including: monetary policy, minimum reserves, central bank base rates, exchange rates, issuing operations, payment transactions and oversight, central bank information system. Chapter IV, Arts. 31–38, contain the rules on the ‘Basic tasks related to the identification and management of systemic risks’, namely: the monitoring of credit supply, measures to prevent the excessive credit outflow, the countercyclical capital buffer, measures to mitigate systemic liquidity risks, measures to reduce the probability of bankruptcy in systemically important institutions, measures mitigating systemic or macro prudential risks, additional tasks relating to the management of systemic risk. Chapter V, Arts. 39–44, contains the rules on the HCB’s supervisory tasks.

52 Art. 1 para. (2) of the HCB Act.

53 The detailed rules on the nexus between the HCB and the institutions named in the HCB Act are elaborated on in detail in Arts. 131–148 of the HCB Act.

54 However, according to Art. 5 para. (2), the company name of the HCB did not need to be entered in the Register of Companies and the designation ‘company limited by shares’ did not need to be included in the company name of the HCB.

55 Art. 5 para. (5): ‘The subscribed capital of the HCB is HUF 10,000,000,000 that is ten billion forints.’

the HCB in a Shareholder Resolution. The shareholder is represented by the minister in charge of public finances (hereinafter: the minister) and presented to the National Assembly (hereinafter: Parliament). The executive board has a duty to notify shareholder of accounting reports.⁵⁶ The Act on Civil Code⁵⁷ shall apply to the HCB as a company limited by shares – with the exceptions laid down by the HCB Act.

Art. 41 para. (3) of the FLH states that the president of the Republic shall appoint the Governor and Deputy Governors of the HCB for six years. Arts. 10 and 11 of the HCB Act elaborate on this in detail: the head of the HCB shall be the governor, who is appointed by the president of the Republic on the prime minister's proposal for a six-year renewable term. The HCB shall have at least two and at most three deputy governors appointed by the president of the Republic based on the prime minister's proposal. The decision of the President of the Republic to appoint and dismiss the governor of the HCB and deputies requires the countersignature of the prime minister.

According to Art. 8 para. (1) of the HCB Act, the bodies of the HCB include the *Monetary Council*, the *Financial Stability Council*, the *Executive Board*, and the *Supervisory Board*.

According to Art. 9 of the HCB Act, the Monetary Council is the HCB's supreme decision-making body. The scope of competence of the Monetary Council shall include making strategic decisions concerning monetary policy, issuing the legal tender of Hungary, holding and managing official foreign exchange, conducting foreign exchange and collecting and publishing statistical information,⁵⁸ making decisions on the reserve ratio and the interest to be paid on reserves,⁵⁹ making decisions on the exchange rate regime,⁶⁰ defining the strategic framework within which the Financial Stability Council makes its decisions with respect to the supervision of payment and securities settlement systems and the macro-prudential supervision of financial intermediary systems (including the resolution of certain institutions),⁶¹ establishing the rules of procedure of the Monetary Council, and making decisions on any other matter in the exclusive competence of the Monetary Council as defined by law. As a rule, the Monetary Council meets once a month, but may be convened at any time if deemed necessary. The Monetary Council shall consist of at least five and at most nine members, as follows: the governor of the HCB as chairman of the Monetary Council, the deputy governors of the HCB, and other members elected by Parliament for six years. Hungarian citizens with outstanding theoretical knowledge and practical professional expertise in issues related to monetary, financial or credit institution activities may be appointed or elected members of the Monetary Council, after attending a hearing of the Parliament's Standing Committee for Economic Affairs. While the governor and vice-governors shall take an oath before the president of the

⁵⁶ As it is set in point 'b' Art. 12 para. (4).

⁵⁷ Act V of 2013 on the Civil Code.

⁵⁸ Tasks defined in Art. 4 paras. (1)–(4) and (6) of the HCB Act.

⁵⁹ Tasks defined in Art. 20 para. (1) of the HCB Act.

⁶⁰ Tasks defined in defined in Art. 22 para. (2) of the HCB Act.

⁶¹ Tasks defined in defined in Art. 4 paras. (5) and (7)–(9) of the HCB Act.

Republic upon taking office, other members of the Monetary Council shall take an oath before Parliament.

The Executive Board consists of the governor of the HCB as the chairman of the executive board, who acts on behalf of the executive board, and the deputy governors of the HCB.⁶² The Executive Board is responsible for implementing the Monetary Council's decisions.⁶³ Based on para. (5), the Monetary Council may authorise the Executive Board to decide on any matter within its scope of competence. The Executive Board reports these decisions to the Monetary Council. The governor of the HCB may submit any matter within its scope of competence to the executive board for decision-making.

Article 13 of the HCB Act contains provisions related to the Financial Stability Council. Within the strategic framework defined by the Monetary Council, the Financial Stability Council and the person or body determined by a decree of the governor⁶⁴ shall act on behalf of the HCB in decision-making concerning overseeing the payment and securities settlement system and the macro-prudential policy for the stability of the entire system of financial intermediation.⁶⁵ The Financial Stability Council shall continuously monitor the stability of the system of financial intermediation and the financial markets as a whole and shall analyse and consider the risk factors threatening them and issue opinions if necessary or decide on the measures required to reduce or eliminate such risks. If necessary, the recommendations, opinions, and risk warnings of the *European Systemic Risk Board* (ESRB)⁶⁶ relevant to the financial intermediation system were placed on the agenda of the Financial Stability Council of the HCB. Furthermore, the Financial Stability Council publishes non-binding recommendations for persons and bodies covered by the acts defined in Article 39 that describe the grounds of jurisdictional principles followed by the HCB, annually defines the priority target areas of the HCB's control activities, and makes decisions to order a resolution or implement a resolution measure.⁶⁷

According to Art. 14 of the HCB Act, the Supervisory Board is responsible for the continuous supervision of the HCB on behalf of the owner. Under Art. 15, an HCB auditor may be appointed for a maximum of five years. The auditor may not be reappointed as an auditor of the HCB within 5 years of the expiry of the mandate.

According to Article 41(5) of the FLH:

Acting on the basis of authorisation by an Act and within his or her functions laid down in a cardinal Act, the Governor of the Hungarian National Bank shall issue decrees; no such decree shall conflict with any Act. On issuing decrees, the Governor

62 Art. 12 paras. (2)–(3) of the HCB Act.

63 Based on Art. 12 para. (1) of the HCB Act as detailed in para. (4).

64 As Art. 13 para. (11) of the HCB Act provides.

65 Art. 4 paras. (5) and (7)–(9) of the HCB Act.

66 Including decisions addressed to national supervisory authorities calling for specific measures in the event of serious jeopardy to the stability of the European financial system.

67 According to Art. 4 para. (8) of the HCB Act as defined in a separate Act.

of the Hungarian National Bank may be substituted by the Deputy Governor he or she designated in a decree.⁶⁸

Article 41(4) of the FLH provides for democratic accountability when it stipulates that the Governor of the HCB shall give an annual account of the activities of the HCB to Parliament. This provision is echoed in Article 2 of the HCB Act, which states that the governor of the HCB shall be obliged to provide oral and written reports to the Parliament, and is further elaborated on in Article 131 of the HCB Act.⁶⁹ The following seven articles elaborate on the nexus between the HCB and the government as well as that between the HCB and the public:⁷⁰

2.2. The legislative framework of the HCB as a financial supervisor: The HCB and the Banking Union

As mentioned above, Article 41(2) of the FLH doubles the HCB's mandate, stating that the HCB should supervise the financial intermediary system. The HCB is a member of the European System of Central Banks and European System of Financial Supervision. With this membership, the HCB shall perform the tasks imposed on it by the European Banking Authority, European Insurance and Occupational Pensions Authority, European Securities and Markets Authority, and the ESRB.⁷¹ The HCB should cooperate in the supervision of financial intermediation with the European Commission and entities of the Banking Union, including the Central Banks of other Member States.⁷² The HCB cooperates with the ESRB in performing its duties related to macro-prudential policy for the stability of the entire system of financial intermediation⁷³ and cooperates with the European Banking Authority with respect to its

68 Art. 171 of the HCB Act provides a detailed list of issues to be regulated by a decree of the governor.

69 The governor of the HCB shall report to the Parliament's standing committee for economic affairs in writing. At the request of the standing committee, the governor of the MNB is obliged to attend in person and supplement the report orally. Furthermore, the governor may be requested on an ad hoc basis by Parliament – and certain functionaries of the Parliament – to provide information orally or in writing.

70 Based on Arts. 132 and 133 of the HCB Act, the HCB shall be consulted regarding any draft legal acts related to the tasks of the HCB, the operation of financial system and on the proposal on the central budget by the government. To this end, the minister shall provide information on the proposal to the HCB without delay. The HCB is entitled to send its opinion on the proposal directly to the minister and the governor of the HCB shall present this opinion at the meeting of the Budgetary Council. However, the governor is not bound by this opinion as a member of the Budgetary Council. Based on Art. 134 of the HCB Act, the government shall invite the governor of the HCB to attend its meetings if the agenda concerns the competences of the HCB. Under Art. 136 of the HCB Act, the government and the central administrative bodies are obliged to provide information related to their activities at the request of the HCB.

71 Under Art. 1 paras. (1)–(3) of the HCB Act.

72 Under Art. 140 para. (1) regarding the duties set out in Art. 4 para. (9) of the HCB Act.

73 As set out by Art. 4 para. (7) of the HCB Act.

tasks as a resolution authority,⁷⁴ as defined by a separate act.⁷⁵ The HCB must meet the notification, data, and information supply requirements of these authorities.⁷⁶

2.3. The evaluation of the chosen regulatory path in scholarly literature

As István Simon described,⁷⁷ in the current regulatory framework of the HCB, the FLH is a so-called ‘core constitution’, which directs the Parliament to pass cardinal laws on subjects specified within it. In line with this, the HCB is regulated by cardinal acts, which regulate fiscal rules. However, some such rules were incorporated directly into the FLH. Unlike the previous Constitution,⁷⁸ which did not contain regulations on the currency, Article K) of the FLH declared that Hungary’s official currency was the forint. As Simon argues, while the previous Constitution was neutral in terms of economic policy – as well as other issues – the Fundamental Law is not.⁷⁹ In his view, the causes of the constitutional and policy changes were rooted in the crisis before 2010.⁸⁰ Simon argues that while it has a symbolic meaning and practical importance, i.e. the forint fulfils the functions of money in Hungary, but what is even more important changing the legal tender of Hungary would mean amending Fundamental Law, which requires at least a two-thirds majority vote and thus the existence of proper democratic legitimacy. Others, however, contest this decision of the drafters, arguing that this provision runs counter to the obligations arising from the founding treaties of the European Union, since, upon accessing the EU, Hungary agreed to adopt a common currency. A quick research done by the author on the constitutional and statutory rules of the V4 countries and Germany revealed that the constitutions of the Czech Republic,⁸¹ Poland,⁸² Slovakia,⁸³ and Germany⁸⁴ do not nominate legal tender; instead, they are regulated by their statutes on their central

74 Art. 4 para. (15) of the HCB Act: ‘In performing the function provided for in Paragraph (8), adequate arrangements shall be in place to ensure operational independence of the department responsible for enforcement of resolution functions from other departments of the MNB, including that these functions must be performed under the direct control and supervision of the governor or any of the deputy governors of the MNB.’

75 Act XXXVII of 2014 on the further development of the system of institutions strengthening the security of the individual players of the financial intermediary system (Resolution Act).

76 Art. 140 paras. (3)–(12) contain detailed provisions on the HCB’s obligations to notify the above entities.

77 Simon, 2018, pp. 113–114.

78 Act XX of 1949.

79 As József Szájer, who chaired the committee responsible for drafting the FLH, argues in his memoirs it is a value-based constitution in other regards as well: Szájer, 2014, pp. 736–737, 774–775; see also: Árva, 2022; Kiss, 2023, p. 424; Jakab, 2011, p. 379.

80 Simon 2018, p. 114.

81 Ústava České republiky č. 1/1993 Sb. (16. prosince 1992).

82 Konstytucja Rzeczypospolitej Polskiej (2. kwietnia 1997).

83 Ústava Slovenskej republiky (1. septembra 1992).

84 Grundgesetz für die Bundesrepublik Deutschland (23.05.1949).

banks. Art. 13 of the Czech National Bank Act⁸⁵ states that the Czech Republic's legal tender should be the Czech Koruna. Art. 31 of the Polish National Bank⁸⁶ law states that the currency of the Republic of Poland should be banknotes and coins, denominated in złoty and grosz. Art. 15 para. (1) of the Act on the Slovak National Bank⁸⁷ states that Slovakia's legal tender should be the Euro. In the case of Germany, legal tender is determined in Art. 14 para. (1) of the law on the German National Bank (Bundesbank),⁸⁸ which states that banknotes denominated in Euros are the sole unrestricted legal tender. Thus, one may argue that the solution chosen by the drafters of the FLH is unusual, or 'unorthodox', since even the Czechs, who are the most dismissive of the idea of a common currency among the V4 countries,⁸⁹ dispensed with regulating the national currency in the constitution, which would make it impossible for a government without a qualified majority to introduce the Euro, like the FLH. The author of the current chapter is of the view that what Simon identifies as a wise regulatory choice by the drafters of the FLH is undesirable, since once a situation may occur in which the country cannot access the Eurozone despite being mature enough in terms of real convergence and having the political will to do so.

Finally, the author conducted some research on the constitutional and statutory rules of the V4 countries and Germany to explore whether they contain a phrase similar to the HCB Act, according to which the HCB should facilitate the government's economic policy. As Simon reiterated,⁹⁰ Art. 127 para. (1) of the TFEU contains a similar provision⁹¹ related to the ECB. The above research reveals that both the Acts on the Czech Central Bank and the Polish Central Bank contain a regulation almost identical to the Hungarian one. While Art. 98 para. (1) of the Czech Constitution provides that the primary purpose of the Czech Central Bank shall be to maintain price stability, sentence two of Art. 2 para. (1) of the Act on the Czech National Bank states that:

Without prejudice to its primary objective, the Czech Central Bank shall support the general economic policies of the Government leading to sustainable economic growth and the general economic policies in the European Union with a view to contributing to the achievement of the objectives of the European Union.

85 Zákon č. 6/1993 Sb. o České národní bance.

86 Ustawa z dnia 29 sierpnia 1997 r. o Narodowym Banku Polskim.

87 Zákon 566/1992 (z 18. novembra 1992) o Národnej banke Slovenska.

88 'Gesetz über die Deutsche Bundesbank in der Fassung der Bekanntmachung vom 22. Oktober 1992 (BGBl. I S. 1782), das zuletzt durch Artikel 14 Absatz 3 des Gesetzes vom 28. Juni 2021 (BGBl. I S. 2250) geändert worden ist'.

89 *Eurobarometer – Introduction of the Euro in the Member States that have not yet adopted the common currency* [Online]. Available at: <https://europa.eu/eurobarometer/surveys/detail/2187> (Accessed: 5 November 2023); Republikon Intézet, 2022, p. 5.

90 Simon, 2018, p. 137.

91 'Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.'

Meanwhile, based on the third sentence of Art. 227 para. (1) of the Polish Constitution, the Polish Central Bank ‘[...] shall be responsible for the value of Polish currency.’ Art. 3 para. (1) of the Act on the Polish National Bank states that the basic objective of the Polish Central Bank is to maintain price stability while supporting the economic policy of the government, insofar as this does not constrain the pursuit of the Polish Central Bank. Art. 56 of the Slovak Constitution, which contains provisions for the Slovak Central Bank, does not mention price stability. Art. 2 para. (1) of the Act on the Slovak Central Bank states, ‘The main goal of the Central Bank of Slovakia is to maintain price stability. For that purpose, the Central Bank of Slovakia participates in the common monetary policy determined by the European Central Bank for the Eurozone [...]’ Art. 41a para. (1) of the Act of the Slovak Central Bank reflects the provision in Art. 127 para. (1) of the TFEU when stipulating that, as part of the Eurosystem, the Slovak Central Bank supports the general economic policies of the EU with the intention of contributing to the achievement of the goals of the EU without prejudice to maintaining price stability as its main goal. According to Art. 88 of the German Basic Law, monetary policy was transferred to the ECB.⁹² The second sentence of Art. 12 of the Act on the Bundesbank states, ‘As far as is possible without prejudice to its tasks as part of the European System of Central Banks, it shall support the general economic policy of the Federal Government.’

3. The monetary aspects of crisis management

3.1. *Handling the ‘Eurozone crisis’*

However, the current study focuses mainly on the monetary policy of the HCB aimed at handling the 2010 Eurozone crisis and the 2008 financial crisis (hereinafter: the Eurozone crisis). It is worth mentioning that, Csaba Lentner provides a good oversight of the pre-crisis monetary policy of the HCB and how the HCB changed its perception on its role during the handling of the crisis. This study also highlights certain similarities and differences between international tendencies and the HCB’s approach. The HCB’s pre-crisis monetary policy was based on the one-dimensional monetary model; that is, it focused on controlling the money supply and featured a loose approach to banking regulation according to the neoliberal market economy model,⁹³ which gained momentum in the eighties and resulted in

92 The second sentence of Art. 88 of the Basic Law of Germany states that ‘[The German Federal Bank’s] tasks and powers may be transferred within the framework of the European Union to the European Central Bank, which shall be independent and committed to the primary objective of maintaining price stability.’

93 Simon, 2018, pp. 119–120.

worldwide failure by the end of the 2000s. While central banks were mostly successful at achieving price stability,⁹⁴ risks undermining financial stability have also emerged simultaneously.⁹⁵

As argued by Oliver Blanchard⁹⁶ and co-authors Kolozsi and Novák,⁹⁷ among others, the ‘post-crisis’ monetary policy framework brought two major changes in the ‘Western World’: on the one hand, the separation between monetary and prudential competencies became less rigid – that is, financial stability also became a priority for central banks in addition to price stability, since disinflation trends allowed the central banks to focus on other tools without jeopardising their inflation targets. On the other hand, some unconventional elements were added to the central banking toolkit, and, as a result, central banks started to play a greater role in crisis management.

Most developed countries’ central banks soon achieved interest rates near zero and, in some cases, even negative interest rates. However, this traditional tool proved to be insufficient for the crisis at hand. Therefore, the central banks of these countries started to apply quantitative easing (QE).⁹⁸ Notably, the ECB has only recently started phasing out QE and increasing its base rate (this is further detailed in the chapter on the EU’s monetary policy).

In Lentner’s view, the distinct and independent monetary policy of the HCB presented an opportunity to create a constructive harmony between fiscal and central banking policies.⁹⁹ As detailed above, the operation of HCB and the programmes it implements are determined under the HCB Act. Based on Art. 3 paras. (1)–(2) the primary objective of the HCB shall be to achieve and maintain price stability; however, without prejudice to its primary objective, the HCB shall support the maintenance of the stability of the system of financial intermediation, the enhancement of its resilience, and its sustainable contribution to economic growth. The HCB shall also support the government’s economic policy using the instruments at its disposal.

Regarding the HCB’s crisis management tools, the author of the current chapter highlights the most significant ones in the following paragraphs; however, the author does not endeavour to introduce every part of every measure, considering the restrictions on the length of the chapter and the rich work that has already been done on this issue in HCB documents and academic literature.

First, like most central banks in developed countries, the HCB reduced the base rate from 7.0% to 0.9% and maintained it at that level between 2012 and 2019.¹⁰⁰

94 Lentner, 2021, p. 104.

95 Lentner, 2021, pp. 104–105.

96 Blanchard, 2012, pp. 7–13.

97 Kolozsi and Novák, 2017, p. 397.

98 Kolozsi and Novák, 2017 pp. 397–400.

99 Lentner, 2021, pp. 109–111.

100 *Policy rate and interest rate corridor* [Online]. Available at: <https://www.mnb.hu/en/monetary-policy/monetary-policy-instruments/policy-rate-and-interest-rate-corridor> (Accessed: 5 November 2023).

According to Lentner, this decline significantly reduced the government's interest expenditure, saving 4.5% of the GDP (HUF 1,600 billion) between 2013 and 2018.¹⁰¹ As its second tool for handling the crisis, the HCB launched the *Funding for Growth Scheme* (*Növekedési Hitelprogram*, hereinafter: FGS),¹⁰² which it announced in the spring of 2013. This scheme offered banks refinancing loans at a 0% interest rate, enabling them to lend to small- and medium-sized enterprises (SMEs) at an interest rate margin capped at 2.5%.¹⁰³ According to a study conducted under the aegis of the HCB, loans disbursed under the FGS generated new investments amounting to HUF 137 billion and HUF 210 billion in the first and second phases of 2014, respectively.¹⁰⁴ According to another HCB study, this scheme contributed substantially to employment over time.¹⁰⁵ Further, FGS and its derivatives also played an important role in mitigating the negative effects of the COVID-19 pandemic – as elaborated on later.

The third tool of the HCB crisis management program was the introduction of the *Self-Financing Program* (*Önfinanszírozási Program*, hereinafter: SFP) in the middle of 2014 to reduce external vulnerability. The programme was much needed since, at the onset of the crisis and in the first years of the crisis, the financing of the Hungarian economy displayed an unhealthy structure: it was over-reliant on foreign financial sources denominated in foreign currency. In 2013, the foreign currency debt's share of the public debt was still above 40% when almost a dozen European countries had virtually no debt denominated in non-domestic currencies, except for Croatia, Bulgaria, Romania, and Lithuania.¹⁰⁶ The HCB encouraged¹⁰⁷ banks to keep their liquid assets in other liquid assets, particularly in forint-denominated government securities, instead of depositing them in the HCB. The SFP can be divided into three phases. The first phase, 2014, started in summer and involved the deposit of the biweekly central bank benchmark and the introduction of the *Conditional Interest Rate Swap* (IRS). The most important change in the second phase, announced in June 2015, was the extension of the maturity of the benchmark instrument and the gradual introduction of the two-week deposit facility limitation on the two-day deposit facility. In the context of EU harmonisation, the HCB tailored its policy on reserves to better fit the practice of the ECB, which also had a positive effect on demand for government securities. The third phase was the full phasing out of the two-week deposit in April 2016.¹⁰⁸ According to studies issued under the

101 Lentner, 2021, p. 110.

102 *Funding for Growth Scheme* (FGS) [Online]. Available at: <https://www.mnb.hu/en/monetary-policy/funding-for-growth-scheme-fgs> (Accessed: 5 November 2023).

103 Lentner, 2021, p. 110.

104 Bauer, 2016, p. 58.

105 Oláh, 2022, pp. 26–33.

106 Kolozsi and Novák, 2017, p. 405.

107 It has to be highlighted that the self-financing scheme is not a regulatory one, the HCB only adjusts the parameters of the central bank instruments offered to banks, while not imposing any mandatory rules on how banks should react to the new situation. See: Kolozsi and Novák, 2017, pp. 405–406.

108 Kolozsi and Novák, 2017, pp. 405–406.

aegis of the HCB¹⁰⁹ and scholars, the SFP initiative was successful¹¹⁰ as the purchase volume of government securities by banks increased, which considerably contributed to improving the structure of financing government debt. *Kolozsi* and *Novák* argue that the most striking success of the SFP was that in 2014 and 2015 when the HCB was able to refinance maturing foreign currency debt in forints and do so with a substantial increase in demand from the banking system. The ratio of central government foreign currency debt has declined markedly as well: between December 2013 and September 2015, the ratio of gross debt in foreign currency to total government debt declined from 40.5% to 33%. Furthermore, the share of foreigners has fallen to 25%, the domestic banking sector became the largest public finance financier (with a share of 35%), and Hungarian households now hold more than one sixth of the total share of Hungarian government debt denominated in forints.¹¹¹

The fourth element is the phasing out of household loans denominated in foreign currencies, which also reached an unhealthy level, thereby increasing the vulnerability of the country's economy. The HCB first played a proactive role in the negotiations between the government and the Hungarian Banking Association, and by providing the required foreign currency liquidity¹¹² for the banking sector, approximately EUR 9 billion, it substantially contributed to the conversion of foreign currency-denominated household loans into Hungarian forint-denominated loans.¹¹³ As a result of this programme, one of the highest household foreign currency-denominated exposures decreased to one of the lowest in Europe, from 14% to 1% of the GDP, based on the HCB's 2015 report. In practice, Hungarian households had no foreign-currency-denominated loans by the end of 2015. As co-authors *Matolcsy* and *Palotai*¹¹⁴ wrote, this risk was eliminated once and for all from the Hungarian economy.

Lentner argued that the HCB's crisis management was a great success for several reasons. First, the HCB contributed to halting the decline in lending, which was one of the priority objectives of Hungarian economic policy. The corporate credit portfolio shrank by 4–5% annually between 2009 and 2013 in Hungary and was still decreasing in 2013. This sharp declining trend broke after 2013, and a credit freeze became avoidable. Since 2015, SME credit portfolios have experienced continuous growth.¹¹⁵ Second, the gross external public finance debt began to moderate in 2014, reaching 50% of the central budget, and decreased significantly in 2015 to 40%. The foreign currency ratio of the gross debt of the central budget also decreased from 42% in March 2015 to less than 30% in March 2016 and 27.1% in June the same year, reaching pre-crisis levels. Subsequently, it reduced further. However, other scholars

109 Bodnár et al., 2016, pp. 35–65.

110 Lentner, 2021, p. 110.

111 Kolozsi and Novák, 2017, pp. 410–412.

112 Hoffmann, Kolozsi and Nagy, 2014.

113 Kolozsi and Novák, 2017, pp. 403–404.

114 Matolcsy and Palotai, 2018, pp. 5–42.

115 Lentner, 2022, p. 110.

present varying opinions. László Csaba argues that the success is highly attributable to external, one-time factors, including low global energy prices, growth recovery in the EU, and sustaining the zero bound interest rate in global capital markets. In his view, it is hard not to see how European trends are followed by Hungarian ones; when the EU entered a recession from 2011 to 2012, Hungary followed.¹¹⁶ Similarly, from 2013 to 2017, when Europe recovered, Hungary also recovered.¹¹⁷ In Csaba's view, Hungarian economic performance was satisfactory, but by no means exceptional.¹¹⁸

3.2. Handling the crisis induced by the COVID-19 pandemic and the Russo-Ukrainian War

By the time the serious negative economic effects of the COVID-19 crisis started to hit the Hungarian economy, the HCB's targeted measures had helped put the Hungarian economy on a sustainable path to catch up, while also strengthening the economy's immune system, according to György Matolcsy.¹¹⁹ In the words of co-authors Csontos and Nagy-Kékesi, the HCB has sufficient 'firepower' to deal with the challenges posed by the COVID-19 pandemic.¹²⁰ Although the pandemic initially lowered inflation, it caused market dysfunction.¹²¹ In response, the HCB decided to modify its monetary policy instruments and defined three objectives: first, to provide adequate liquidity to the banking system and financial markets while maintaining price and financial stability. Second, to allow more flexibility in short-term yields in response to the negative money market developments induced by the coronavirus and, last but not least, to ensure that the HCB is able to shape and influence long-term yields, which have gained increasing importance in recent years, directly and in as many relevant markets as possible.

The HCB reduced the policy rate and provided long-term liquidity, temporarily suspended penalisations for breaching reserve requirements,¹²² and enhanced the 'good-old' FGS and the relatively new *Bond Funding for Growth Scheme (Növekedési Kötvényprogram, hereinafter: BGS)*.¹²³ The HCB also enhanced its asset purchase programs¹²⁴

116 Except for the banking sector, which in Hungary remained solid.

117 Csaba, 2022, pp. 5, 8, 10.

118 Csaba, 2022, p. 1.

119 Matolcsy, 2020, pp. 13–35.

120 Csontos and Nagy-Kékesi, 2020.

121 Hungarian Central Bank, 2020a.

122 Hungarian Central Bank, 2020b, p. 20.

123 From mid-2019, the MNB, supplementing its present set of unconventional monetary policy instruments, will launch a corporate bond purchase programme with a facility amount of HUF 300 billion, within the scope of which it will buy the bonds of non-financial corporations of good credit rating. Furthermore, within the scope of the scheme, it will be also possible to purchase securities backed by corporate loans, through which the MNB wishes to contribute to the spread of securitisation in Hungary. See: Hungarian Central Bank, 2020b, p. 22.

124 Hungarian Central Bank, 2020b, pp. 22–24.

(APPs): while before the pandemic, the HCB had purchased securities worth about 1.2% of GDP, during the pandemic and until the end of 2021 (when these purchase programs expired), the HCB bought bonds worth an additional 9.1% of GDP – most of them government securities.¹²⁵ APPs were an important component in alleviating market dysfunction, ensuring adequate liquidity support to mitigate the abiding tendency toward liquidity hoarding and shorter investments during a crisis, and, later, easing government funding costs. The HCB also temporarily eased certain micro-and macro-prudential rules. After the initial depreciation, the exchange rate stabilised. Meanwhile, the negative real interest rates remained relatively stable.¹²⁶

As the most serious effects of the pandemic were mitigated, the HCB, like the ECB, launched a policy that could be labelled a 'return to normalcy'. In June 2021, the Monetary Council decided to increase the base rate from 0.60% to 0.90% and followed this move with several similar cautious increases, resulting in a base rate of 3.40% in February 2022. On 24 August 2021, the HCB's Monetary Council decided to moderate its refinancing role and gradually phase out purchase programs. The Council underlined that the HCB was ready to intervene to maintain market stability with occasional and targeted purchases if deemed necessary. However, it also emphasised that occasional purchases do not indicate a change in devotedness to the restrictive stance of monetary policy.¹²⁷

Due to the extraordinarily high inflation rate induced by the Russo-Ukrainian War, the HCB objectively took into account price stability and decided to drastically raise the base rate and significantly restrict its refinancing role as assumed in the previous decade and in the first year of the pandemic crisis. As for the base rate, the HCB increased it by 1% from 3.40% to 4.40% from February to March 2022. By September 2022, it reached 13% and remained at this peak until October 2023, when the Monetary Council decided to cut it to 12.25% due to the improved economic situation.¹²⁸

4. Conclusions

In the first part of the current chapter, the author introduced data on Hungary obtained from convergence reports from the years that were deemed milestones and he concluded that, before 2014, the Eurozone accession was wishful thinking due to the undisciplined fiscal policy of the former governments and the financial crisis that started in 2007, as pointed out by many scholars. However, in his view, somewhere between 2014 and 2020, Hungary would have had the opportunity to fulfil

125 Delgado and Gravelle, 2023, p. 36.

126 Lybek, 2023, p. 15.

127 Delgado and Gravelle, 2023, p. 37.

128 Hungarian Central Bank, 2023.

the Maastricht criteria and access the Eurozone with some extra effort. Nevertheless, for decision makers, concerns other than accession were more important. This ship sailed a while ago: the 2022 Convergence Report showed that indicators started to deteriorate as a result of the COVID-19 pandemic and the Russo-Ukrainian War, which affected the country's economic performance. Currently, there is no official target date; however, based on the declarations of government members and the governor of the HCB, Hungary may meet the so-called 'Maastricht 2.0' criteria determined by the HCB by 2030. This means that, by this time, real convergence could reach a level where accession would have less negative consequences than positive ones. Scholars mostly shared the views of the HCB regarding this cautious approach to Eurozone accession.

The second part of the chapter introduced the constitutional and statutory framework of the HCB's aims, functioning, and structure, as well as certain academic debates on the regulation, including the decision of the drafters of the Fundamental Law of Hungary to grant a constitutional rank to the forint by nominating it as Hungary's legal tender in the Fundamental Law. This solution was praised and criticised at the same time: while it grants that the introduction of the common currency is only possible if a certain level of democratic legitimation is possessed by the actual government (namely, a two-thirds majority), the author of the current chapter argues along with other scholars that it may lead to a situation in which Hungary will not be able to adopt the Euro despite fulfilling the Maastricht criteria and having the political will. Perhaps it is no wonder that other V4 countries and Germany, whose regulations were examined by the author in this regard, did not grant constitutional status to their currencies. Even the Czech Republic dispensed with such regulatory solutions despite being the most reluctant to introduce the Euro.

The third part of this chapter introduces the HCB's monetary policy for crisis management in two parts: crisis management tools aimed at tackling the Eurozone crisis and those aimed at mitigating the negative economic effects of COVID-19 and the Russo-Ukrainian War. During the Eurozone crisis, Hungary was in a vulnerable condition, mainly because of the country's dependence on foreign funding, denominated in foreign currency, which applied to both government and household debts. After the change of direction in monetary policy in 2013, the HCB considered the reduction of external vulnerability a strategic goal and successfully accomplished it. Specifically, the SFP helped reduce the state budget's dependence on foreign sources, with the ratio of the government's foreign currency debt declining markedly from 40.5% to 33% between 2013 and 2015. Hungarian households became holders of Hungarian government debt denominated in forints. Similarly, by providing the required foreign currency liquidity to the banking sector, the HCB contributed to converting foreign currency-denominated household loans into Hungarian forint-denominated loans. As a result, households had practically no foreign currency-denominated loans by the end of 2015. Low (almost zero) interest rates and refinancing programs also contributed to the successful tackling of the negative effects of the crisis by providing liquidity to the economy. These tools proved to be effective in mitigating

the negative economic effects of the COVID-19 pandemic. The Funding for Growth Scheme, which came to light as a response to the Eurozone crisis, proved to be an effective tool alongside its derivatives. However, the negative economic effects of the Russo-Ukrainian War required a rather different approach: the challenges of the new crisis characterised by high inflation rates, contrary to the disinflation trends of the Eurozone and COVID-19 crisis, required a return to 'good-old' restrictive monetary policy with high interest rates and the abandonment of refinancing. The cut in the base rate in October 2023 after it spent more than a year at a peak (13%) underscores that the HCB picked the right tools to fight the crisis.

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POLAND: MONETARY POLICY STILL OUTSIDE THE EUROZONE



AGNIESZKA MIKOS-SITEK

Abstract

Poland is an EU Member State that has not adopted the single currency status and remains outside the Eurozone. It has also not yet joined the European Banking Union based on the so-called ‘close cooperation’. In the European integration process, numerous measures were taken to align Polish legal solutions in the banking field with European Union regulations. Among other things, the introduced changes concerned the functioning of the central bank of the state and led to its inclusion in the single monetary and currency policy of the European System of Central Banks. Despite growing expectations in recent years that Poland will soon adopt the euro, Poland has not taken decisive steps in this regard due to its ambiguous assessment of the benefits and possible risks involved. It should also be noted that Poland’s accession to the Euro area is not currently possible because of its insufficient fulfilment of the convergence criteria. Further, Poland’s decision to function in the euro area is complicated by the specific predispositions of the Polish banking sector as well as by the uncertain timeline for adopting a single currency due to the ongoing economic crisis.

Keywords: *central bank, monetary policy, banking union, monetary policy tools, European integration*

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1. Introductory issues

When joining the European Union (EU) on 1 May 2004, Poland had the status of a Member State of the Economic and Monetary Union (EMU) with derogation. Poland had the right to participate in the third stage of economic and monetary integration, but did not adopt a common currency. However, it was obliged to meet the convergence criteria and adopt the euro in the future. In the process of European integration, numerous actions were undertaken in Poland related to changes in the functioning of the state's central bank and its inclusion in the single monetary and currency policy conducted within the European System of Central Banks (ECSB).

The process of European integration was primarily related to the adaptation of Polish legal solutions in the field of banking to EU regulations, and thus the need for extensive legislative changes. In the case of central bank institutions, these changes concerned, in particular, the provisions of the Act of 29 August 1997 on the National Bank of Poland (NBP),¹ which is still in force today, including issues of the legal status of the central bank and its independence. The strengthening of the independence of the NBP was to be facilitated by solutions regarding the principles of cooperation between the central bank and state authorities, and the terms of office of members of the Monetary Policy Council² and the financial management of the NBP (e.g. changes in the scope of the NBP regarding its own funds, rules for submitting annual financial statements, and accounting rules).³ Accordingly, the principles of banking supervision have changed over time. In this case, the solution was to separate the tasks of the central bank related to monetary policy from those related to banking supervision. Competencies, in this respect, were held by the Commission for Banking Supervision and its executive body, the General Inspectorate of Banking Supervision, which was organizationally separated within the structure of the NBP.⁴

Changes in the regulations introduced as part of the European integration process were also related to the adjustment of the monetary and exchange rate policy solutions adopted in Poland. The adjustment activities related to monetary policy tools are particularly important. It was assumed that this process would be of a long-term nature due to significant differences in conditions in the money market, primarily those related to the structural liquidity shortage prevailing in the euro system, as opposed to the situation in Poland, where the NBP operated under conditions of excess

1 Consolidated text: Journal of Laws of 2022, item 2025 (hereinafter: n.b.p.a.).

2 See: Art. 13 n.b.p.a. and the judgment of the Constitutional Tribunal of 24 November 2003, K 26/03, Jurisprudence of the Constitutional Tribunal, Series A, 2003, No. 9, item 95.

3 See for more: Mikos-Sitek, 2021, pp. 73–76.

4 On 1 January 2008, further changes took place in this respect related to Poland's introduction of solutions based on the model of integrated supervision over the financial market, as a result of which banking supervision activities were transferred to the Polish Financial Supervision Authority. See also: Ofiarski, 2017, pp. 680–681; Mikos-Sitek, 2011, pp. 226–229; Narodowy Bank Polski, 2003, p. 34.

liquidity in the money market.⁵ Therefore, activities aimed at reducing the sources of liquidity and related to the absorption of part of the existing surplus of money on the market were considered basic in the discussed scope. Ultimately, this goal was achieved primarily through gradual changes in the exchange rate policy, which was mainly related to the widening of the range of the exchange rate fluctuations of the zloty, the liquidation of the existing fixing mechanism, and the full release of the zloty exchange rate from April 2000.⁶

The rules for implementing open-market operations and the mandatory reserve system were then analysed and changed. In the latter case, the main differences concerned the mandatory reserve rate, which was higher in Poland than in the Euro system, and the funds held as reserves did not bear interest. Therefore, a process of reducing the mandatory reserve rate was implemented, and interest in funds held by banks on accounts with the central bank was introduced. The method of calculating reserves and the maintenance period were also changed.

In April 2000, changes were made to the scope of credit and deposit operations. They were concerned, among others, with Lombard loans, for which the time horizon was shortened to one day. A Lombard loan is a loan against securities granted up to an amount equal to a certain proportion of the nominal value of securities. However, on 1 December 2001, an end-of-day deposit was introduced for all banks with current accounts at the NBP as a monetary policy instrument, allowing for the absorption of excessive liquidity in the money market.

Changes in the NBP interest rates concerned the reference rate, which ceased to function as an instrument to determine the minimum level of rates in the deposit market. However, it retained its role as an instrument in the current direction of the central bank's policy and determined the minimum interest rate for basic open-market operations. To determine the lower limit of fluctuations in the interbank market interest rates, the NBP introduced the deposit rate (interest rate on deposits). The Lombard and deposit rates constituted the upper and lower limits of fluctuations in one-day deposits on the interbank market, respectively.⁷

At the same time, the NBP conducted detailed analyses of the impact of the introduction of the euro on the Polish banking system. Several editions were created in 2000, 2001, 2002, and 2003.⁸ and included issues related to changes and consequences of the introduction of the euro for the Polish banking sector, countries already members of the Eurosystem and those that have undertaken preparations in this regard, the process of preparing banks for the exchange of national currencies into euros, and activities aimed at creating a single payment area. The role of the NBP in the process of introducing a common currency in Poland is also defined.

5 The role of the National Bank of Poland in the process of European integration, pp. 15–16.

6 Narodowy Bank Polski, 2003, pp. 12, 16. See also: Rada Polityki Pieniężnej, 1998.

7 Narodowy Bank Polski, 2003, pp. 17–19.

8 See: Szeląg et al., 2000, *passim*; Szeląg et al., 2001, *passim*; Glibowska et al., 2002, *passim*; Górńska et al., 2003, *passim*.

In terms of legislative activities, work was also undertaken to prepare a draft act regulating issues related to the process of introducing the euro. The result of this work was the adoption of the Act of 25 May 2001 on the effects of introducing the common currency, the euro, in certain Member States of the European Union,⁹ which regulated, among other things, solutions regarding the dual circulation period; rules of conversion and rounding when determining the amount of benefits; the issue of the continuity of contracts; the rules, places, and dates of the exchange of banknotes and coins; and bank fees for the exchange of the euro.¹⁰

The adjustment of banking regulations, as part of the initial stage of the European integration process, involved the need to amend many applicable laws or adopt new legal regulations. Legislative changes covered the basic legal acts that set the framework for the functioning of the banking sector in Poland and numerous related regulations. Art. 227 of the Constitution of the Republic of Poland, which came into force in 1997 and regulated the systemic position of the central state bank in Poland for the first time, has become an important element of the Polish legal order.

2. The constitutional basis for the functioning of Poland's central bank

Art. 227 para. 1 of the Constitution of the Republic of Poland indicates that the NBP is the central bank of the state, which has the exclusive right to issue money and determine and implement monetary policy. Thus, the cited provision refers to the classic functions of a modern central bank, including the functions of issuing and that of state banks. The NBP is equipped with the exclusive right to issue legal tenders in the form of coins and banknotes, which are legal tenders in the territory of the Republic of Poland, and with the power to regulate money circulation. In connection with the competencies covering the determination and implementation of monetary policy, the Constitution of the Republic of Poland also indicates that the NBP is responsible for the value of the Polish currency (Art. 227 para. 1 sentence 3 of the Constitution of the Republic of Poland). However, when interpreting the provision in question, it should be noted that it should be understood more broadly than only in relation to the primary objective of the central bank: maintaining a stable price level and the strategy of direct inflation-targeting monetary policy. Art. 3 para. 1 n.b.p.a. specifies the primary objective of the central bank: to maintain a stable price level while supporting the economic policy of the government, provided that this does not jeopardise the realisation of the primary objective of the NBP. The

⁹ Journal of Laws No. 63, item 640 as amended.

¹⁰ See: Mikos-Sitek, 2006, pp. 159–160 and the literature cited there.

value of money depends on price stability as well as on the condition of the state's economy. Therefore, the implementation of the basic objective of the central bank of the state also includes the conduct of monetary policy in a manner conducive to comprehensive economic development.¹¹ However, it should be noted that Art. 3 para. 1 n.b.p.a., which indicates that the maintenance of a stable price level is the primary objective of the NBP's monetary policy, is not the full equivalent of Art. 227 para. 1 of the Constitution of the Republic of Poland, which requires the central bank of the state to be responsible for the value of Polish money. This implies that the central bank is responsible for both internal value (price stability) and external value (exchange rate stability).¹²

Therefore, the Constitution of the Republic of Poland defines the political position of the central bank of the state not only by formulating the purpose of its activity and indicating its basic tasks, but also by defining its organizational structure and the rules for appointing the bodies of the NBP.¹³

The provisions of the Constitution of the Republic of Poland do not explicitly formulate the principle of central bank independence, but should be derived from the provisions of Art. 227. The NBP is endowed with the exclusive right to issue money and independently makes decisions regarding the development and implementation of monetary policy and other aspects of the operation of the institution in question. There is also no doubt that the independence of the Polish central bank is supported by the mode of appointment as well as the status and rules of the operation of its bodies, which, as tenure bodies, cannot be dismissed without important reasons. Moreover, their term of office is sufficiently long to ensure a monetary policy that remains independent of the state's current political situation.¹⁴

Pursuant to the provisions of the Constitution of the Republic of Poland, the bodies of the NBP are subject to control by the Supreme Audit Office (Art. 203 para. 1), which applies to all bodies listed in Art. 227 para. 2 of the Constitution of the Republic of Poland; namely, the President of the NBP, the Monetary Policy Council, and the Management Board of the NBP. However, in the case of the state's central bank, it is necessary to consider its position each time and enable it to perform the

11 See: Judgment of the Constitutional Tribunal of 24 November 2003, K 26/03, Jurisprudence of the Constitutional Tribunal, Series A, 2003, No. 9, item 95. See also: Góral and Koperkiewicz-Mordel, 2016, pp. 1602–1603; Kosikowski, 1997, pp. 161–162; Banaszak, 2009, p. 960; Zawadzka, 2014, pp. 29–30.

12 Nowak-Far, 2023b, p. 610.

13 See: Banaszak, 2009, pp. 961–968; Góral, Karlikowska and Koperkiewicz-Mordel, 2000, pp. 36–37; Kokoszczyński, 2004, pp. 94–105; Kosikowski, 2002, p. 18; Ofiarski, 2008, pp. 344–355; Karwowski, 1999, p. 190.

14 Baka, 2001, p. 99; Blinder, 2001, pp. 77–78; Frankowski, 2001, pp. 2–9; Gruszecki, 2004, pp. 277–279; Kokoszczyński, 2004, pp. 164–165, 247–248; Judgment of the Constitutional Tribunal of 28 June 2000, K 25/99, Jurisprudence of the Constitutional Tribunal 2000, No. 5, item 141; Judgment of the Constitutional Tribunal of 24 November 2003, K 26/03, Jurisprudence of the Constitutional Tribunal, Series A, 2003, No. 9, item 95; Judgment of the Constitutional Tribunal of 22 September 2006, U 4/06, Jurisprudence of the Constitutional Tribunal, Series A, 2006, No. 8, item 109.

tasks entrusted to it independently. Notably, literature on this subject postulates that the NBP is excluded from state control.¹⁵

The provisions of the Constitution of the Republic of Poland regulating the principles of constitutional responsibility before the Tribunal of State indicate that the President of the NBP is among the entities covered by this responsibility (Art. 198 para. 1 of the Constitution of the Republic of Poland). In this regard, it should be noted that the Tribunal of State is a constitutional organ of the state in Poland that enforces the responsibility of the highest authorities and state officials for violations of the Constitution or acts in connection with the position they hold or within the scope of their office.¹⁶

3. Poland's position as a country outside the euro area

Poland's entry into the eurozone has been an open issue since 2004. When it joined the EU, Poland did not meet the convergence criteria;¹⁷ therefore, its adoption of a common currency was postponed without specifying a timeframe for completing this process. As noted above, many actions were initially taken to meet all conditions for quick accession to the Eurozone. However, the 2008 financial crisis fundamentally changed the assessment of the benefits and possible threats related to adopting a common currency. Poland and other Member States outside the Eurozone, analysing the factors influencing financial difficulties and the recession that affected the countries operating within the Eurozone, reinforced the belief that decisions in this regard should be postponed. This was also related to uncertainty about the future of the EU, which intensified when Great Britain left. Decisions in this area are influenced by the current uncertain situation in Europe and worldwide, which is the result of many complex factors.¹⁸

Although expectations for the faster adoption of the euro have become stronger in recent years, Poland is currently not taking decisive action to adopt the euro. It should also be noted that its accession to the Eurozone is not currently possible because of the insufficient implementation of related conditions, evident in the latest convergence reports prepared by the European Commission¹⁹ and the European Central Bank (ECB).²⁰

15 See: Stębeliski, 2016, pp. 1382, 1388 and the literature cited therein.

16 See: Art. 198 of the Constitution of the Republic of Poland and the Act of 26 March 1982 on the Tribunal of State (consolidated text: Journal of Laws 2022, item 762, as amended).

17 See: Ořeziak, 2004, pp. 23–24; Pronobis, 2008, pp. 129–130.

18 Szpringer, 2019, pp. 173–175; Mikita, 2019, pp. 69–70.

19 European Commission, 2022.

20 European Central Bank, 2022.

The reports mainly draw attention to the issue of the compliance of national legislation with the Treaties and indicate the need to introduce numerous changes, primarily the provisions of the Constitution of the Republic of Poland and the Act on the National Bank of Poland. The first issue requiring attention is the independence of the central bank at the institutional, personal, and financial levels. The reports indicated the need to adapt the provisions of the Polish Act regulating the principles of operation of the state's central bank to the requirements of Art. 130 TFEU and Art. 7 of the Statute of the European System of Central Banks and of the European Central Bank. This Act does not prohibit the NBP or members of its decision-making bodies from seeking or receiving instructions from other state authorities. This Act also does not expressly prohibit the government administration from taking actions related to exerting influence on members of the NBP's decision-making bodies in situations where this may affect the central bank's performance of tasks related to participation in the ESCB.²¹ In the context of adaptation to Art. 130 of the TFEU and Art. 7 of the Statute of the ESCB and the ECB, attention was also paid to the principles representing the interests of the Republic of Poland by the President of the NBP in international banking institutions (Art. 11 para. 3 n.b.p.a.) and submitting draft monetary policy assumptions by the President of the NBP to the Council of Ministers and the Minister of Finance (Art. 23 para. 1 point 2 n.b.p.a.).

Another issue regarding institutional independence that requires clarification is the competence of the Supreme Audit Office, implemented based on Art. 203 para. 1 of the Constitution of the Republic of Poland. The competence of this office is related to controlling the activities of the NBP from the point of view of its legality, economy, expediency, and reliability. The convergence reports indicate the need to clarify the scope of the Supreme Audit Office's control; respect the institutional independence of the NBP bodies; and ensure that when auditing the activities of the NBP, the purposefulness criterion used by the Supreme Audit Office does not extend to the assessment of its activities related to the main objective of maintaining price stability (see Art. 3 para. 1 n.b.p.a.).

In practice, implementing the assumptions that are the basis for the personal independence of the person acting as the President of the NBP and members of collegial bodies (the Management Board of the NBP, the Monetary Policy Council) requires, in accordance with the guidelines covered by the reports, a change in the provisions regarding their dismissal from the position and the adaptation of these provisions (see Art. 9 para. 5, Art. 13 para. 5, and Art. 17 para. 2b n.b.p.a.) to the requirements of Art. 14 para. 2 of the Statute of the European System of Central Banks and the European Central Bank.²²

21 See: Judgment of the Constitutional Tribunal of 16 July 2009, Kp 4/00, Jurisprudence of the Constitutional Tribunal, Series A, 2009, No. 7, item 112.

22 In this context, Art. 25 para. 3 also requires changes in connection with Art. 3 and Art. 1 para. 1 point 3 of the Act of 26 March 1982 on the State Tribunal (consolidated text: Journal of Laws of 2022, item 762).

In the context of financial independence, attention was paid to the provisions of the Act on the National Bank regarding the remuneration of NBP employees and the restrictions applicable in this respect. Regulatory changes leading to pay cuts have been identified in the Convergence Reports as being incompatible with the principle of financial independence if they adversely affect the ability of the central bank of a country to recruit and retain staff to independently perform the tasks imposed by the Treaty on the European Union and the Statute of the European System of Central Banks and the European Central Bank (see Art. 66 para. 3 n.b.p.a.).²³

The incompatibility of national regulations with EU law was also demonstrated in the scope of the rules applied in the NBP's activities for transmitting information to external entities, which concern the disposal of data obtained from various entities under Art. 23 n.b.p.a. (collected for the preparation of statistical summaries, studies, assessments, balance sheets, international investment positions, and monetary policy or periodic assessments of the state's monetary situation). Art. 23 para. 7 n.b.p.a. specifies cases in which data obtained from individual financial institutions (which are obligated to transmit them) as well as compilations, studies, and assessments enabling their linking with specific entities are made available by the NBP to external entities. One of the cases mentioned in the above-mentioned provision, which has a broad interpretative context, is the disclosure by NBP of information to 'other entities', which is done based on 'separate provisions'. The ECB's Convergence Report noted that the disclosure of information could affect compliance with the data protection rules covered by the principle of confidentiality applicable to the ESCB (see Art. 37 of the Statute).

In terms of information protection issues, attention was also paid to the above-mentioned competencies exercised by the Supreme Audit Office, pursuant to Art. 203 para. 1 of the Constitution of the Republic of Poland. The Supreme Audit Office, exercising its powers related to auditing NBP activities, has wide access to protected documents and information. The convergence reports drew attention to the need to change the regulations that would provide the Supreme Audit Office with access to documents and confidential information during its audits while limiting its access to only information necessary to perform its statutory tasks. Moreover, its access to protected information must not violate the principles of independence and confidentiality of the ESCB, to which members of the decision-making bodies of national central banks and their employees are obliged. The amendment to the

²³ For an overview of the applicable regulations, see: Blinder, 2001, pp. 77–78; Frankowski, 2001, pp. 2–9; Gruszecki, 2004, pp. 277–279; Kokoszczyński, 2004, pp. 164–165, 247–248; Ofiarski, 2017, pp. 605–609; Mikos-Sitek, 2006, pp. 90–91; Mordwiłko, 2002, pp. 117–120. See also: The Judgment of the Constitutional Tribunal of 28 June 2000, K 25/99, Jurisprudence of the Constitutional Tribunal 2000, No. 5, item 141; Judgment of the Constitutional Tribunal of 24 November 2003, K 26/03, Jurisprudence of the Constitutional Tribunal, Series A, 2003, No. 9, item 95; Judgment of the Constitutional Tribunal of 22 September 2006, U 4/06, Jurisprudence of the Constitutional Tribunal, Series A, 2006, No. 8, item 109.

provisions of national law should also include a provision according to which the Supreme Audit Office should ensure the protection of the confidentiality of information and documents provided to it by the NBP at the level and in accordance with the standards used by the central bank.²⁴

An important issue regarding the non-compliance of national regulations with the provisions of the European Union Treaty is the rules for granting refinancing loans to banks. Art. 42 para. 2 n.b.p.a. establishes that the condition for granting a loan is based on the bank's ability to repay it. Notably, a refinancing loan may be granted for the specific purpose of replenishing a bank's cash resources.²⁵ However, Art. 42 para. 3 n.b.p.a. also provides for the possibility of granting a refinancing loan to implement the bank's recovery plan, which occurs in the event or threat of a breach by the bank of requirements relating primarily to its own funds, its coverage of its net outflows to credit institutions, and the value of its liquid assets.²⁶ Even if we consider the application of solutions provided in the regulations to secure timely loan repayment, it cannot be ruled out that, in practice, a bank may receive a refinancing loan, implement a restructuring program, and then become insolvent. Accordingly, the ECB Convergence Report indicated the need to introduce more explicit safeguard measures that apply to all financial institutions to which the NBP provides support to replenish their monetary resources. The temporary nature of such support and its limitation to entities that are not at risk of insolvency (see Art. 123 of the Treaty on the Functioning of the European Union [TFEU]) also needs to be emphasised in the applicable regulations.

Art. 43 n.b.p.a., Art. 270 para. 1 point 6, and Art. 306 of the Act of 10 June 2016 on the Bank Guarantee Fund, the deposit guarantee system, and resolution are also considered inconsistent with the provisions of the Treaty on the European Union.²⁷ Pursuant to the above-mentioned regulations, the NBP may grant the Bank Guarantee Fund (BGF) a short-term loan, provided that appropriate security is established. The loan granted to the BGF is a unique instrument used when there is a threat to financial stability to cover the fund's urgent needs.²⁸ The Convergence Report indicates that the inclusion of the BGF in the catalogue of entities constituting the public finance sector is also important in this case (Art. 9, point 5 of the Public Finance Act). In connection with the above, these provisions, which allow the NBP to grant a short-term loan to the BGF, are not consistent with the prohibition of financing from the central bank and should be amended accordingly.²⁹

Another issue covered by the convergence reports is the legal integration of national central banks into the Eurozone system. In this respect, attention was drawn

²⁴ European Central Bank, 2022, p. 180.

²⁵ See: Nowak-Far, 2023a, pp. 790–794; Banaszak-Soroka, 2013, p. 187.

²⁶ See: Art. 142 paras. 1 and 2 of the Act of 29 August 1997 – Banking Law (consolidated text: Journal of Laws of 2022, item 2324, as amended) in connection with Art. 42 para. 7 n.b.p.a.

²⁷ Consolidated text: Journal of Laws of 2022, item 2253 as amended.

²⁸ Zawadzka, 2009, p. 247; Mikos-Sitek, 2021, p. 68.

²⁹ European Central Bank, 2022, p. 181.

to the need to change the provisions of the Act on the National Bank of Poland specifying the basic objective of the NBP. Art. 3 para. 1 n.b.p.a. provides that the NBP should maintain a stable price level while supporting the government's economic policy, as long as this does not limit the basic objective of the NBP.³⁰ This provision was inconsistent with Art. 127 para. 1 of the TFEU and Art. 2 of the Statutes of the European System of Central Banks and the European Central Bank due to the lack of reference to the issue of supporting general EU economic policies.

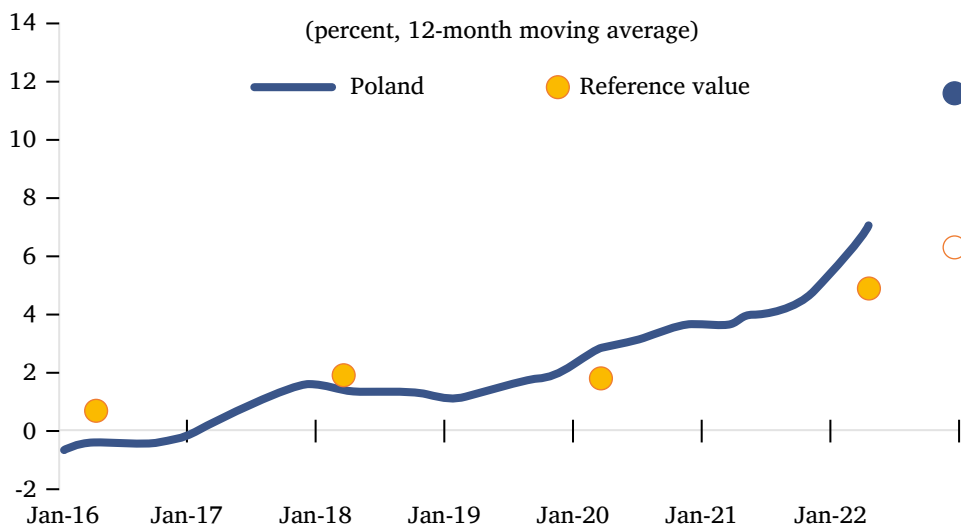
As far as the provisions regulating the NBP's implementation of tasks related to the conduct of monetary policy are concerned, the inconsistency was indicated in relation to Art. 227 paras. 1 and 6 of the Constitution of the Republic of Poland and Arts. 12, 23, 38–50a, and 53 n.b.p.a., which, when defining this category of tasks, do not recognise the ECB's powers in this respect. Similarly, the inconsistency of the provisions regarding the collection of statistical information by the NBP (Art. 3 para. 2 point 7 and Art. 23 n.b.p.a.), the management of foreign exchange reserves (Art. 3 para. 2 point 2 and Art. 52 n.b.p.a.), and the tasks of the NBP in organising monetary settlements (Art. 3 para. 2 point 1 and Art. 53 n.b.p.a.) have been pointed out. Art. 227 para. 1 of the Constitution of the Republic of Poland and Arts. 4 and 31–37 n.b.p.a., which specify the exclusive right of the NBP to issue banknotes and coins that are legal tender and withdraw them from circulation, were pointed out as not recognising the powers of the Council and the ECB in this respect.

According to the Convergence Reports, the powers of the Council and the ECB should also be taken into account; for example, they should have been considered in the application of Art. 69 para. 1 n.b.p.a., which regulates the issue of auditing the financial statements of the NBP (see: Art. 27 para. 1 of the Statute of the European System of Central Banks and the European Central Bank) and the tasks of the NBP regarding its implementation of the exchange rate policy (Art. 3 para. 2 point 3, Art. 17 para. 4 point 2, and Art. 24 n.b.p.a.), opinions on draft normative acts relating to the activities of banks, and impact on the banking system (see: Art. 21 para. 4 n.b.p.a. and Art. 127 para. 4 and Art. 282 para. 5 of the TFEU).³¹

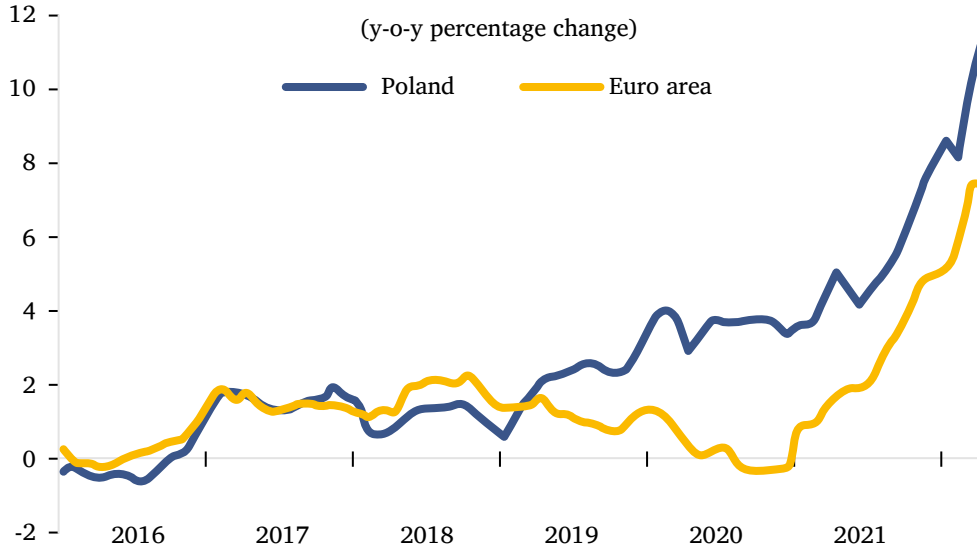
When it comes to meeting the economic criteria – according to the data covered by the latest convergence report of the European Commission – Poland's average inflation rate from May 2020 to April 2021 manifestly exceeded the reference value at 7%. A gradual increase in inflation was also assumed in the following months, primarily due to the higher prices of raw materials, extension of price pressure to other product categories, and further deterioration of supply problems as a result of the Russian-Ukrainian conflict.

30 Mikos-Sitek, 2021, pp. 49–50 and the literature cited there.

31 See: European Commission, 2022, p. 127–128; European Central Bank, 2022, pp. 176–177.

Figure 1: Poland – inflation criterion³²

Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018, and 2020 refer to those calculated in previous convergence reports.

Figure 2: Poland – HICP inflation³³

³² Source: European Commission, 2022, p. 130.

³³ Source: European Commission, Convergence Report, p. 131.

When assessing the fiscal criterion, the European Commission noted that Poland is not subject to the excessive deficit procedure; however, in its economic forecast in Spring 2022, the Commission reported that it estimated that Poland would exceed the permissible budget deficit in 2022 and 2023 (4% and 4.4% of GDP, respectively). This was supposed to be a consequence of the burden of costs of helping refugees from Ukraine, higher interest costs, temporary relief in response to high energy and food prices, and lower revenues from income tax reform. However, the European Commission forecasted a significant improvement in the public debt ratio (a drop to 50.8% and 49.8% of the GDP in 2022 and 2023, respectively).

*Table 1: Poland – budgetary developments and projections
(as % of GDP unless indicated otherwise)³⁴*

Outturn and forecast ¹⁾	2016	2017	2018	2019	2020	2021	2022 ¹⁾	2023 ¹⁾
General government balance	−2.4	−1.5	−0.2	−0.7	−6.9	−1.9	−4.0	−4.4
– Total revenue	38.7	39.8	41.3	41.0	41.3	42.3	39.9	38.6
– Total expenditure	41.1	41.3	41.5	41.8	48.2	44.2	43.9	43.0
of which:								
– Interest expenditure	1.7	1.6	1.4	1.4	1.3	1.1	1.5	1.8
p.m.: Tax burden	34.3	35.0	36.0	36.0	36.4	37.7	35.4	34.4
Primary balance	−0.7	0.1	1.2	0.6	−5.6	−0.8	−2.5	−2.6
Fiscal stance ²⁾					0.1	1.7	−3.4	1.7
Government gross debt	54.2	50.6	48.8	45.6	57.1	53.8	50.8	49.8
p.m.: Real GDP growth (%)	3.1	4.8	5.4	4.7	−2.2	5.9	3.7	3.0

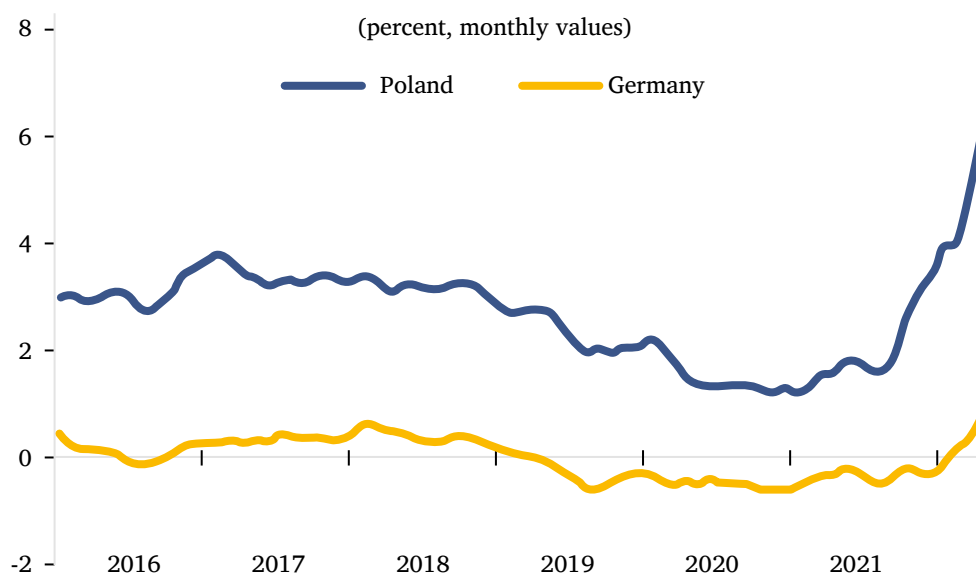
1) Commission's Spring 2022 Economic Forecast.

2) A negative (positive) indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating expansionary (contractionary) fiscal policy.

According to the convergence report, in the analysed period, the average long-term interest rate in Poland was 3% and it was higher than the reference value (adopted at the level of 2.6%).³⁵

34 Source: European Commission, Convergence Report, p. 134.

35 Gąsior and Kloc-Konkołowicz, 2022, pp. 16–18; European Commission, 2022, pp. 130–131.

Figure 3: Poland – long-term interest rates³⁶

4. The banking union

The issue of economic integration within the European Union is primarily associated with the process of adopting a common currency and, in this context, it appears most often in public debate. It is obvious, however, that the issue of adopting the euro itself is very complex, especially in the context of the ongoing economic crisis, and that it should be considered in light of a wide range of factors affecting its course in a specific country as well as its long-term consequences. Additionally, solutions covered by the European Banking Union (EBU) are still being implemented and are often perceived as an important element in mitigating the crisis³⁷ and counteracting any future risk from the operation of national (separate) banking sectors in the Eurozone.³⁸ For this purpose, a project with three complementary pillars was developed; specifically, these pillars comprise the EBU's Single Supervisory Mechanism, Single Bank Restructuring and Resolution Mechanism, and European Deposit

³⁶ Source: European Commission, Convergence Report, p. 137.

³⁷ Oręziak, 2020, p. 176.

³⁸ See: Mazur, 2019, p. 10.

Guarantee Scheme³⁹ – the first two are operational, while the third is awaiting full implementation.⁴⁰ It should also be noted that the shape of the solutions adopted at the individual levels of the EBU has changed many times in the course of the ongoing work, and assuming that the entire project is still in the initial phase of operation, further significant modifications cannot be ruled out. Therefore, it is impossible to predict the real effectiveness of these solutions in the course of the crisis and the Eurozone's resistance to it, which applies – as the 2008 crisis precisely demonstrated – not only to the banking sector itself but also to the entire finances of individual countries.

All activities related to the continuation of the process of building and expanding the EBU to other EU countries, apart from the detailed aspects of its functioning and obvious discrepancies in its assessment, which still need to be determined, must consider the basic issue of the nature of the individual pillars of the EBU in light of the principle that they mutually complement each other. Therefore, failure to implement solutions may be a threat, dooming this huge undertaking to failure. On the other hand, many years have been devoted to this process, involving a huge amount of work and numerous analyses focusing on creating the best possible model of the adopted solutions, as well as on legislative efforts and efforts related to the practical implementation of individual elements of the EBU structure by Eurozone countries. Moreover, the EBU is an advanced process firmly embedded in the institutional framework of the EMU, allowing for the possibility of stopping it at all. Therefore, in this case, the only question is the final shape and dates within which further actions in this area will be taken. It seems that the essence of the discrepancies in adopting the direction of economic integration in the Eurozone has recently become the limit on the financial solidarity of Member States in the face of the crisis, and this approach perpetuates the continuing state of economic crises and inflation.

Poland, as a country outside the Eurozone, may join the EBU on the basis of close cooperation, like other countries that have not adopted the common currency. However, until these countries adopt the euro, they cannot use all the rights associated with such membership, which notably include full representation within the Single Supervisory Mechanism, which is tantamount to a limited influence on supervisory decisions. They also cannot use the liquid funds of the European Stabilisation Mechanism provided for in the financing mechanisms of the II pillar.⁴¹ The decision in this respect in Poland remains complicated because of the specific predispositions

39 Ořeziak, 2020, pp. 176–178; Koleśnik, 2013, pp. 93–94; Więclawski, 2015, pp. 237–238; Hryckiewicz and Pawłowska, 2013, pp. 17–18; Zielińska-Lont, 2020, pp. 121–122; Waliszewski, 2016, pp. 9–10; Borsuk and Klupa, 2017, pp. 17–18

40 There are three basic regulations in this regard in Poland: The Act of 29 August 1997 – Banking Law (consolidated text: Journal of Laws of 2023, item 2488, as amended); Act of 21 July 2006 on financial market supervision (consolidated text: Journal of Laws of 2023, item 753, as amended) and Act of 10 June 2016 on the Bank Guarantee Fund, the deposit guarantee system and compulsory restructuring (consolidated text: Journal of Laws of 2022, item 2253, as amended).

41 Mazur, 2019, p. 14.

of the Polish banking sector; however, the time horizon for adopting the common currency is difficult to determine. First, the Polish banking sector is still clearly smaller and less developed; Polish banks pursue a more conservative policy, base their operations primarily on standard banking products, are less active in investing, and show less involvement in the derivatives market. It is estimated that these factors, among others, mean that the Polish banking sector has been less affected by threats caused by the recent crisis in the Eurozone. In this case, the method of carrying out supervision was also of particular importance, as it coordinated the conservative policy of Polish banks and the national deposit guarantee system, which is one of the best capitalised systems in the EU in times of crisis.

Considering the latest data announced by the NBP at the end of 2022, the ratio of domestic financial system assets to GDP was 117%, a decrease from the end of 2021. According to the NBP, the Polish financial sector, including the banking sector, is not overdeveloped compared to most economically developed countries. Poland's banking sector, which is also characteristic of other countries in the region, constitutes the largest part of the financial system, accounting for approximately 76% of the assets of the Polish financial system at the end of 2022. When assessing the assets of the Polish banking sector, it should be noted that the largest item is (as in previous years) loans to the non-financial sector, including loans to households, while the second-largest item in terms of value is treasury securities and securities guaranteed by the State Treasury.⁴²

When assessing the validity of Poland's accession to the EBU, one should first consider the course of the process of shaping the principles of its functioning in practice, including the level of advancement of work on its final shape, considering all three pillars and the status of countries participating in the EBU on the basis of close cooperation, which is important in the context of limiting their rights. The key factor that should be considered in this case is the situation of the Polish banking sector and its ability to adapt to the structures of the EBU, which are related to the specificity and degree of development of the banking sectors of Eurozone countries. The process of accession to the EBU for countries that have not yet adopted a common currency is also important. Further, it should also be noted that one of the factors contributing to Poland's reluctance to join the EBU is the actions undertaken in recent years related to ownership transformations within the Polish banking sector aimed at increasing the involvement of the State Treasury (the so-called 'repolonisation' process of banks). Greater state participation in the banking sector in the context of accession to the EBU raises certain concerns because it means a change in the rules for deciding on the initiation of orderly bank resolution and controlling this process in relation to domestic banks.

Considering the above-mentioned circumstances and the state of the Polish banking sector, the assessment that it is currently more advantageous for Poland to remain outside the EBU remains valid. However, this assessment should be related to

⁴² Markowskiego and Tymoczko, 2023, p. 12.

the course of Poland's adoption of the common currency or at least the determination of the probable date of its adoption.

5. Monetary aspects of crisis management

In accordance with the provisions of the Act on the National Bank of Poland, the main objective of monetary policy is to maintain stable prices (Art. 3, para. 1). The central bank's monetary policy is intended to ensure long-term price stability and support sustainable economic growth and the stability of the financial system. The NBP implements its monetary policy using an inflation-targeting strategy. Since 2004, the goal of monetary policy has been to maintain inflation at 2.5% with a symmetrical deviation band of $\pm 1\%$ in the medium term. The NBP implemented an inflation targeting strategy under a floating exchange rate. However, the floating exchange rate regime does not exclude intervention in the currency market when it is justified by current market conditions or when it facilitates the country's macroeconomic or financial stability.⁴³

Specific monetary policy tools are defined by law and can be divided into administrative instruments and market instruments. The basic instruments of monetary policy are NBP interest rates (currently the reference rate, deposit rate, Lombard rate, bill of exchange rediscount, and bill of exchange discount rate). The market tools comprise open-market operations (basic, fine-tuning, and structural). The provisions of the Polish Act regulating the principles of the operations of the central bank of the state also provide the NBP with the ability to conduct deposit and credit operations (e.g. lombard loans, bills of exchange loans, end-of-day deposits) and the mandatory reserve system.⁴⁴ The regulation also allows the NBP to use unique tools, such as credit caps and mandatory interest-free deposits at the NBP for foreign funds used by banks and domestic entrepreneurs; however, this right is exceptional and can only be used in the situations specified by law (Art. 46 n.b.p.a.).⁴⁵

The NBP's monetary policy strategy is also flexible in terms of the scope of instruments it uses; this allows the NBP to adapt its responses to particular economic disturbances and market conditions.⁴⁶ However, an analysis of the NBP's actions during the 2008 financial crisis shows that it did not significantly diverge from standard monetary policy. After the crisis, the NBP identified possible liquidity disturbances in the banking sector as the main threat to the stability of the national financial system. Attention was also drawn to the possible decline in trust in the

43 Narodowy Bank Polski, Rada Polityki Pieniężnej, 2023, p. 4.

44 Ofiarski, 2017, pp. 637–655; Zawadzka, 2014, pp. 174–175; Mikos-Sitek, 2021, pp. 63–70.

45 Mikos-Sitek, 2006, p. 97.

46 Narodowy Bank Polski, Rada Polityki Pieniężnej, 2023, p. 4.

interbank market.⁴⁷ The ‘Confidence Package’, implemented in October 2008, modified the NBP’s standard monetary policy tools and included actions aimed at improving the operating conditions of domestic banks (primarily by supporting their liquidity). The Confidence Package was subsequently changed, but the solutions were ultimately geared to ensure that banks could obtain funds for longer periods (changes to the rules for conducting repo operations), providing liquidity to banks – including currencies (currency swaps), and expand the list of securities acceptable to the central bank in open market operations. The rules for granting Lombard loans were modified by extending the list of securities accepted by the NBP and accepted as collateral.⁴⁸ In 2010, a discount credit facility aimed at domestic banks, branches of foreign banks and credit institutions was also made available to banks. This instrument differed the most from the traditional tools used in NBP monetary policies. As part of the activities discussed, the NBP decided to use forward guidance to communicate with and intervene in currency markets.⁴⁹

6. Conclusions

Poland joined the EU in 2004 using so-called ‘derogation’ rules, thereby committing to adopting a common currency in the future. In the first period of European integration, significant efforts were made to adapt Polish regulations to the EU standards and activities required to meet the convergence criteria. In all these activities, enthusiasm for the adoption of the common currency and its function within the Eurozone was clearly visible.⁵⁰ The 2008 financial crisis fundamentally changed this approach, necessitating an additional assessment of the benefits and possible threats related to adopting the euro. Poland and other Member States outside the Eurozone adopted a wait-and-see attitude, postponing the decision in this regard and making it dependent on further observations and analyses of the economic crisis and its impact on the Eurozone.

The concerns that arise most often in connection with the adoption of a common currency are the loss of monetary sovereignty and the related consequences of the ECB’s monetary policy decisions, as well as the limiting of economic policy tools that may be employed during a slowdown to fiscal instruments. This also applies to maintaining the competitiveness of individual countries and the mechanisms shaping them. The adoption of the euro is also conditional on Poland carrying out

47 Pyka, 2010, p. 148; Skibińska-Fabrowska, 2022, p. 148.

48 Skibińska-Fabrowska, 2022, pp. 160–161.

49 Skibińska-Fabrowska, 2022, pp. 165–167.

50 See: Borowski, 2004; Narodowy Bank Polski, 2009.

the structural and institutional reforms necessary for it to integrate with the Eurozone fiscally, economically, and financially.

However, the adoption of a common currency may offer benefits – in particular, the most frequently mentioned benefits are macroeconomic stabilisation, the prospect of increasing the economic growth rate, eliminating the risks and costs resulting from fluctuations in the exchange rate, and eliminating the impact of exchange rates (e.g. on the development of trade, security, and credibility) in foreign investors' assessments. Achieving these benefits depends on implementing the aforementioned reforms as well as future macroeconomic factors, which further emphasises the need to create stable foundations for the functioning of the Eurozone answerable to the specificities of the countries constituting it.

It should be noted that Poland's accession to the Eurozone is currently not possible because it does not yet meet most of the economic convergence criteria and does not participate in the Exchange Rate Mechanism II; indeed, the latest convergence reports of the European Commission and the European Central Bank (from 2022)⁵¹ indicate (like the 2020 reports) significant inconsistencies between Poland's national legislation and the Treaties and, therefore, the need for Poland to introduce numerous changes. Given these circumstances, it is expected that Poland will not adopt the euro in the coming years and will not enter the Eurozone. A return to the process of gradual integration will probably be possible only when a macroeconomic balance is achieved and inflation rates and budget deficits improve.

51 European Commission, 2022; European Central Bank, 2022.

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ROMANIA: SOCIAL ACCEPTANCE, UNMET CRITERIA



BÍBORKA ESZTER BÍRÓ

Abstract

The present chapter explores the most important monetary policy issues in Romania; specifically presents Romania's state of preparedness for joining the euro area, its place and role in the banking union (as an outsider but EU Member State), and the measures it took during the crisis. This chapter also examines the different components of the Maastricht criteria, such as the price stability criterion, government budgetary position criterion, exchange rate stability criterion, and interest rate convergence criterion. A short detour is made to discuss the real convergence criteria in addition to the nominal criteria. Moreover, the most important findings referring to Romania in the Flash Eurobarometer Report are presented, providing insights into public opinion concerning the adoption of the common currency. Subsequently, aspects related to the banking union, the Single Rulebook, and banking supervision are explored. In this context, it is important to mention that Romania follows a dual supervisory mechanism, in which banking supervision requires a national authority (the National Bank of Romania) in addition to the European one. However, as Eurozone banks own a large part of the Romanian banking system, the Single Supervisory Mechanism, the domestic supervisory authority of Eurozone banks, is a key partner of the National Bank of Romania. Further, this chapter discusses the monetary aspects of crisis management processes, the most important decisions of the Governing Council of the National Bank of Romania on monetary policy issues from 2020 to 2023, why the monetary policy interest rate changed from 1.25%/year at the beginning of 2021 to 7% at the beginning of 2023 (where it remained until October 2023), and changes in the inflation rate.

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1. Lessons related to the introduction of the Euro

1.1. The Maastricht convergence criteria, their economic rationale, and Romania's compliance

The nominal convergence criteria, based on which Member States are entitled to join the Eurozone, are laid down in the Maastricht Treaty. The aim of the criteria is to ensure sustainable nominal convergence in terms of price development, exchange rates, and long-term interest rates, as well as budget deficits and government debt.

According to the price stability criterion,

a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5% that of, at most, the three best performing Member States in terms of price stability.¹

The reference period considered in the latest ECB report was May 2021–April 2022, and the reference value was calculated as the unweighted arithmetic average of the three lowest inflation rates of the EU Member States; namely, France (3.2%), Finland (3.3%) and Greece (3.6%), the reference value this way having been 4.9%.²

The criterion for the government budgetary position stipulates that candidate Member States fulfil the following two fiscal requirements: the ratio of the planned or actual government deficit to GDP must not exceed 3% of the GDP reference value, and the ratio of government debt to GDP must not exceed 60% of the GDP reference value.³

The criterion regarding exchange rate stability requires that a Member State has respected the normal fluctuation margins provided by the exchange rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State should not have devalued its currency's bilateral central rate against the euro on its own initiative for

1 European Central Bank, 2022, p. 7.

2 Malanca and Cîndea, 2022, p. 193.

3 Ibid.

the same period.⁴ In the latest ECB report, the reference period for this criterion was 26 May 2020 to 25 May 2022.⁵

The interest rate convergence criterion assumes that the average nominal long-term interest rate

does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.⁶

The reference period taken into account was May 2021–April 2022 and the reference value was calculated only on the basis of the interest rates of France (0.3%), Finland (0.2%), and Greece (1.4%). Thus, the average rate was 0.6%; adding two percentage points yields a rate of 2.6%.⁷

According to the convergence report of the European Central Bank (ECB) issued in 2022, Romania's degree of fulfilment of the Maastricht criteria is as follows: (i) In April 2022, Romania's average annual HICP inflation rate was 6.4%, well above the reference value of 4.9% for the price stability criterion. Over the last 10 years, this indicator has fluctuated over a relatively wide range, between 1.7% and 6.4%, while the average over the period has been moderate at 2.2%.⁸ This rate gradually increased in the following months, particularly as a result of rising commodity prices, widespread price pressure, and the further worsening of bottlenecks in production and distribution chains in light of the war between Russia and Ukraine. (ii) Although Romania's budget deficit significantly exceeded 3% of the GDP reference value in 2021, the excessive deficit procedure, initiated in April 2020, has been temporarily suspended. As of April 2020, Romania has been subject to an excessive deficit procedure as its fiscal position exceeded 3% of the GDP reference value in 2019 (4.3%). In 2021, the budget deficit was 7.1% of GDP, below the recommended target, and the required fiscal effort was achieved; therefore, the excessive deficit procedure was temporarily suspended. Thus, the budget deficit decreased to 6.3% by 2022.⁹ Looking over a longer period reveals that Romania had better values in the past decades; specifically: 5.5%, 3%, and 2.3% from 2011 to 2013.¹⁰ Although the public debt ratio is below 60% of GDP, it has increased since 2019. The European Commission's latest assessment in the area of fiscal sustainability points to low risks to sustainability in

4 European Central Bank, 2022, p. 12.

5 Malanca and Cîndea, 2022, p. 193.

6 European Central Bank, 2022, p. 13.

7 Malanca and Cîndea, 2022, p. 194.

8 European Central Bank, 2022, p. 73.

9 *Governance Finance Statistics* [Online]. Available at: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Government_finance_statistics#General_government_surplus.2Fdeficit (Accessed: 15 January 2024).

10 Eurostat, 2014.

the short term, high risks in the medium term, and moderate risks in the long term. Moving forward, Romania needs to address the problems associated with population aging.¹¹ The public debt ratio also had better values in the 2011–2013 period, varying from 33.9% in 2011 to 32.7% in 2013;¹² from 2020 to 2022, these values were between 46.8% and 47.2%. (iii) During the reference period from 26 May 2020 to 25 May 2022, the RON did not participate in the European Exchange Rate Mechanism, but was traded under a flexible exchange rate regime with a controlled float. The exchange rate of the Romanian leu against the euro was characterised, on average, by a very low degree of volatility during the reference period. On 25 May 2022, the exchange rate was 4.9416 RON/EUR, 2.2% lower than the average level in May 2020. In June 2020, the National Bank of Romania (NBR) agreed to a repo facility arrangement with the ECB whereby it could lend up to EUR 4.5 billion against high-quality euro-denominated collateral to provide euro liquidity to financial institutions in Romania to meet potential liquidity needs during the pandemic. Because this arrangement reduced the potential risk posed by financial vulnerabilities, it also likely impacted the development of the exchange rate during the reference period.¹³ From a longer-term perspective, the available RON/EUR exchange rate communicated on 31 May 2012 was 4.4652¹⁴ (for more recent exchange data, see Figure 1. (iv) In the reference period, from May 2021 to April 2022, the long-term interest rates in Romania were, on average, 4.7% – well above the benchmark of 2.6% and thus in alignment with the interest rate convergence criterion. In Romania, long-term interest rates have been on a downward trend since 2012, with 12-month average rates falling from just above 7% to approximately 4.5%.¹⁵

The aforementioned Convergence Report of the ECB also emphasises that creating an environment conducive to sustainable convergence in Romania requires stability-oriented economic policies and comprehensive structural reforms. Furthermore, regarding macroeconomic imbalances, the European Commission selected Romania for an in-depth analysis in the 2022 Alert Mechanism Report, highlighting its external position and cost competitiveness issues. Although Romania has made significant progress in meeting the conditions for economic convergence since the early 2010s, concerns remain regarding its low levels of productivity. The relatively poor quality of the country's institutions and governance, as well as its vulnerable business environment, continue to mitigate its growth potential. In addition, the effective absorption of EU funds remains essential for stimulating medium-term growth and guiding the economy through upcoming green and digital transitions. Efforts are also required to implement reforms aimed at fighting corruption, improving competition, and increasing the predictability of the country's fiscal, judicial,

11 European Central Bank, 2022, p. 73.

12 Eurostat, 2014.

13 European Central Bank, 2022, p. 73.

14 *Arhiva Curs Bnr – Curs valutar (exprimat in RON) comunicat in data de 31 mai 2012* [Online]. Available at: <https://www.cursbnr.ro/arhiva-curs-bnr-2012-05-31> (Accessed: 15 January 2024).

15 European Central Bank, 2022, p. 74.

regulatory, and administrative systems. To further boost confidence in the financial system, competent national authorities should continue to improve their supervisory practices, *inter alia*, by complying with applicable recommendations issued by relevant European and international bodies and working closely with other national supervisory authorities in EU Member States in supervisory colleges.¹⁶

The Convergence Report also points out that Romanian legislation does not meet all requirements regarding central bank independence, the prohibition of monetary financing, and the legal integration of the central bank into the Eurosystem. It is important to note that Romania is an EU Member State with a derogation that must comply with all adaptation requirements.¹⁷

According to an ECB report of May 2012, Romania fulfilled only one nominal convergence criterion: the level of public debt as a percentage of its GDP.¹⁸ In 2011, this level was 38.4%, which is well below the 60% reference value. It is clear that Romania has not made any progress in meeting the nominal convergence criteria in the sense that, according to the ECB report of June 2022, it still only meets the criterion for the level of public debt. In addition, although Romania still meets this criterion its level of public debt increased significantly in 2022 to 50.9%.¹⁹

Regarding the above description, Romania is seriously lagging behind most of the nominal convergence criteria, putting the adoption of a single currency on a rather distant horizon. In particular, the degree of fulfilment of the nominal convergence criteria must be considered in conjunction with the fulfilment of the real convergence criteria and optimal currency area criteria as well as a cost-benefit analysis. In this context, justified postponements must be understood and accepted because speeding up accession without any corresponding changes to the economic reality can only have harmful consequences for a country that has been unduly ambitious to benefit from advantages that are not actually available to it. At the same time, however, the unjustified procrastination of accession to the European Monetary Union (EMU) widened the gap between Romania and the countries in the EMU.²⁰

In addition to nominal convergence, it is important to consider real convergence. In the Romanian context, several indicators have been proposed to measure the degree of the economy's real convergence, such as the openness of the economy,²¹ the sectoral structure of the economy,²² the ratio of EU exports and imports to foreign trade,²³ and the evolution of GDP per capita.²⁴

16 Ibid.

17 Ibid.

18 European Central Bank, 2012.

19 Malanca and Cîndea, 2022, p. 198.

20 Ibid.

21 Szeles and Marinescu, 2010, p. 183.

22 Duhnea, Ghita-Mitrescu and Vancea, 2012, p. 154.

23 Bădîrcea, Pîrvu and Manta, 2017, p. 57.

24 Dumitru, 2009, p. 26.

In its broadest sense, ‘real convergence’ refers to the process of adjusting economic and social structures to those of the euro area. Notably, per capita gross domestic product (GDP/capita) is one of the main indicators used to assess the extent of differences in economic development.²⁵ According to Eurostat data, the real GDP per capita in Romania was EUR 10,110 in 2022, which is 35.03% of the EU27 average and 31.90% of the average of the 20 countries forming the Eurozone.²⁶ The dynamics of real GDP growth rates in Romania were higher than those in other countries in the 2000–2020 period, with real GDP moving closer to the EU average at an accelerating rate after 2012.²⁷

1.2. Romania’s perspective on accession to the Eurozone

The introduction of the euro would undoubtedly be beneficial for Romania; however, it also has a number of negative effects. Notably, the current scope of the community process is determined by these effects. To be sure, introducing the euro incurs several administrative, legal, operational, and psychological costs (as a result of changing banknotes).²⁸ Romania’s approach to the Eurozone is essential in terms of all opportunities at the moment, and preparing for the adoption of the euro increases its credibility as a responsible partner within the EU.

The euro has become the second-most widely used currency in the world in terms of economic size. It has stimulated world trade as well as the size and liquidity of capital markets. One of the major advantages of joining the EMU is the positive effect of trade expansion on the entering country, which is often called the ‘Rose effect’. Indeed, increased trade is crucial for stimulating economic growth. The Rose effect has appeared in both theoretical and empirical studies, particularly in the works of Andrew K. Rose.²⁹ Specifically, based on a gravity model, Rose presents the Rose effect to argue in support of monetary unions and situate national currencies as an ‘obstacle’ to international trade. In this scenario, monetary integration brings about a better correlation to the affairs of the Member States. A 1% increase in a country’s trade results in a 0.33% increase in its GDP. By eliminating the exchange rate, the common currency reduces risk and thus leads to a lower real interest rate, which, in turn, stimulates economic growth.³⁰

Some aspects of Romania’s perception of the adoption of the euro should be analysed. First, the evolution of the RON/EUR exchange rate is an interesting research question, particularly regarding changes during the COVID-19 pandemic period. In 2020, despite the extreme circumstances triggered by the health crisis, the overall

25 Schipor, 2020, p. 193.

26 Eurostat Data Browser – Real GDP per capita [Online]. Available at: https://ec.europa.eu/eurostat/databrowser/view/sdg_08_10/default/table?lang=en (Accessed: 29 September 2023).

27 Schipor, 2020, p. 193.

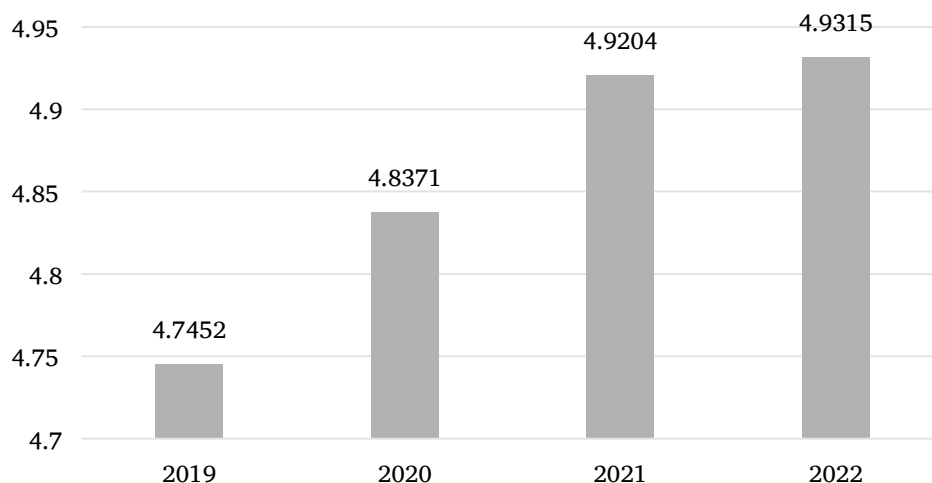
28 Istrate and Gontariu, 2019, p. 285.

29 Istrate and Gontariu, 2019, p. 286; See also: Frankel and Rose, 2000.

30 Schadler et al., 2005, p. 2.

dynamics of RON/EUR volatility indicated a slight depreciation of the national currency against the euro. Consequently, the RON/EUR exchange rate rose by 1.89% in 2020, from 4.7789 RON/EUR (3 January 2020) to 4.8694 RON/EUR (31 December 2020).³¹ Despite the provisions from 2020 that suggested a gradual depreciation of the Romanian leu that could have led to the value of 5.00 RON/EUR, the exchange rate remained below 5.00 even in 2023.

Figure 1: Yearly average RON/EUR exchange rate from 2019 to 2022³²



In 2018, the Romanian Government adopted Emergency Ordinance No. 24/2018 (approved by Law No. 249/2018), which established the National Commission to substantiate the National Plan for the adoption of the euro. The main objective was to identify the actions and promote the necessary reforms to prepare the Romanian economy for the changeover to the euro.³³ The National Commission is headed by the Prime Minister and President of the Romanian Academy (as co-chairs) and by the Governor of the NBR and a Deputy Prime Minister appointed by the Prime Minister, by decision (as vicechairs). The members include, among others, representatives of the Economic Planning Council and other independent experts; representatives of the Romanian Academy; the Minister of Public Finance; the Minister Delegate for European Affairs; a representative of the NBR; the President of the Financial Supervisory Authority; personalities of science, culture, and university academic life appointed

³¹ Schipor, 2020, p. 196.

³² Source: Author, based on: *Banca Națională a României – Statistics* [Online]. Available at: <https://www.bnr.ro/Statistics-3229-Mobile.aspx> (Accessed: 25 October 2023).

³³ Ordonanța de urgență nr. 24 din 21 martie 2018 privind înființarea, organizarea și funcționarea Comisiei Naționale de fundamentare a Planului național de adoptare a monedei euro, Monitorul Oficial, nr. 273 din 28 martie 2018.

by the Prime Minister; representatives of non-governmental organisations; civil societies with experience in the field of economics; and the President of the National Institute of Statistics. It is, therefore, clear that experts and politicians alike are involved in the National Commission to draw up the right plan for the introduction of the euro, taking into account the country's economic constraints. The National Plan for the adoption of the euro, prepared in 2018, scheduled the date for euro adoption in Romania for 2024,³⁴ which was later postponed to 2029 and changed again. With the rise of the COVID-19 pandemic, priorities have shifted towards protection and prevention, with less emphasis placed on measures to introduce a single currency.

Şimandan and others classify the determinant factors for Euro adoption into three categories: economic factors, political economic factors, and internal political factors. Economic factors refer to economic structure, trade relations, labour market flexibility, and business cycle synchronisation, while political economic factors deal with the nominal and real convergence criteria analysed above. The internal political factors focus on the president, political parties, and their relationships with the national bank.³⁵

According to Dăianu and others, accession will be a political decision and must receive the widest possible democratic support from citizens.³⁶ In this context, another important issue to discuss is public opinion in different Member States that have not yet adopted a common currency. The latest report in this context, the Flash Eurobarometer 527, was published in June 2023.³⁷ The Romanian situation is similar to other member states (Bulgaria, Czechia, Hungary, Poland, and Sweden). The key findings regarding the awareness of the euro show that, in Romania, 41% of respondents feel informed about the common currency and 28% are aware that the Eurozone contains 20 Member States (the overall average of the six countries for this point is 34%). The proportion of Romanian respondents who reported that they had used euro banknotes or coins is 80%, making Romania the country in which interviewees are most likely to have used euro banknotes or coins in their own country

34 Guvernul României, 2018.

35 Şimandan, Leuştean and Dobrescu, 2019, p. 273.

36 Dăianu et al., 2016, p. 8.

37 Between 17 April 2023 and 25 April 2023, Ipsos European Public Affairs carried out Flash Eurobarometer 527 at the request of the European Commission, Directorate-General for Economic and Financial Affairs. This was a general public survey coordinated by the Directorate-General for Communication, 'Media monitoring and Eurobarometer' Unit. The Flash Eurobarometer 527 covers the population of EU citizens, aged 15 years and over, and residents in the six Member States that have not yet joined the euro area and have no specific opt-out. All interviews were carried out via Computer-Assisted Telephone Interviewing (CATI). In each country, respondents were called both on landlines and mobile phones. The telephone numbers sampled and contacted were generated via Random Digit Dialling (RDD) methods. The basic sample design applied in all countries is a random (probability) design. In households contacted via a landline phone, the respondent was drawn at random from all household members (aged 15 years and over) following the 'most recent birthday rule'. In Romania 1,011 interviews were conducted. The maximum margin of sampling error when comparing individual country results between surveys is $\pm 8.8\%$ for countries with a sample size of 500 and $\pm 6.2\%$ for countries with a sample size of 1,000.

(Swedish people are the most likely to have used them only abroad). In Romania, 67% of respondents were aware that euro banknotes look exactly the same in all countries in which the euro is used, which is much higher than the average of the six countries (47%). However, 27% of Romanian respondents knew that euro coins have partly different designs from country to country (the average of the six countries for this point was 41%).³⁸ Regarding information campaigns, National Central Banks are the most trusted sources of information. In Romania, the ratio of trust in the Romanian National Bank is 82%; meanwhile, European institutions occupied second place, trusted by 70% of Romanian respondents. Referring to information actions considered essential in both 2022 and 2023, Romanian respondents are more likely to say that a dual display (in shops, bills, and payslips) is essential.³⁹

Section 3 of the Flash Eurobarometer Report describes attitudes toward introducing the euro. Across the six countries surveyed, an average of 60% of respondents believed that the introduction of the euro has positive rather than negative consequences for countries that are already using it; this rate is slightly above the 2022 value (63 %). Meanwhile, the proportion of respondents who believed that the euro had negative consequences increased by five percentage points, from 27% to 32%.⁴⁰

In response to the question, ‘What consequences do you think the introduction of the euro has had in countries that are already using the euro?’ Romanian respondents’ answers were distributed as follows: 17% felt it has had very positive consequences, 49% felt it has had rather positive consequences, 18% felt it has had rather negative consequences, 10% felt it has had very negative consequences, and 6% answered that they did not know.⁴¹

In particular, regarding public opinion about introducing the euro, Question 11 of the Flash Eurobarometer is essential: ‘Generally speaking, are you personally more in favour or against the idea of introducing the euro in Romania?’ Romanian respondents’ answers were distributed as follows: 71% were in favour of its introduction, 28% were against its introduction, and 1% answered that they did not know. Regarding Romanian respondents’ perception of Romania’s readiness to introduce the euro, their answers were distributed as follows: 36% felt that Romania was ready to introduce it, 60% felt that its introduction would have very positive (19%) or rather positive (41%) consequences for Romania, and a large proportion of respondents (65%) felt that its introduction would have very positive (22%) and rather positive (43%) consequences for them personally.⁴²

Respondents from Romania were most likely to want the euro to be introduced as soon as possible (45%), even though 12% felt that the common currency should never be introduced. In this context, it is interesting to examine the respondents’ answers to

38 European Commission, 2023, p. 3.

39 European Commission, 2023, p. 17.

40 European Commission, 2023, p. 19.

41 Ibid.

42 Ibid.

Question 4c: ‘When do you think the euro will be introduced in (THIS COUNTRY)?’ Romanian respondents’ answers were distributed as follows: 42% thought it would be introduced within five years, 37% within 10 years, and 20% thought that it would never be introduced (1% of the respondents did not know).⁴³

A slim majority (52%) of Romanian respondents thought that introducing the euro would increase prices; meanwhile, more than one-third (37%) believed it would keep prices stable and 9% thought it would reduce prices.⁴⁴

Views on the likely impact of the euro on national control of economic policy and national identity diverge from country to country. In Romania, 29% of the respondents totally agree and 19% tend to agree that with the introduction of the euro, control over national economic policy will be lost. Almost half of the respondents (49%–31% totally agreed, 18% tended to agree) agreed that adopting the euro would mean that their country would lose part of its identity. Respondents with a higher level of education, living in large towns, and who felt informed about the euro were more likely to disagree that adopting it would lead to a loss of national identity.⁴⁵

2. The banking union: The Single Rulebook, supervision, resolution, deposit insurance

2.1. The Single Rulebook (2013–)

On 27 June 2013, the EU adopted banking regulations in response to the financial crisis, comprising Regulation (EU) 575/2013 on prudential requirements for credit institutions (Capital Requirements Regulation [CRR]) and Directive 2013/36/EU (Capital Requirements Directive [CRD IV]) on the prudential supervision of credit institutions. These acts constitute the ‘single regulatory framework for the banking union’ and implemented the Basel III Accord – the internationally agreed capital adequacy standards adopted by the Basel Committee on Banking Supervision (BCBS) in December 2020 – in EU law.

The BCBS is responsible for developing minimum standards for banking supervision. The committee has 45 members, including countries like Argentina, Australia, Belgium, Brazil, Canada, China, Switzerland, France, Germany, India, Indonesia, Italy, Japan, Mexico, UK, Netherlands, Russia, Turkey, and United States. The European Commission, European Banking Authority, and ECB have observer status.

⁴³ European Commission, 2023, p. 30.

⁴⁴ Ibid.

⁴⁵ European Commission, 2023, p. 38.

As a member of the EU, Romania is subject to and aligned with its common regulatory framework for banking supervision. The EU regulatory framework for banking supervision has undergone significant changes since the 2008 global financial crisis and subsequent sovereign debt crisis. The adoption of the CRR and CRD IV, which constitute the Single Rulebook, was an important step towards stronger prudential regulation.⁴⁶ Specifically, the CRR, which is directly applicable to all EU Member States, sets prudential requirements for capital, liquidity, and credit risks. Regarding the capital requirements, the CRR requires banks to have sufficient capital buffers to cover unexpected losses and maintain solvency in times of stress. The amount of capital required – the ‘own funds requirement’ – depends on the risk associated with the assets held by a particular bank. Regarding the liquidity requirements, the CRR requires credit institutions to hold sufficient liquid assets to cover net cash outflows during a severe crisis for a 30-day period; this indicator has been phased in gradually, starting at 60% in 2015 and reaching 100% in 2018. Regarding credit risk, the CRR situates a bank’s assets as ‘leveraged’ when they exceed the bank’s funds (‘leverage’ is the ratio of a bank’s funds to its total assets).⁴⁷

On 27 June 2019, the acts amending the Single European Banking Framework, Regulation (EU) 2019/876 (CRR II), and Directive (EU) 2019/878 (CRD V) entered into force, introducing certain additional requirements, particularly regarding the own funds requirements, leverage ratio, and counterparty credit risk. The new regulations became applicable in February 2022⁴⁸ as the CRD V was only partially implemented by Romania. Within the CRD V framework, the new regulations also include new provisions on capital adequacy evaluations performed by the NBR, as well as on remuneration policies and implementing gender-neutral remuneration policies at the level of supervised entities.

The implementation of new capital and liquidity requirements has effectively meant that banks have to set aside more capital and liquid assets to be able to lend, which cannot be used for any other purpose until the loan is repaid in full or the deadline for granting the loan has been reached. Committing credit facilities thus limit the capital available to banks to cover capital and liquidity requirements, inciting higher funding costs for banks. As a result of these higher costs, banks are increasingly considering offering non-committing credit lines. The CRR allows banks to apply for a credit facility that has not drawn down an exposure amount equal to 0% if the facility meets its requirements. These non-committing loans have a dual benefit for the customer and the bank: they reduce funding costs associated with

46 International Monetary Fund, World Bank, 2018, p. 6.

47 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013, 1–337.

48 Regulament nr. 2 din 1 februarie 2022, Monitorul Oficial, Partea I 121 7 februarie 2022, Intrare în vigoare la 7 februarie 2022, Regulamentul nr. 2/2022 pentru modificarea și completarea Regulamentului Băncii Naționale a României nr. 5/2013 privind cerințe prudențiale pentru instituțiile de credit.

loans for the benefit of the customer, while simultaneously reducing the impact of this type of lending on capital and liquidity requirements. Notably, the CRR does not necessarily consider a loan to be non-committing in the sense that the bank does not assume any obligation to grant the loan. Non-committing loans for which the bank assumes an obligation to make the loan available and which has not been drawn down may be classified as an asset (on-balance sheet or off-balance sheet as appropriate) with an exposure value of 0% when the bank has the right to unconditionally cancel or revoke this commitment, at any time, and without prior notice.⁴⁹

2.2. Banking supervision (2014–)

The architecture of the EBU consists of three pillars: a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM), and a System Deposit Guarantee Scheme (SDGS).⁵⁰

As Eurozone banks own a large part of the Romanian banking system, the SSM, as the domestic supervisory authority for Eurozone banks, is a key partner of the NBR. Prudential regulation of the NBR is broadly aligned with the requirements of the Basel Core Principles. As of 2017, the NBR identified 11 banks as systemically important, of which eight are supervised at the group level by the SSM.⁵¹

In Romania, deposits at domestic banks have increased in value and, as a result, dependence on foreign banks has fallen dramatically, despite 29 of Romania's 35 banks being foreign banks. In general, the financial sector in Romania is dominated by banks. The lending practices of the non-bank financial sector are likely to increase non-performing loans.⁵²

As noted above, Romania follows a dual supervisory mechanism, with both national (the NBR) and European banking supervision. However, in January 2023, the ECB signed a Memorandum of Understanding with the national competent authorities of six EU Member States that are not part of the European banking supervision system, one of which is Romania (along with the Czech Republic, Denmark, Hungary, Poland, and Sweden).⁵³

With its 14 articles, the agreement aimed to further strengthen supervisory cooperation at the European level. The agreement builds on the already-strong culture of cooperation between the ECB and non-participating EU national authorities that emerged from the work of the European Banking Authority. The Memorandum of Understanding provides a framework for Member States to exchange information on supervisory issues and matters relating to cross-border supervised institutions, as well as supervisory methods, approaches, and priorities.⁵⁴

49 Regulament nr. 2 din 1 februarie 2022.

50 Lungu and Kállai, 2015, p. 37.

51 International Monetary Fund, World Bank, 2018, p. 6.

52 Batrancea et al., 2020, p. 2.

53 European Central Bank, 2023a.

54 Ibid.

According to the Memorandum of Understanding, the NBR is entrusted with specific tasks concerning the prudential supervision of credit institutions in accordance with Law No. 312/2004 of the Statute of the NBR, Government Emergency Ordinance No. 99/2006 regarding credit institutions and capital adequacy approved by Law No. 227/2007, and Government Emergency Ordinance No. 98/2006 on the supplementary supervision of credit institutions, insurance and/or reinsurance entities, investment firms, and asset management companies in a financial conglomerate.⁵⁵

In accordance with the Confidentiality article of the Memorandum of Understanding (Art. 4), any confidential information requested or received by the ECB or the NBR (and the other authorities under the Memorandum) will be exchanged in accordance with applicable EU and national law, used exclusively for lawful purposes, and used only in relation to the performance of the duties and tasks of the ECB or the NBR (and the other authorities under the Memorandum).⁵⁶

Art. 6 of the Memorandum regarding cooperation in relation to authorisation procedures, qualifying holdings assessments, fit, and proper assessment of key function holders provides that the ECB and the NBR (and the other authorities under the Memorandum) intend to notify each other, without undue delay, of applications for approval to establish cross-border establishments or make cross-border acquisitions. In accordance with the provisions of the CRD, the ECB and the NBR (and the other authorities under the Memorandum) intend to consult each other before authorising a cross-border establishment of a supervised institution in the jurisdiction of Romania (or other participating countries under the Memorandum) or assessing any acquisition of holdings in a supervised institution by or through a supervised institution located or operating in the jurisdiction of Romania (or other participating countries under the Memorandum).⁵⁷

Art. 10 of the Memorandum refers to cooperation in emergencies. In this regard, the ECB and the NBR (and the other authorities under the Memorandum) will endeavour to inform each other immediately if an emergency situation arises (as provided in the regulation of CRD) or if they become aware of an emerging crisis such as, but not limited to, serious financial difficulties which might have an adverse impact on operations relating to any supervised institution in the jurisdictions of the ECB and the NBR (and the other authorities under the Memorandum).⁵⁸

Romania's domestic legal regulations regarding banking supervision are based on ensuring the health and soundness of banks and the banking system.⁵⁹ According to the provisions of Law No. 312/2004 on the Statute of the National

55 European Central Bank, 2023b, p. 3.

56 European Central Bank, 2023b, p. 7.

57 European Central Bank, 2023b, p. 9.

58 European Central Bank, 2023b, p. 11.

59 Cosmescu, 2015, p. 9.

Bank of Romania, the NBR has exclusive power to authorise credit institutions and is responsible for the prudential supervision of the credit institutions it has authorised to operate in Romania.⁶⁰ Government Emergency Ordinance No. 99/2006 regarding credit institutions and capital adequacy provides that the NBR ensures the prudential supervision of credit institutions registered in Romania (including their subsidiaries established in other member states or third countries).⁶¹ The objective of supervision is to monitor compliance with prudential rules and indicators according to regulations to assess the risks to which banks are exposed. The results of banking supervision consist of preventing and limiting risks specific to banking activities, protecting depositors' interests, and ensuring the stability of the banking system.⁶²

If we take into account the content of banking supervision in Romania, a structure can be conceived based on three pillars; namely: banking risk assessment, proportionality, and capital requirements and liquidity. Banking risk assessment consists of a review of how banks manage and evaluate the risks to which they may be exposed (e.g. credit, operational, market, liquidity, and other significant risks), risks to which the bank exposes the financial system, and risks identified through stress test simulations. Proportionality refers to the verification and evaluation of the nature, extent, and complexity of bank activities. The pillar of capital requirements and liquidity means that the NBR determines whether the bank is managed prudently and if the risks are covered according to the risk profile. Moreover, the NBR demands additional capital and liquidity to improve its governance framework.⁶³

The NBR exercises macro- and micro-prudential supervision of its financial systems. On the one hand, the objective of macro surveillance is to minimise systemic risk by limiting the malfunctioning of the financial system. This requires focusing on banks of systemic importance. Macro-surveillance instruments include the countercyclical capital buffer, systemic risk buffer, and systemic institution buffer. Meanwhile, the objective of micro-surveillance is to monitor the risks that may affect the liquidity of banks. This implies increased attention to banks' solvency and liquidity. Micro-surveillance instruments include capital, liquidity, and governance requirements.⁶⁴

The SRM and European Deposit Insurance Scheme are further steps toward a banking union. Because Romania is outside the Eurozone, it is not obligated to participate in the SRM or other pillars of the banking union. However, as an EU Member State, Romania also needs to cooperate.

60 Art. 25 of Lege nr. 312 din 28 iunie 2004 privind statutul Băncii Naționale a României, Monitorul Oficial, nr. 582 din 30 iunie 2004.

61 Art. 1 of Ordonanța de urgență nr. 99 din 6 decembrie 2006 privind instituțiile de credit și adecvarea capitalului, Monitorul Oficial, nr. 1.027 din 27 decembrie 2006.

62 Cosmescu, 2015, p. 9.

63 Cosmescu, 2015, p. 10.

64 Cosmescu, 2015, p. 14.

3. The monetary aspects of crisis management

The COVID-19 crisis has given rise to not only health, but also economic challenges in all countries, including Romania. Countries and their institutions must proactively intervene to mitigate the negative effects of macroeconomic challenges, which include fiscal and monetary problems. Accordingly, the NBR was involved and aligned with specific measures through monetary policy and recommendations from the ESCB and the Bank for International Settlements. In March 2020, the Governing Council of the NBR held an emergency meeting and adopted measures to mitigate the impact of the COVID-19 outbreak on the Romanian population and companies. According to this, the monetary policy interest rate was reduced by 0.5 percentage points, from 2.5% to 2%; this narrowed the symmetric corridor formed by standing facility interest rates around the policy rate to $\pm 0.5\%$ from $\pm 1\%$. Thus, from 23 March 2020, the interest rate on the deposit facility was maintained at 1.50% and the interest rate on the lending facility (the Lombard rate) was reduced from 2.50% to 3.50%.⁶⁵ Moreover, together with the government, banks and creditors contributed to the measure to defer loan payments to firms and households for up to nine months under a government guarantee scheme. The beneficial effects stemming from the good position of the Romanian banking system in terms of capitalisation and a low level of non-performing loans consisted of providing liquidity to the national financial system to support the economic environment, lowering the ROBOR interest rate (to 2% instead 3%), and stopping massive cash withdrawals.⁶⁶

Regarding liquidity assurance, the NBR reduced the level of minimum reserve requirements for liabilities in RON and foreign currency – a still-limited convergence measure within the levels practiced in the Euro Area – and initiated the purchase of government securities in RON on the secondary market. This decision was unprecedented and much commented upon by analysts, as it was equivalent to conducting quantitative easing to provide easy financing to the state. Moreover, the NBR said it was prepared to further reduce the minimum reserve requirement on RON and foreign currencies and reconsider some prudential requirements related to the capitalisation and liquidity of commercial banks (in line with the recommendations of the ECB) and the treatment of loan portfolios. Notably, aggressive measures, as they have been labelled in the market, have been taken to the limit at which the RON exchange rate could be contained in the face of depreciation. We can expect that the stress created by the exchange rate of the RON against the euro during the pandemic would be part of the stabilisation effort required in the coming period of the national currency's entry into the European Exchange Rate Mechanism.⁶⁷

65 Banca Națională a României, 2020a.

66 Pop, Ioan-Franc and Diamescu 2021, p. 199.

67 Pop, Ioan-Franc and Diamescu 2021, p. 200.

In March 2020, given the high degree of uncertainty in economic and financial development, the Governing Council of the NBR decided to suspend the previously announced calendar of monetary policy meetings and hold them whenever necessary. The next meeting of the Governing Council of the NBR on monetary policy issues was held two months later, on 29 May 2020, when the following actions had been decided: reducing the monetary policy interest rate to 1.75%/year from 2.0%/year from 2 June; reducing the interest rate on the deposit facility to 1.25%/year from 1.50%/year and of the interest rate on the lending facility (the Lombard rate) to 2.25%/year from 2.50%/year; maintaining the current levels of reserve requirements for credit institutions' liabilities in RON and foreign currency; continuing repo operations and the purchase of government securities in RON on the secondary market.⁶⁸

The annual Consumer Price Index (CPI) inflation rate remained steady in March at 3.05% before falling to 2.68% in April (from 4.0% in December 2019). Its decline from December 2019 was driven by disinflationary base effects and a sharp decline in oil prices, along with the removal of the fuel excise tax. Lending activities remained relatively strong in March 2020; however, the effects of the pandemic were evident in April. The stock of loans to the private sector shrank slightly, with the annual growth rate falling from 5.7% to 6.9% during the previous month. The share of the RON component in total credit declined slightly from 67.1% to 67.6% in December 2019. Simultaneously, the RON/EUR exchange rate eased its fluctuations, oscillating within a narrow range, even in the context of improvement in the international financial market.⁶⁹

A subsequent meeting of the Governing Council of the NBR on monetary policy issues took place at the beginning of August 2020. The most important actions decided upon at this meeting were as follows: reducing the monetary policy interest rate to 1.50%/year from 1.75%/year from 6 August; reducing the interest rate on the deposit facility to 1.00%/year from 1.25%/year, and the interest rate on the lending facility (Lombard) to 2.00%/year from 2.25%/year; maintaining the current levels of reserve ratios for credit institutions' liabilities in RON and foreign currency; and continuing repo operations and the purchase of government securities in RON on the secondary market. During this period, the average annual CPI and harmonised index of consumer prices (HICP) inflation rates decreased in June to 3.3% and 3.2%, respectively, from 3.6% in April. At the same time, the RON/EUR exchange rate remained almost stable, even showing a slight downward trend in July, in line with movements in the region in the context of optimism generated by the major economic recovery plan agreed upon at the EU level.⁷⁰

The National Bank's Governing Council discussed monetary policy issues for the next time in November 2020. On this occasion, the following actions were decided:

68 Banca Națională a României, 2020b.

69 Ibid.

70 Banca Națională a României, 2020c.

maintaining the monetary policy interest rate at 1.50%/year; maintaining the interest rate on the deposit facility at 1.00%/year and the interest rate on the lending facility at 2.00%/year; reducing the reserve requirement rate for foreign currency liabilities of credit institutions from 5% to 6%; and maintaining the reserve requirement rate for liabilities in RON at 8%. Regarding the CPI inflation rate, the Governing Council's decision provides that the annual CPI inflation rate fell to 2.45 percent in September (2.68% in August) and 2.24% in October, dropping significantly below expectations, mainly on the back of a much larger-than-expected decline in vegetable and fruit prices. Thus, it fell from the last month of the second quarter, when it stood at 2.58%, while also sharpening its decline from the 4.04% level it reached at the end of the previous year.⁷¹

This gradual reduction and maintenance of the monetary policy interest rate allowed the rate to reach a minimum value of 1.25%/year at the beginning of 2021. The NBR retained this value until October 2021, when it increased it by 1.50%/year. This upward trend has not stopped until today; an increase of 0.5–1% was characteristic with the occasion of each meeting of the Governing Council of the NBR. From a value of 2% in January 2022, it reached an outstanding value of 7% in January 2023, which was maintained as of October 2023.

This increasing tendency can also be observed in the case of interest rates on deposits and lending facilities. Accordingly, the interest rate on deposit facilities rose from 1% in January 2022 to 6% at the beginning of 2023, while the interest rate on lending facilities reached 8% in January 2023, in comparison with the 3% applicable from the beginning of 2022. Similar to the monetary interest rate, the values of the deposit and lending facility rates remained the same during 2023. The maintenance of the reserve requirement rate for liabilities in RON and foreign currencies was also notable.

However, a significant increase in the CPI inflation rate is understandable. The average annual CPI inflation rate is expected to increase from 4.5% in November 2021 to 14.6% in November 2022. This excessively high value remained as of 2023. According to the latest decision of the Governing Council of the NBR, the annual inflation rate calculated based on the HICP (the inflation indicator for EU Member States) stood at 9.3% in August, similar to the level recorded in June 2023. Simultaneously, the average annual CPI and HICP inflation rates declined in August to 13.2% and 11.8%, respectively, from 14.2% and 12.5% in June, remaining below those prevailing in the region and Baltic countries.⁷²

71 Banca Națională a României, 2020d.

72 Banca Națională a României, 2023.

4. Summarizing thoughts

The aim of the present chapter on Romania's monetary policy was to provide an overview of Romania's state of preparedness for joining the euro area, place and role in the banking union as an outsider but EU member state, and measures during the crisis.

An important conclusion is that Romania seriously lags behind most nominal convergence criteria, placing the adoption of a single currency on a rather distant horizon. In particular, Romania's degree of fulfilment of the nominal convergence criteria must be taken up in conjunction with its fulfilment of the real convergence criteria and optimal currency area criteria as well as a cost-benefit analysis. In the context of real convergence criteria, per-capita GDP is one of the most suitable indicators. According to Eurostat data, Romania's real GDP per capita was EUR 10,110 euro per capita in 2022, 35.03% of the EU27 average and 31.90% of the average of the 20 countries forming the Eurozone. Therefore, Romania still has a long way to go, even if its dynamics of real GDP growth rates were higher than those of other countries during the 2000–2020 period.

Despite these backlogs, it is important to highlight the RON/EUR exchange rate as a positive example. In 2020, against the extreme circumstances triggered by the health crisis, the overall dynamics of RON/EURO volatility indicated a slight depreciation of the national currency against the euro. Although a gradual depreciation of the Romanian RON was suggested in 2020, which could have led to a value of 5.00 RON/EUR, the exchange rate remained below 5.00, even in 2023.

In addition to the specific economic parameters that can be described in numerical terms (nominal and real convergence criteria), another important issue is public opinion regarding the introduction of a common currency. In this context, the Flash Eurobarometer 527 was published in June 2023. The respondents generally (71%) favoured the introduction of the euro in Romania and believed this would have positive rather than negative consequences for countries already using the euro.

Regarding the banking union, the Single Rulebook, and banking supervision, the most important aspects referring to Romania were discussed. In particular, it is notable that Romania follows a dual supervisory mechanism as it is subject to both national (NBR) and European supervising authorities for banking. However, in January 2023, the ECB signed a Memorandum of Understanding with the national competent authorities of six EU Member States that are not part of European banking supervision, one of which is Romania (along with the Czech Republic, Denmark, Hungary, Poland, and Sweden).

Romania's domestic legal regulations regarding banking supervision are based on ensuring the health and soundness of banks and the banking system. In accordance with EU common regulations, the content of banking supervision in Romania consists of a structure based on three pillars: banking risk assessment, proportionality, and capital requirements and liquidity.

This chapter also discussed the monetary aspects of crisis management processes, the most important decisions of the Governing Council of the NBR on monetary policy issues from 2020 to 2023, and how the monetary policy interest rate changed from 1.25%/year at the beginning of 2021 to 7% at the beginning of 2023 (where it remained until October 2023). Further, the changes in the inflation rate are also presented.

In conclusion, Romania has made a lot of progress in becoming a member of the euro area on the basis of the real and nominal convergence criteria. The positive effects of this move include a relatively stable exchange rate (even in times of crisis) and public affirmation of the introduction of the euro.

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SERBIA: CHALLENGES FOR MONETARY POLICY DURING THE TRANSITION PERIOD



DUŠAN V. POPOVIĆ

Abstract

The National Bank of Serbia, acting as a central bank, was established as an independent and autonomous institution accountable for its work in the National Assembly of the Republic of Serbia. The status, organisation, mandate, and functions of the central bank, as well as its relations with other national and international institutions, are regulated by the Constitution of the Republic of Serbia, the Act on the National Bank of Serbia, and the Statute. The National Bank of Serbia has engaged in long-standing cooperation with the European Central Bank. Over the last 20 years, the two authorities have conducted numerous cooperation projects and (in 2018) signed a memorandum of understanding. Since 2014, the National Bank of Serbia and the European Central Bank have held regular annual bilateral meetings. In addition to capacity-building cooperation agreements, the two authorities signed the Agreement on Cooperation in the area of preventing counterfeiting and detecting counterfeit euro banknotes in Serbia. Based on this agreement, the European Central Bank will deliver the technical specifications of the original euro banknotes and the classification of counterfeits to the Serbian central bank. The main challenge faced by the national authorities in recent years has been the COVID-19 crisis. Both the National Bank of Serbia and the Government undertook measures in response to the COVID-19 pandemic. The central bank's measures consist of monetary policy and a moratorium on debt payments. In addition, the Government of Serbia adopted the Program of Economic Measures to reduce the negative effects caused by the coronavirus pandemic and support the Serbian economy. The programme included tax policy measures, direct assistance to the private sector, measures to preserve liquidity in the private

Dušan V. Popović (2024) 'Serbia: Challenges for Monetary Policy During the Transition Period'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 789–804. Miskolc–Budapest, Central European Academic Publishing.

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sector, and other measures. Notably, the COVID-19 crisis was complemented by an energy crisis, which was further highlighted by recent geopolitical developments.

Keywords: *monetary policy, Serbia, European integration, central bank, convergence*

1. Introduction

The monetary policy decisions made by central banks are intentional responses to macroeconomic conditions. The systematic response reflects the preferences of policymakers (e.g. price stability or a high employment rate), which may change over time. Monetary policy affects the economy through financial channels such as interest rates, exchange rates, and financial asset prices. This contrasts with fiscal policy, which relies primarily on changes in taxation and government spending.

During the transition to market economies, the economies of formerly socialist countries, including Serbia, underwent major changes. Regarding monetary policy, central banks changed their monetary policy goals, regimes, and instruments. Although the starting points of the formerly socialist countries were not identical, their central banks focused on low and stable inflation during the transition period. The Serbian economy, which can be characterised as a rather small and open economy, had deep roots in euroization and hyperinflation in the 1990s. Since 2012, however, the central bank and government have turned this situation around; imbalances have been reduced, growth structures have changed, prices and exchange markets have stabilised, and structural reforms have been implemented. In Serbia, the key policy rate is the main instrument of monetary policy in an inflation-targeting regime. Other monetary policy instruments also play supporting roles. These instruments include open market operations, required reserves, lending and deposit facilities (standing facilities), and foreign exchange market interventions. Several specific aspects of Serbian monetary policy should be analysed: the convergence of the Serbian economy with the European Union (EU) and Eurozone, the division of competences within the central bank and between the central bank and other institutions, the cooperation of the Serbian central bank with the European Central Bank (ECB), and crisis management.

2. Convergence of the Serbian economy

The process of convergence in the EU is usually viewed in light of meeting the Maastricht criteria or the so-called ‘nominal convergence’ criteria. Nominal convergence refers to the predefined requirements for accessing the European

Monetary Union (EMU), which are related to inflation, long-term interest rates, exchange rates, budget deficits, and public debt. However, the concept of real convergence is equally important, particularly in the aftermath of the financial crisis that European countries faced over the past decade. The concept of real convergence implies a reduction in the difference between national economies in terms of ‘real economic indicators’, such as those related to production and employment.¹ Once adopted, the Maastricht criteria were applied both to ‘old’ EU Member States and the Central and Eastern European countries that joined the EU more recently. Economic theory argues that the Maastricht criteria are too restrictive and perhaps even inappropriate for new member states with considerably less developed economies. New Member States have a greater need for public expenditures to speed up convergence in areas such as infrastructure, institutional building, and the environment.² Similar arguments may be made regarding Serbia as a candidate EU country.

Serbia applied for EU membership in December 2009. Based on the recommendations of the European Commission, the European Council granted candidate status to Serbia in March 2012. Membership negotiations began in 2014. After joining the EU, Serbia adopted the euro as legal tender as soon as it fulfilled the relevant Maastricht criteria. Under the general fiscal rules prescribed by the Budget System Act, government sector debt, including liabilities based on restitution, should not exceed 60% of GDP, while the target medium-term fiscal deficit should represent 0.5% of GDP.³ The general government debt-to-GDP ratio decreased from a peak of over 70% in 2015 to 53% in 2019. However, it increased to 57.8% in 2020 as a result of the high crisis-induced deficit and broadly stabilised at 57.1% in 2021 and 55.10% in 2022.⁴ The National Bank of Serbia (NBS) has been implementing a full-fledged inflation targeting regime since 2009, with elements of the regime gradually being introduced into practice since 2006. In December 2008, the NBS Monetary Policy Committee adopted a memorandum on inflation targeting as a monetary strategy, which defines the formal implementation of the inflation targeting regime.⁵ The headline inflation target for the period from January 2023 to December 2025 is set at the level of 3%, with a tolerance band of $\pm 1.5\%$.⁶

Given the rather vague perspective of Serbia’s accession to the EU and, consequently, to the EMU, both state officials and academics refrain from making

1 Durkalić, Fedajev, Furtula and Stanišić, 2019, p. 699.

2 Mihaljek, 2006, p. 2.

3 Budget System Act, *Official Journal of the Republic of Serbia*, 54/2009, 73/2010, 101/2010, 101/2011, 93/2012, 62/2013, 63/2013, 108/2013, 142/2014, 68/2015, 103/2015, 99/2016, 113/2017, 95/2018, 31/2019, 72/2019, 149/2020, 118/2021, 138/2022 and 118/2021, Art. 27e.

4 For a detailed analysis of the economic situation in Serbia prior to 2015, see: Jovancai Stakić and Stokanović, 2015, pp. 111–122.

5 National Bank of Serbia, 2008.

6 See: *National Bank of Serbia’s Memorandum on Inflation Targets until 2025* [Online]. Available at: https://www.nbs.rs/export/sites/NBS_site/documents-eng/monetarna-politika/memorandum_ciljevi_do_2025_eng.pdf (Accessed: 15 November 2023).

predictions about the date of the accession. A simulation using the macroeconomic model undertaken by Neck and Weyerstrass showed that Serbia's accession to the EU and introduction of the euro would bring about a higher real gross domestic product, more employment, and more sustainable public finances. These benefits of joining the Eurozone are primarily due to increased productivity. All the simulations were performed from 2018 to 2040. The baseline simulation assumes that Serbia has not joined the EU. In the second simulation, it is assumed that Serbia joined the EU in 2025 but did not introduce the euro until 2040. Finally, in the third simulation, it was assumed that Serbia would join the Eurozone by 2028. According to the simulation results, the average real GDP growth rates are 3.0%, 3.1 %, and 3.2% in the baseline, EU accession, and Eurozone accession scenarios, respectively.⁷

3. Institutional framework

The NBS acts as an institution independent and autonomous from the executive and legislative branches of the government. Following an analysis of the status and competencies of the central bank, we explore its relationship with the ECB.

3.1. Division of competences

The NBS, acting as a central bank, was established as an independent and autonomous institution that is accountable for its work in the National Assembly of the Republic of Serbia. The status, organisation, mandate, and functions of the NBS, as well as its relations with other national and international institutions, are regulated by the Constitution of the Republic of Serbia,⁸ the Act on the National Bank of Serbia (hereinafter: the NBS Act),⁹ and the Statute of the National Bank of Serbia (hereinafter: the NBS Statute).¹⁰ The NBS, its bodies, and the members of these bodies are prohibited from seeking or taking instructions from government bodies and institutions.¹¹ However, the government and related bodies are prohibited from threatening the autonomy and independence of the NBS, its governing bodies, and their members from carrying out their tasks.¹²

7 Neck and Weyerstrass, 2019, p. 285.

8 *Official Journal of the Republic of Serbia* 98/2006 and 115/2021, Art. 95.

9 *Official Journal of the Republic of Serbia* 72/2003, 55/2004, 85/2005, 44/2010, 76/2012, 106/2012, 14/2015, 40/2015 and 44/2018.

10 *Official Journal of the Republic of Serbia* 12/2013, 18/2015, 72/2015 and 50/2018.

11 NBS Act, Art. 2.

12 NBS Act, Art. 2.

The primary objective of the NBS is to achieve and maintain price stability.¹³ Without countering its primary objective, the NBS also contributes to maintaining and strengthening the stability of the financial system. Additionally, without countering these other objectives or its independence and autonomy, the NBS may support the pursuit of economic policy by the Government of the Republic of Serbia, operating in accordance with the principles of a market economy.¹⁴ The monetary policy objective is expressed as a numerical target: the annual percentage change in the Consumer Price Index. The target until the end of 2023 was 3.0%, with a tolerance band of $\pm 1.5\%$.¹⁵

The NBS is entrusted with the following tasks: (i) determine and implement the monetary and foreign exchange policies; (ii) manage foreign exchange reserves; (iii) determine and implement, within its scope of authority, the activities and measures aimed at maintaining and strengthening the stability of the financial system; (iv) issue banknotes and coins and manage cash circulation; (v) regulate, supervise, and promote the smooth performance of domestic and cross-border payment transactions, in accordance with law; (vi) issue and revoke bank operating licenses, carry out prudential supervision of bank operations, and perform other activities in accordance with the law governing banks; (vii) issue and revoke licenses to carry on the insurance business, exercise the supervision of such business, issue and revoke authorisations for the conduct of specific activities within the insurance business and perform other activities in accordance with the law governing insurance; (viii) issue and revoke licenses to carry on financial leasing operations, exercise supervision of such operations and perform other activities in accordance with the law governing financial leasing; (ix) issue and revoke the operating and fund management licenses of voluntary pension fund management companies, supervise this business, and perform other activities in accordance with the law governing voluntary pension funds; (x) issue and revoke licenses of payment institutions to provide payment services and licenses of electronic money institutions to issue electronic money, supervise the provision of payment services and the issue of electronic money, and perform other activities in accordance with the law governing payment services; (xi) pursue activities relating to the protection of rights and interests of the consumers of services provided by banks, insurance companies, financial leasing providers, voluntary pension fund management companies, payment service providers and electronic money issuers, in accordance with law; (xii) determine whether the conditions for initiating the resolution procedure in respect to banks and/or members of a banking group are met, conduct the resolution procedure, decide on the resolution tools and measures to be applied and perform other activities relating to bank resolution, in accordance with the law governing banks; (xiii) issue and revoke operating

¹³ For further analysis, see: Furtula, 2007, p. 32.

¹⁴ NBS Act, Art. 3.

¹⁵ Decision on the adoption of the Monetary Policy Program of the National Bank of Serbia in 2023, *Official Journal of the Republic of Serbia* 137/2022, Art. 2.

licenses to and from payment system operators, exercise supervision of their operations and perform other activities, in accordance with the law governing payment services; (xiv) issue and revoke authorisations to perform exchange operations, supervise exchange and foreign exchange operations and perform other operations, in accordance with the law governing foreign exchange operations; (xv) perform statutory tasks or tasks established by contracts on behalf of the Republic of Serbia without threatening its autonomy and independence; and (xvi) perform other tasks, in accordance with law.¹⁶

The NBS performs its tasks through three main bodies: the Executive Board, the governor, and the Council of the Governor.¹⁷ The governor is appointed by the National Assembly upon the proposal of the President of the Republic of Serbia for a six-year renewable term in office. The person eligible for the office of governor must be a national of the Republic of Serbia, meet the general requirements for employment, hold a university degree, and have at least ten years of professional experience in the fields of economics, banking, and finance. The Governor's main task is to implement the decisions of the Executive Board and of the Council. The Executive Board consists of an NBS governor and vice-governors. It determines monetary and foreign exchange policies and performs activities aimed at maintaining and strengthening the stability of the financial system. Some of its competencies include the elaboration of the monetary policy programme of the NBS, the manner of setting the interest rates of the NBS, the terms and conditions of issuing securities, the terms and conditions under which the NBS performs open-market and discount operations, the short-term loan policy, and the determination of the RSD exchange rate policy. The Executive Board sets the key policy rate and other interest rates applied by the NBS during the implementation of monetary policy. It also issues regulations related to the supervisory function of the NBS. Further, the Executive Board makes decisions at meetings through a majority vote of all members. In the event of a tie, the governor holds a cast vote. Finally, the Council of the Governor consists of five members, including the president, appointed by the National Assembly to propose the Parliamentary Committee in charge of finance. Council members were appointed for a five-year renewable term in office. The Council submits a report on its work to the National Assembly whenever deemed necessary but no less than twice a year. The main competencies of the Council include the adoption of the NBS Statute on the proposal of the Executive Board, the determination of the exchange rate regime for the dinar, the proposal of the Executive Board and (with the government's consent) the adoption of the strategy of foreign exchange reserve management, the proposal of the Executive Board, and the adoption of a decision to join international financial organisations and institutions. The Council makes decisions based on the majority vote of all members.

16 NBS Act, Art. 4.

17 NBS Act, Section II.

On the one hand, relations between the NBS and the government and the National Assembly are regulated under the NBS Act.¹⁸ The NBS is required to submit the monetary policy programme for the forthcoming year to the National Assembly – for information purposes only – by no later than 15 December of the current year. The monetary policy programme must be published in an official journal. Further, the NBS governor is required to explain the National Assembly’s monetary policy program. The NBS is also required to submit ‘backward looking reports’ to the National Assembly, which comprise semi-annual and annual reports on monetary policy that explain all the factors affecting the implementation of the policies, as well as an annual report on the stability of the financial system. In addition to reports related to monetary policy and the stability of the financial system, the NBS is required to submit a general annual report on its activities and results to the National Assembly by no later than 30 June of the following year. The National Assembly may not provide any instructions to the NBS based on the monetary policy programme or other submitted NBS reports. Furthermore, to submit different types of reports to the National Assembly, the NBS is entitled to propose the former laws within its scope of competence.

The government and the NBS are allowed to exchange opinions and information while maintaining their respective independence and decisional autonomy. The NBS governor may be invited to attend government meetings. The government and/or relevant ministries may submit drafts of laws relating to the objectives, tasks, rights, and obligations of the NBS to obtain an opinion thereon. The government and/or the relevant ministry is required to submit to the NBS a draft of the memorandum on budget, economic, and fiscal policies and a Draft Budget Act for the purpose of obtaining an opinion thereon.¹⁹ Meanwhile, the Ministry of Finance is required, at least once a year, to provide the NBS with a written notification of planned new borrowings from the Republic of Serbia abroad, as well as the expected disbursement of foreign loans and repayment under such loans, to allow the NBS to analyse the impact of such borrowing on monetary policy. The Ministry of Finance is also required to notify the NBS of any transactions related to external borrowing in the Republic of Serbia.

Case law related to the competencies and activities of the NBS is rather scarce. In 2014, the Constitutional Court of the Republic of Serbia found that Art. 86b of the NBS Act does not comply with the Constitution.²⁰ Under this provision, the NBS, the governor, vice-governors, and other NBS employees cannot be held liable for the damage caused to the performance of the tasks of the NBS *unless it is proven that they did not act in good faith*. The Constitutional Court found that the subjective

18 NBS Act, Section VII.

19 For a comparative analysis of the relationship between the central bank and the government, see: Golubović and Dimitrijević, 2022, pp. 147–152; Jovanić, 2009, pp. 307–320. For a more critical assessment of the central bank independence, see: Siklos, 2008, pp. 802–816.

20 Constitutional Court of the Republic of Serbia, decision no. IUz–1243/2010, 23 December 2014.

criterion prescribed by Art. 86b of the NBS Act contradicts Art. 35 of the Constitution, which proclaims that everyone has the right to compensation for material or non-material damage inflicted on him by the unlawful or irregular work of a state body, entities exercising public powers, bodies of the autonomous province, or local self-government.

3.2. Relations with the European Central Bank

The NBA has long cooperated with the ECB. In 2011, the ECB launched a central bank cooperation programme with the NBS funded by the EU. The aim of the programme was to support the NBS in implementing the central banking standards of the EU. The 3-year programme, which was a follow-up to an analysis of the specific needs of the NBS carried out from 2008 to 2009, covered eleven different areas of cooperation: (i) financial sector supervision; (ii) legal harmonisation; (iii) liberalisation of capital movements; (iv) foreign exchange reserve management; (v) monetary and exchange rate operations; (vi) financial services consumer protection; (vii) EU accession support; (viii) economic analysis and research; (ix) statistics; (x) payment systems; and (xi) financial stability. The aim of the programme was to help the NBS prepare strategies, internal policies, and economic models that meet the standards applied by central banks in the EU as well as laws that transpose the EU regulatory regime into Serbian law. The NBS staff acquired expertise through training courses and visits to institutions in EU Member States.

A similar project, entitled ‘Strengthening of the institutional capacities of the NBS in the process of EU accession’, was implemented in cooperation with the ECB and the European System of Central Banks (ESCB) from September 2018 to March 2020. The objective of this project was to prepare the NBS to join the ESCB under Serbia’s accession to the EU. The NBS then participated in a capacity-building project; namely, the regional project ‘Programme for strengthening the central bank capacities in the Western Balkans with a view to the integration to the European System of Central Banks’. The project lasted from 2019 to 2021 and was intended for central banks and banking supervisory authorities in EU candidate and potential candidate countries. The Deutsche Bundesbank, together with nineteen national central banks, and with contributions by the ECB, organised an intensive regional training programme on key central banking and supervision issues in the areas of: (i) banking supervision; (ii) financial stability; (iii) financial consumer protection and financial inclusion; (iv) recovery and resolution; (v) monetary policy; (vi) payment systems; (vii) statistics; (viii) compliance and European integration; (ix) governance policies; (x) accounting; and (xi) internal audit. Finally, Serbia also participates in the ‘Pericles 2020’ programme, which funds staff exchanges, seminars, trainings, and studies for law enforcement, judicial authorities, banks, and others

involved in combating euro-counterfeiting to prevent and fight counterfeiting and related fraud.²¹

In July 2014, the ECB and the NBS held the first bilateral dialogue in Frankfurt, when, on the sidelines of the meeting, then-president of the ECB, Mario Draghi, and the Governor of the NBS, Jorgovanka Tabaković, signed an agreement on co-operation in the area of preventing counterfeiting and detecting counterfeit euro banknotes in Serbia. With this agreement, the ECB promised to deliver the technical specifications of the original euro banknotes and the classification of counterfeits to the NBS. Since this first meeting, bilateral dialogues have been held once a year in Frankfurt and Belgrade.

Following a series of joint cooperation projects, the NBS signed a comprehensive memorandum of understanding (MoU) with the ECB in December 2018.²² The purpose of the MoU is to formalise cooperation and information-sharing mechanisms between the ECB and the NBS. Each signatory is required to provide the other party with any information necessary for exercising the other party's supervisory tasks on a timely basis upon request or on its own initiative, where appropriate and insofar as feasible. The parties endeavour to preserve the confidentiality of the information received to the extent permitted by laws, regulations, and requirements. Each party is required to hold confidential information received from the other party except if it is legally obligated to disclose confidential information.²³ The MoU also regulates cooperation between the NBS and ECB in relation to authorisation, qualifying holdings assessments, and the assessment of directors. Signatories are required to notify each other without delaying their applications for approval to establish cross-border establishments or make acquisitions. Upon request, the parties will inform each other whether the applicant is in substantial compliance with the applicable laws and regulations and whether it may be expected, in light of its administrative structure and internal controls, to manage the supervised entity or cross-border establishment in an orderly manner. On request, the parties are required to assist each other by verifying or supplementing any information submitted by the applicant.²⁴ Additionally, on request, each signatory is required to inform the other of non-public administrative pecuniary penalties, enforcement, or sanction decisions with respect to cross-border establishments or supervised entities, insofar as they relate to the operation of cross-border establishments in that

21 The programme is governed by the Regulation (EU) 2021/840 of 20 May 2021 establishing an exchange, assistance and training programme for the protection of the euro against counterfeiting for the period 2021–2027 (the 'Pericles IV' programme), and repealing Regulation (EU) No 331/2014, OJ L 186, 27.5.2021, 1–11.

22 The MoU is available at the website of the National Bank of Serbia: *Memorandum of Understanding between the SSM-ECB and the National Bank of Serbia* [Online]. Available at: https://www.nbs.rs/export/sites/NBS_site/documents/ostalo/memorandum/MoU-between-the-central-bank-of-Serbia-and-the-ECB.pdf (Accessed: 15 November 2023).

23 MoU, Art. 3.

24 MoU, Art. 7.

jurisdiction.²⁵ The signatories are also required to assist each other, when feasible, in conducting on-site inspections of cross-border establishments situated in the other party's jurisdiction.²⁶ Given that the document signed by the NBS and the ECB is merely a MoU, it does not create any directly or indirectly enforceable rights for signatories or third parties.

During the COVID-19 crisis, the NBS requested assistance from the ECB. The two parties reached an agreement to establish a repo line to provide liquidity in euros to Serbian financial institutions that should arise under the conditions of market disruptions caused by the pandemic. Through this repo line, the ECB may provide liquidity in euros to the central banks of countries that are not members of the Eurozone in exchange for the corresponding collateral. The repo line enables the NBS to borrow a maximum of EUR 1 billion from the ECB. Each individual used funds for a maximum of three months.

4. Crisis management

The three main challenges the national authorities faced in recent years were the European monetary crisis, the COVID-19 crisis, and the energy crisis, with the latter intensified by the outbreak of the Russian-Ukrainian conflict. The reactions of Serbian authorities to these events are analysed in the present section.

4.1. Reaction to the European monetary crisis

In response to the European monetary crisis, which started in 2007, the NBS and the Government of Serbia undertook measures to increase the use of dinars in monetary transactions. The dinar (RSD) has been the Serbian currency since the Middle Ages, with the Serbian dinar mentioned for the first time in documents from late 1214, at the time of Stefan the First-Crowned. Although the contemporary Serbian dinar is the only official currency, both citizens and businesses tend to use the euro as a reference currency. This is one of the consequences of the turbulent period that the country went through at the end of the twentieth century, characterised by a high level of inflation. Research undertaken by the European Bank for Reconstruction and Development (EBRD) in 2010 showed that Serbia was one of the most euroised economies in Eastern Europe and on bank balance sheets. At 72 per cent, loan euroization in Serbia was higher than in most Eastern European countries – in both fixed exchange rate and inflation-targeting regimes in Eastern Europe, loan euroisation is no more than 60 per cent and typically less. The Serbia's median

²⁵ MoU, Art. 9.

²⁶ MoU, Art. 10.

household euro cash holdings exceeded those of any other Central or Southeastern European country.²⁷

In March 2012, this situation led to the adoption of a set of measures and activities aimed at enhancing the use of dinars in Serbia's financial system, called the Dinarization Strategy. The NBS considers that greater use of the dinar would result in a more powerful monetary policy transmission mechanism, allowing for the more efficient achievement and maintenance of price stability as its principal objective. Consequently, since 2011, dinarisation has been highlighted as one of the objectives of the NBS in the NBS Monetary Policy Programme. In 2012, the NBS and Government of the Republic of Serbia signed the Memorandum on the Strategy of Dinarisation of the Serbian Financial System and reaffirmed their commitments in 2018. The Memorandum defined the steps that the two institutions need to undertake to boost the use of the dinar in Serbia; specifically, this work rests on three interconnected pillars: (i) strengthening the macroeconomic environment characterised by low and stable inflation, a stable financial system, and sustainable economic growth; (ii) promoting dinar instruments and markets, with special emphasis on the development of the dinar securities market; and (iii) developing and improving FX hedging instruments in the non-banking sector. Under the Dinarisation Strategy, the government undertook additional measures, such as developing the domestic dinar financial market, increasing dinar loans and encouraging banks to rely more on dinar sources of funding. As a result of these additional measures, as of 2015, government dinar securities may have also been traded on the Belgrade Stock Exchange, which contributed to the development of the dinar capital market in Serbia. In 2014, the government adopted a programme for subsidising interest rates exclusively on dinar corporate loans, with a maximum repayment term of 18 months. Approximately RSD 130 billion of loans have been approved under the program.²⁸

The two memorandum signatories have committed to monitoring and analysing the degree of dinarisation and regularly inform the public about the measures and activities being taken, as well as about the progress achieved in the process of dinarisation. For this purpose, the NBS publishes a quarterly Report on Dinarisation of the Serbian Financial System. In its latest²⁹ report, the NBS indicated that the share of dinars in total corporate and household deposits will increase to a record high in Q1 2023. However, when only new deposits are observed in Q1 2023, this share decreases. At the end of Q1 2023, the degree of dinarisation of Serbia's public debt decreased compared to the end of the previous quarter (specifically, it dropped to 22.9%); more broadly, this trend began in Q3 2021.³⁰

27 Chailloux, Ohnsorge and Vavra, 2010, p. 1.

28 National Bank of Serbia and Government of the Republic of Serbia, 2018, Section 4.2.

29 As of September 2023.

30 All reports are available at the NBS website: *Report on Dinarisation of the Serbian Fiscal System* [Online]. Available at: <https://www.nbs.rs/en/drugi-nivo-navigacije/publikacije-i-istrazivanja/dinarizacija/> (Accessed: 11 October 2023).

4.2. Reaction to the COVID-19 crisis

Both the NBS and the Government of the Republic of Serbia undertook measures in response to the COVID-19 pandemic. The NBS measures can be classified into two groups: (i) monetary policy measures and (ii) moratoriums on debt payments. In March 2020, the NBS Executive Board decided to lower its key policy rate by 50 basis points to 1.75%, while narrowing the corridor of its main interest rates from ± 1.25 percentage points to ± 1 percentage point relative to the key policy rate. Consequently, the deposit facility rate was reduced by 25 basis points to 0.75%, whereas the lending facility rate was reduced by 75 basis points to 2.75%. The following month, the rate was reduced by another 25 basis points to 1.50%, which was the lowest key policy rate in the inflation-targeting regime. The NBS also provided dinar and foreign currency liquidity to the banking sector in the state of emergency by applying additional EUR/RSD swap auctions and repo operations (the FX swap auctions were discontinued in March 2021 and the repo securities purchase auctions were discontinued in October 2021). Finally, the NBS provided dinar liquidity to the banking system by repurchasing dinar government securities. The second type of NBS measures consisted in prescribing a moratorium on debt payments. In March 2020, the NBS adopted a decision on temporary measures to preserve financial system stability³¹ and a decision on temporary measures for lessors aimed at preserving the stability of the financial system.³² This set of decisions was made to prevent the growth of non-performing loans facing Serbia's banking sector. A moratorium was envisaged for all debtors (natural persons, farmers, entrepreneurs, the corporate sector). However, debtors were allowed to decide whether to accept an offer from a bank/lessor, which implied a suspension of debt payments for at least 90 days (i.e. the duration of the state of emergency).

In addition to the measures of the central bank, the Government of Serbia adopted a programme of economic measures for reducing the negative effects caused by the COVID-19 pandemic to support the Serbian economy in March 2020. The program, worth EUR 5.1 billion (or RSD 608.3 billion), included tax policy measures, direct assistance to the private sector, measures to preserve liquidity for the private sector, and other measures.³³ The first set of government measures was related to the deferral of taxes and contributions for the duration of the state of emergency and the payment of those liabilities beginning at the earliest in 2021, as well as the deferral of income tax payments in the second quarter. The objective

31 *Official Journal of the Republic of Serbia* 33/2020.

32 *Official Journal of the Republic of Serbia* 33/2020.

33 For the Program, see: *Програм економских мера – за смањивање негативних ефеката проузрокованих пандемијом вируса Ковид 19 и подршку привреди Србије* [Program ekonomskih mera – za smanjivanje negativnih efekata prouzrokovanih pandemijom virusa Kovid 19 i podršku privredi Srbije] [Online]. Available at: https://privreda.gov.rs/sites/default/files/inline-files/Ekonomske-Mere_prezentacija_konacno.pdf (Accessed: 11 October 2023).

of this measure was to facilitate tax relief and preserve liquidity. The second set of government measures consisted of direct assistance to entrepreneurs and micro-, small-, and medium-sized enterprises through the provision of three minimum wages, as well as to large private sector enterprises, for which a payment of 50% of the net minimum wage was envisaged during the state of emergency. The third group of measures consisted of providing liquidity to the economy through loans from the Development Fund of the Republic of Serbia, and a guarantee scheme for supporting the economy through the banks. This measure was allocated the largest share of the funding from the economic programme: RSD 264 billion (4.8% of GDP). Other measures included a moratorium on dividend payments until the end of 2020, except for public undertakings, and a payment of EUR 100 to all adult citizens.

4.3. Reaction to the energy crisis

Several government agencies and bodies regulate the energy sector in Serbia; the two most important are the Ministry of Mining and Energy and the Energy Agency of the Republic of Serbia (hereinafter: the AERS). The Ministry of Mining and Energy is responsible for developing and implementing policies related to Serbia's energy sector. It oversees the country's energy strategy, efficiency, renewable energy, and security. Meanwhile, the AERS is an independent regulatory body that oversees the operation of electricity and natural gas markets in Serbia. It regulates prices, network access, the quality of service, and technical and safety standards. Serbia is a member of the Energy Community, a regional organisation that promotes the development of a sustainable energy market in Southeast Europe.³⁴ Membership in the Energy Community implies the harmonisation of energy laws and regulations with those of the EU. The umbrella law which regulates the energy sector in Serbia is the Energy Act.³⁵ The Energy Sector Development Strategy of the Republic of Serbia up to 2025, with projections up to 2030 (hereafter, the Energy Strategy),³⁶ identified current problems and defined the main priorities for all segments of the energy sector: electricity, heat, coal, oil, gas, renewable energy sources, and energy efficiency.³⁷

The energy sector in Serbia is dominated by companies that are partly or fully owned by the state, which limits their capacity to invest given that their pricing policy is heavily influenced by the government's social welfare objectives. Indeed, energy prices in Serbia are low, especially for electricity. Further, in Serbia, budget assistance is available to help energy-jeopardised customers pay their electricity

³⁴ See: Section 2.2.1. *supra*.

³⁵ *Official Journal of the Republic of Serbia* 145/2014, 95/2018, 40/2021, 35/2023 and 62/2023.

³⁶ *Official Journal of the Republic of Serbia* 101/2015.

³⁷ Serbia's approach to energy security was initially specified in 2005, in the Energy Development Strategy until 2015 (*Official Journal of the Republic of Serbia* 44/2005). For an in-depth analysis, see: Dimitrijević, 2018, pp. 140–141.

and gas bills; currently, this support extends to nearly 70,000 households and costs the state around EUR 10 million per year. All socially vulnerable citizens and recipients of child allowances have the right to reduce their electricity and gas bills without submitting an application; other citizens receive subsidies based on the earnings of each household member and must submit an application to be granted the privilege.³⁸

In February 2023, Serbia received financial aid from the EU to address its energy crisis. Financial aid was provided through the Financial Agreement for the Energy Support Package of the European Union to Serbia, worth EUR 165 million. This aid was made available for the implementation of the Serbian Government's Road Map for Energy Support, which describes what EU funds should be spent.³⁹ The plan included six measures. The first measure comprised subsidies for vulnerable households; thus, at least the same number of households will be protected in 2023 as in the previous year. The second measure protects small- and medium-sized enterprises from high electricity prices to help them continue operating; of these enterprises, at least the same number of companies – 70,000 – will be supported by 2023 as in the previous year. The third measure involves saving energy through incentives for electricity consumers. The fourth measure consists of increasing competition in the gas and electricity markets, which implies the separation and certification of all gas operators, opening of the gas market, and auctions for producers of electricity from renewable sources. The fifth measure is energy security, which implies the co-financing of projects and the adoption of investment plans in the power, oil, and gas sectors. The sixth measure refers to the promotion of energy efficiency and renewable energy sources and includes a subsidy scheme for households in multifamily residential buildings to implement energy efficiency measures and subsidise solar panels and heat pumps for private homes, small- and medium-sized enterprises, and public buildings. In addition to the EU's financial aid, the EBRD approved a financing package of EUR 300 million in May 2023 to support Serbia's electricity sector. The funds will be channelled to the national electricity utility 'Elektroprivreda Srbije' to improve its liquidity. This project will support the government's strategy to decarbonise the electricity sector, phase out coal by 2050, develop a regulatory framework for the launch of renewable energy auctions, incentivise their rollout, and ensure both energy security and sustainable supply. No part of the EBRD loan has been used for existing coal assets.

38 For example, for a one-member household, the income limit is up to RSD 15,690 (cca EUR 135), for a household with two and three members up to RSD 22,845 (cca EUR 200), for a household with four to five members up to RSD 29,994 (cca 255 EUR), and for a household with six and more members up to RSD 37,719 (cca EUR 320).

39 Ministry of Mining and Energy, 2022.

5. Concluding remarks

The NBS, acting as a central bank, was established as an independent and autonomous institution that is accountable for its work in the National Assembly of the Republic of Serbia. The status, organisation, mandate, and functions of the NBS, as well as its relations with other national and international institutions, are regulated by the Constitution of the Republic of Serbia, NBS Act, and NBS Statute. The relations between the NBS, on the one hand, and the government and the National Assembly, on the other, are regulated by law. The NBS is required to submit the monetary policy programme for the forthcoming year to the National Assembly, but only for information purposes, no later than 15 December of the current year. This monetary policy programme must be published in an official journal. The NBS Governor is also required to explain the National Assembly's monetary policy program. The government and the NBS are allowed to exchange opinions and information while maintaining their respective independence and decisional autonomy. The NBS governor may be invited to attend government meetings. Further, the government and/or relevant ministries may submit drafts of laws relating to the objectives, tasks, rights, and obligations of the NBS to obtain an opinion thereon.

The NBS long cooperated with the ECB. Over the last 20 years, the two authorities have conducted numerous cooperation projects and signed an MoU (in 2018). The purpose of the MoU is to formalise cooperation and information-sharing mechanisms between the ECB and the NBS. Each signatory is required to provide the other party with any information necessary for exercising the other party's supervisory tasks on a timely basis upon request or on its own initiative, where appropriate and insofar as feasible. Since 2014, the NBS and ECB have held regular annual bilateral meetings. In addition to capacity-building cooperation agreements, the two authorities signed an agreement on cooperation in the area of preventing counterfeiting and detecting counterfeit euro banknotes in Serbia. Based on this agreement, the ECB will deliver the technical specifications of the original euro banknotes and the classification of counterfeits to the NBS.

The main challenge faced by the national authorities in recent years has been the COVID-19 crisis. Both the NBS and the government undertook measures in response to the pandemic. Specifically, the NBS implemented monetary policy measures and a moratorium on debt payments. Meanwhile, the Government of Serbia adopted a programme of economic measures to reduce the negative effects of the pandemic and support the Serbian economy; this programme included tax policy measures, direct assistance to the private sector, and measures to preserve liquidity in the private sector, among others. It is also important to note that the COVID-19 crisis was complemented by an energy crisis, which was further highlighted by recent geopolitical developments.

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SLOVAKIA: THE PATH FROM MONETARY SOVEREIGN TO COMMON EUROPEAN RULES



MIROSLAV ŠTRKOLEC

Abstract

This chapter focuses on the monetary policy of Slovakia, a member of both the EU and the Eurozone. Slovakia's membership in the euro area has fundamentally influenced, and continues to influence, its monetary policy. From the Slovak perspective, we distinguish between the period up to 2009, when the Slovak Republic – represented by the National Bank of Slovakia (NBS) – was the monetary sovereign, and the period from 2009 onwards, when the NBS participated in the common monetary policy set by the European Central Bank for the entire Eurozone. In the introduction, we highlight the historical background of Slovakia's entry into the euro area in terms of its fulfilment of the convergence criteria. We also discuss the advantages and disadvantages of Eurozone membership in terms of assumptions and subsequent realities. The bulk of this chapter deals with the European Banking Union from the perspective of Slovakia, which, as a member of the Eurozone, is obliged to participate in its existing pillars. It takes a closer look at the powers entrusted to the national authorities (NBS, Resolution Board, Deposit Guarantee Fund) to achieve the objectives for which the banking union was created. Finally, the chapter concludes by highlighting Slovakia's limited influence on the European Union's monetary policy, in which it participates mainly through the NBS governor in the Governing Council of the European Central Bank.

Keywords: *monetary policy, convergence criteria, banking union, crisis resolution, deposit guarantee*

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1. The introduction of the euro in Slovakia

From 1993 to the end of 2008, the monetary system in Slovakia had the characteristics of a nation-state legal tender system, that is, it used banknotes and coins – Slovak crowns and hellers, respectively. The tradition of referring to banknotes and coins as ‘crowns’ and ‘hellers’ was inherited from the joint Czech-Slovak state, which ceased to exist at the beginning of 1993 with the establishment of the independent Czech and Slovak Republics.

Even before joining the EU in 2004, the Slovak Republic began taking steps to fulfil the criteria for introducing the euro as a single currency. Before turning to the introduction of the euro to the Slovak Republic, it is necessary to provide background information on the introduction of the euro to EU Member States. Monetary integration and the current use of a single currency within the euro area are the result of rather long and difficult developments – the path towards a common monetary union (i.e. a grouping in which a single currency, a single monetary policy, and a single central bank are used) has involved several stages.

The first stage involved the removal of monetary and exchange-rate barriers between Member States; the second the creation of the European Monetary Institute; and the third the introduction of a single currency (the euro), a single monetary policy, and a single central bank.¹

The legal basis for a monetary union was the Treaty establishing the European Community, which also laid down the conditions for a Member State’s entry into the third stage.² These criteria, which must be fulfilled cumulatively, are as follows: (i) The achievement of a high degree of price stability; this is apparent from the rate of inflation which is close to that of, at most, the three best-performing Member States in terms of price stability (the inflation criterion); (ii) The sustainability of the government’s financial position, which will be apparent from having achieved a government budget position without an excessive deficit (criterion on the government budgetary position); (iii) The observance of the normal fluctuation margins provided by the exchange rate mechanism (ERM II) of the European Monetary System for at least two years, without devaluing against the currency of any other Member State (exchange rate stability criterion); (iv) The durability of convergence achieved by the Member State and its participation in the exchange rate mechanism is reflected in the long-term interest rate levels.³

From a theoretical perspective, these criteria can be divided into fiscal (criterion on government budgetary position) and monetary convergence criteria (all other criteria).⁴ Art. 140 of the Treaty on the Functioning of the European Union (TFEU),

1 Tomášek, 2007, p. 50.

2 The criteria for a Member State to join the euro area are also known as the Maastricht criteria or convergence criteria.

3 Art. 121 of the EC Treaty.

4 Daudrikh and Szakács, 2022, p. 107.

as amended by the Treaty of Lisbon, similarly defines the basic criteria for the introduction of the euro as a single currency, with exchange rate stability linked to the euro as a single currency.

The beginning of Slovakia's efforts to join the euro area and introduce the euro can be defined as the date it adopted the Strategy for the Introduction of the Euro, 16 July 2003 (the 'Strategy'). The Strategy was prepared by the Ministry of Finance and the NBS and clearly stated that Slovakia would introduce the euro as soon as it fulfilled all convergence criteria in a sustainable manner.

When the strategy was adopted, Slovakia fulfilled only one convergence criterion (the exchange rate stability criterion). To fulfil the other criteria, several reforms had to be implemented (e.g. public finance, pension, healthcare, and tax reforms, which occurred from 2000 to 2006). Slovakia managed to fulfil all convergence criteria in the relatively short period of one legislative term. Specifically, it fulfilled the price stability criterion in 2007, the interstate convergence criterion in 2005, and the final criterion of the government budgetary position in 2008 by Council Decision 2008/562/EC on 3 June 2008 abrogating Decision 2005/182/EC on the existence of an excessive deficit in Slovakia. Subsequently, the European Central Bank (ECB) and the European Commission issued a Convergence Report stating that Slovakia fulfilled all convergence criteria for joining the euro area.⁵

1.1. Act on the introduction of the euro in Slovakia

The Commission's report on the fulfilment of the criteria for the introduction of the euro by the Slovak Republic culminated in a multiannual process aimed at fulfilling these criteria. As the introduction of the euro in Slovakia was scheduled for 1 January 2009, the National Council adopted the Act on the Introduction of the Euro in Slovakia on 28 November 2007.⁶ It was not clear at this time when Slovakia would join the euro area – some of the provisions of this Act came into force on 1 January 2008 and others only on the date Slovakia introduced the euro. The date of the introduction of the euro is defined in the Act as the date of the changeover to the euro for both cash and non-cash circulation in the Slovak Republic. The date of the introduction of the euro was identical to the euro adoption date set by the Council of the EU in accordance with the European Community (EC) Treaty (1 January 2009).

This Act (also called the General Act on the Introduction of the Euro) regulates certain necessary measures and procedures related to the preparation and introduction of the euro in Slovakia as an exclusive legal tender, single currency, and currency unit in accordance with the legally binding acts of the EU.

⁵ Daudrikh and Szakács, 2022, pp. 109–110.

⁶ Act No. 659/2007 on the introduction of the euro currency in the Slovak Republic, amending certain acts, as amended.

The adoption of this Act had a number of objectives, including: (i) to ensure an organised and smooth process of the change of legal tender and currency units in the Slovak Republic as a result of the changeover from the Slovak currency to the euro; (ii) to prevent an increase in the inflation rate resulting from the changeover to the euro; (iii) to protect the economic interests of citizens and consumers during the changeover to the euro; (iv) to preserve the continuity of existing legal relations; (v) to achieve price neutrality when money, prices, payments, and other financial and asset values are converted from the Slovak currency to the euro; (vi) to enable natural and legal persons to gradually prepare for and adapt to the assessment of the real value of income, expenses, prices, payments, and living costs in euros through the dual display of prices, payments, and other amounts.⁷

The basic principles and rules of this Act are linked to these objectives. These are: (i) the principle of the protection of economic interests of citizens and consumers; (ii) the principle of price neutrality when money, prices, payments, and other values are converted from the Slovak currency into the euro; (iii) the principle of continuity of existing legal relations in compliance with the principle of freedom of contract, without any change in the real financial value of the object of the legal relations and without any change in their parties, validity, or other content, unless otherwise agreed upon by all the parties concerned or provided for by a law or special regulation.⁸

On the date of the introduction of the euro, cash circulation in the Slovak Republic changed from the Slovak currency to the euro, while euro banknotes and coins, including euro collector coins issued by the NBS, became legal tender at their respective face values for all cash payments in Slovakia. In this context, it is necessary to define the concept of the conversion rate, which is essential for the introduction of the euro.

The conversion rate is the fully irrevocably fixed exchange rate between the euro and the Slovak currency adopted by the EU Council in accordance with the EC Treaty, according to which the Slovak currency was replaced by the euro in Slovakia from the date of its introduction. The conversion rate was set at 30.1260 SKK/EUR on 8 July 2008.

The date of the introduction of the euro marked the beginning of a dual cash circulation period lasting sixteen calendar days, including the date of the introduction of the euro. During this period, legal tenders for all cash payments in the Slovak Republic were, at their respective face values, valid euro banknotes and coins, including commemorative euro coins denominated in euro or euro cents, issued by the ECB, the National Bank of Slovakia (NBS), other euro area countries, or participating third countries. Additionally, Slovak banknotes and coins, including commemorative Slovak coins denominated in Slovak crowns or hellers,

7 Art. 1 para. (1) of the Act on the Introduction of the Euro in Slovakia.

8 Art. 2 para. (1) of the Act on the Introduction of the Euro in Slovakia.

issued by the NBS and valid as of the date of the introduction of the euro, were also accepted.

At the end of the dual cash circulation period, all banknotes and coins issued in Slovakia before the introduction of the euro ceased to be legal tender in Slovakia and their validity expired. At the end of the dual cash circulation period, euro banknotes and coins became the exclusive legal tender for all cash payments in the Slovak Republic at their respective face values.

The Act also laid down detailed procedures for withdrawing Slovak banknotes and coins from circulation. Slovak banknotes and coins were gradually withdrawn from circulation from the date of the introduction of the euro by exchanging them for the euro at the conversion rate and during the exchange periods provided by the Act. The exchange of Slovak banknotes and coins into euro was carried out by the NBS, banks and other credit institutions, branches of foreign banks and branches of other foreign credit institutions, and foreign banks and other foreign financial institutions carrying out banking activities in Slovakia, in all their establishments used for treasury operations in Slovakia.

The exchange of Slovak banknotes and coins from the date the euro was introduced has been carried out during the exchange periods specified by the Act. Slovak banknotes were exchanged by banks and institutions other than the NBS for one year from the date of the introduction of the euro. However, the NBS has been allowed to exchange Slovak banknotes without any time limits. Slovak coins were exchanged by banks and institutions other than the NBS for a period of six months from the date of the introduction of the euro. Slovak coins were exchanged by the NBS for a period of five years from the date of introduction of the euro in the case of Slovak coins other than commemorative coins, and for an unlimited period in the case of commemorative coins.

The General Act on the Introduction of the Euro also regulates a number of other issues related to the introduction of the euro, such as the protection of Slovak banknotes and coins, the conversion and transfer of money and procedures for the conversion of assets and monetary amounts, continuity of legal relations, conversion of nominal values of share capital, conversion of nominal values of securities, assumptions and conditions for dual display, and monitoring of compliance with rules and obligations in preparation for and during the changeover to the euro, including corrective measures and sanctions.⁹

1.2. Benefits and disadvantages of the introduction of the euro in Slovakia

When discussing the advantages and disadvantages of introducing the euro in Slovakia, it is important to distinguish between the *ex ante* and *ex post* views. One of the first documents to estimate the positive and negative effects of the introduction of the euro in Slovakia *ex ante* was the NBS study of March 2006 entitled 'Effects of

⁹ Babčák, Čakoci and Štrkolec, 2022, pp. 448–452.

the introduction of the euro on the Slovak economy'.¹⁰ This study distinguished, in a precise and analytical way, the direct and indirect benefits of introducing the euro as well as the permanent and one-off disadvantages.

Among the direct benefits, this study identified those that would be experienced almost immediately after a changeover. The most important benefit of the euro was the elimination of some of the transaction costs of trading in euros, including the administrative costs of making payments. The exchange rate risk for payments in the euro area was eliminated, and a slight reduction in the exchange rate risk against the dollar and other important currencies for Slovakia was also made possible. Among the direct benefits of introducing the Euro, this study also identified an increase in price transparency in the single European market and a reduction in interest or capital costs for some companies.

Among the indirect benefits, the study identified those that may not be felt immediately after joining the euro area and whose effects may be uneven. The overall effects of the introduction of the euro, such as increased foreign trade, increased foreign direct investment, and, most importantly, improved economic performance and living standards, were the main reasons for the creation of the euro and Slovakia's decision to join the euro area.

The study also examined the disadvantages associated with the introduction of the euro. For example, it identified the loss of independent monetary policy as a major disadvantage of joining the euro area; however, this was likely not a major concern for Slovakia because its ability to use monetary policy to stabilise its real economy was already low. The direct costs of the technical conversion of financial systems and cash changeovers are also considered disadvantages. Other threats mentioned in the study were price increases after the introduction of the euro, either as a long-term increase in inflation above the euro area average or as an immediate jump in the price level and a corresponding reduction in the value of savings or pensions.¹¹

As far as *ex post* views are concerned, despite the lack of a comprehensive study by public authorities, it can be concluded that predictions regarding the prevailing benefits have been fulfilled. Despite the loss of monetary sovereignty, the inflow of foreign investment, currency stability, the elimination of exchange rate risk, increased average economic growth, and low inflation were repeatedly cited as benefits.¹² At the same time, fear of significant increases in the prices of goods and services did not materialise.¹³

¹⁰ Šuster, 2006.

¹¹ Šuster, 2006, pp. 2–3.

¹² Bukov, 2018.

¹³ Vlnková and Rojek, 2019, p. 8.

2. The banking union and its implementation in Slovakia

The European Banking Union (EBU) was launched in response to the 2008/2009 crisis. However, this was not a greenfield project, as its predecessor in 2010/2011 was the European System of Financial Supervision.¹⁴ The main objective of the European System of Financial Supervision was to ensure that the rules applicable to the financial sector were properly applied to preserve financial stability, promote confidence in the financial system as a whole, and provide adequate protection to users of financial services.

The legal basis for the establishment of the European System of Financial Supervision (the ESFS) was provided by regulations by the European Parliament and the Council adopted at the end of 2010, which established that the ESFS would come into effect on 1 January 2011. The ESFS comprises the European Systemic Risk Board (ESRB), European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA).

Building on the common ESFS framework, efforts to strengthen and complete banking unions in response to the crisis have gradually intensified. The main objectives of the EBU are to ensure adequate risk diversification across Member States, build stable confidence in the banking sector, and support the functioning of the monetary union.¹⁵ The EBU consists of three pillars: a single supervisory mechanism (SSM), a single resolution mechanism (SRM), and a single deposit insurance scheme (SDIS).

2.1. *Single Rulebook*

In terms of timing, the introduction of the EBU was preceded by the adoption of the CRR/CRD IV package. These were fundamental changes to banking regulation, adopted as (i) Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (CRR) and (ii) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to credit institutions and prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV).

Together, the CRR and CRD IV form a comprehensive package that fundamentally changes banking regulations. As the CRR and CRD IV significantly altered the previously existing system, structure, and content of banking regulations, it was necessary to approach their transposition into national legislation at the level of

¹⁴ Šimonová, 2012, p. 137.

¹⁵ Čunderlík et al., 2017, p. 182.

the Member States, and thus also at the level of Slovakia, in the most consistent manner.¹⁶

Implementation in Slovakia has occurred at several levels. First, there was an amendment to Act No. 483/2001 on banks, which was implemented in Act No. 213/2014, and most of its provisions came into force on 1 August 2014. According to the explanatory memorandum, the implementation of the CRD IV and CRR was mainly aimed at introducing new international Basel III standards into banking regulations in the context of the financial crisis, which revealed shortcomings in the functioning of banks and the procyclical mechanisms that contributed to its occurrence. The Slovak legislature assumed that the introduction of these stricter requirements for banks and securities dealers would reduce the risk of failure, which would contribute to greater stability of the financial systems in both Slovakia and the EU as a whole.

The need for multilevel implementation is reflected in the question of which authority carries out certain tasks under the CRR and how. In many places, the CRR obliges a Member State or competent authority to choose a certain procedure or introduce an exception. These are the so-called ‘options and national discretion’ (ONDs); that is, the (national) powers of a Member State or competent authority have the ability to choose between two or more options or introduce derogation from a certain procedure. In other words, they can introduce rules that deviate from underlying regulations. It was necessary to analyse which of these provisions are enforceable only on the basis of the text of the CRR and therefore do not require any further interpretation (so-called ‘case-by-case’ or ‘individual ONDs’), and which of these provisions need to be elaborated in national legislation (so-called ‘general ONDs’). At the same time, it was necessary to determine the level at which the relevant provisions of the CRR should be elaborated on in national legislation (e.g. acts, decrees, measures). This national legislation became the NBS measure¹⁷ based on an enabling provision in the Act on Banks. The purpose of this measure was to specify the selected general national authorisations under the CRR and apply the individual national requirements, limits, methods, levels, coefficients, percentages, ratios, and other rules derived from the CRR.¹⁸

2.2. The Single Supervisory Mechanism

The SSM was established by Council Regulation (EU) No. 1024/2013 on 15 October 2013 conferring specific tasks to the ECB concerning policies relating to the prudential supervision of credit institutions. The SSM is a system of financial

¹⁶ Oravec, 2015, p. 7.

¹⁷ Measure of the NBS of 9 December 2014 establishing national elections for institutions under a special regulation. This measure was later repealed and replaced by the Measure of the NBS of 14 November 2017.

¹⁸ Oravec, 2015, p. 8.

supervision composed of the ECB and competent national authorities of participating Member States; that is, the NBS in Slovakia.

The NBS is the only national financial market supervisor that supervises credit institutions either directly or in cooperation with the ECB. The legal basis for the powers and duties of the NBS in supervising credit institutions in Slovakia is provided by several legal acts; namely: (i) Act No. 566/1992 on the National Bank of Slovakia, (ii) Act No. 747/2004 on financial market supervision, and (iii) Act No. 483/2001 on banks.

As a member state of the Eurozone, Slovakia is required to participate in the SSM. The essence of the SSM is cooperation between the ECB and competent national authorities (i.e. the NBS) in the supervision of credit institutions, which are divided from a prudential perspective into significant and less significant credit institutions. The ECB is responsible for the effective and consistent functioning of the SSM.

The group of significant credit institutions comprises more than 100 entities, including three Slovak banks (Slovenská sporiteľňa, a.s., Tatra banka, a.s., and Všeobecná úverová banka, a.s.), which belong to this group for the purposes of the SSM because they are the three most significant credit institutions in the Slovak Republic.¹⁹ Other less significant credit institutions remain under the supervision of national authorities (the NBS); however, this does not mean that they are not subject to the SSM. Indeed, the ECB exercises certain powers over all credit institutions operating in SSM Member States.

Cooperation between the NBS and the ECB is also reflected in the fact that, in the case of these less significant credit institutions, the NBS is required to notify the ECB of any material supervisory action, to further assess certain aspects of the action at the request of the ECB, and to submit material proposals for supervisory decisions to the ECB, on which the ECB may issue an opinion. Additionally, in well-defined cases, the ECB may decide to exercise direct supervision over a less significant credit institution if this is necessary for the consistent application of a high level of supervision. This may be the case, for example, if the credit institution is close to reaching one of the criteria that would qualify it as a significant institution or if the competent national supervisory authority has failed to follow the ECB's instructions in the exercise of supervision.

The ECB's specific supervisory powers in relation to all credit institutions include granting and withdrawing the authorisation of credit institutions and assessing the acquisition of a qualifying holding in a credit institution.

¹⁹ In this context, it should be added that these credit institutions (Slovenská sporiteľňa, a.s., Tatra banka, a.s. and Všeobecná úverová banka, a.s.) are subsidiaries of Erste Group Bank AG, Raiffeisen Bank International AG and Intesa Sanpaolo S.p.A., and are referred to within these groups in the ECB's supervisory framework.

2.3. The Single Resolution Mechanism

The openness of financial markets and the interconnectedness of their players have led to various initiatives aimed at establishing a SRM. At the EU level, Directive 2014/59/EU of the European Parliament and Council, adopted on 15 May 2014, established a framework for the recovery and resolution of credit institutions and investment firms (BRRD).

This Directive was implemented in Slovakia through the adoption of Act No. 371/2014 on resolutions in the financial market, which amended certain acts. The aim was to introduce a new framework for the prevention and resolution of potential financial market crises, which was developed at the EU level in response to the financial crisis. It demonstrates the significant scale and different forms of risks in the financial market, where the complexity of interconnectedness creates the possibility of a systemic crisis in the event of the failure of a single financial institution, which can be transmitted to the entire financial system.

The Act regulates the procedures of selected institutions in resolving financial market crises and the preparation and approval of financial market resolution plans in the Slovak Republic by the newly established Resolution Board, which has the status of a national resolution authority. At the same time, the Act provides for the establishment and functioning of the National Resolution Fund (the 'National Fund').

Thus, the Resolution Board exercises resolution powers in Slovakia. It is responsible, among other things, for on-site and remote supervision as well as for acting and deciding on resolution proceedings. In these proceedings, the Resolution Board decides on the imposition of a resolution measure, which may take the form of the sale of a business, an asset separation tool, or a bail-in tool. Although the Resolution Board, as the national resolution authority, has significant power to intervene in the property rights of creditors and shareholders, its primary role is to prevent crises in selected institutions.²⁰

Establishing a National Fund is an important step. Selected institutions – banks and securities dealers with share capital of at least EUR 750,000 – were required to participate in the resolution by paying contributions to finance an effective resolution. Specifically, these selected institutions were required to pay an annual contribution and an extraordinary contribution to the National Fund. The annual contribution is determined by the Resolution Board in consultation with the Ministry of Finance and the Deposit Guarantee Fund in a manner specified by law, so that the accumulated resources of the National Fund reach the target level of 1% of the covered deposits of selected institutions operating in Slovakia in the transitional period until 31 December 2024.

The resources of the National Fund may only be used to the extent necessary to finance an effective resolution; namely, for: (i) guaranteeing the liabilities of the customers of a selected institution or the liabilities of a selected institution under

²⁰ Satinová and Slezáková, 2014, p. 13.

resolution; (ii) providing loans to a selected institution or its subsidiaries; (iii) providing funds to a bridge institution and an asset management vehicle free of charge and on a no-return basis; (iv) paying compensation to shareholders or creditors; (v) providing funds to a selected institution instead of writing off its debt or converting the liabilities of certain creditors if the bail-in tool is applied and the board decides to deprive certain creditors of their right to apply the bail-in tool; (vi) lending funds voluntarily to the financial arrangements of other Member States, (vii) repaying loans, interest on loans, and other costs related to the loans provided to the National Fund; (viii) using the National Fund's resources in any of these combinations.²¹

2.4. Single Deposit Insurance Schemes

The primary legislation on deposit protection is Directive 2014/49/EU on deposit guarantee schemes, implemented in Slovakia under Act No. 118/1996. The institutional component of Slovakia's statutory deposit guarantee scheme is the deposit guarantee fund. The fund concentrates monetary contributions from banks and branches of foreign banks to provide compensation for deposits placed with banks and branches of foreign banks and uses them in accordance with the Act. The scope of compensation provided by the fund has been amended several times by law in recent years. For the sake of clarity, the following three decisive periods can be outlined. From 1 May 2004 to 31 October 2008, the compensation limit was 90% of the nominal value of the deposit, up to a maximum of EUR 20,000, converted into Slovak crowns according to the exchange rate announced by the NBS on the day the deposits became unavailable. From 1 November 2008 to 29 December 2010, bank deposits were fully guaranteed – that is, they were not subject to any limit; the fund would cover the full amount of unavailable legally guaranteed deposits. As of 30 December 2010, bank deposits of up to EUR 100,000 were protected by the fund.

On 15 October 2015, an amendment to the Act came into force, according to which the compensation limit of up to EUR 100,000 remained unchanged. However, in certain specific cases, compensation is granted in the full amount of the deposit even if it exceeds the established limit; specifically, this occurs if deposit becomes unavailable within a period of 12 months from the date the deposit was first credited or from the date the deposit became legally transferable if the deposit had a specific origin (e.g. transfer of real estate, inheritance, insurance claim, old-age pension, compensation for damages).

Slovakia's attitude towards the completion of the banking union through the third pillar, a common European deposit guarantee scheme, is rather positive. At the same time, official voices have suggested that a hybrid model based on the co-existence of national deposit guarantee schemes and a common European scheme could be the most promising solution.²²

²¹ Art. 92 para. (4) of the Act on resolutions in the financial market.

²² European Central Bank, 2023.

Such a compromise could overcome the objections raised by the incomparable capitalisation of national schemes and the problems of banks in selected countries. At the same time, it would partially eliminate the risks associated with the so-called ‘moral hazard’, whereby some states may pay to cover failed deposits in the banks of other states. In Slovakia, we did not observe any significant disagreement between the banking sector and the government regarding a common deposit guarantee scheme.

3. The monetary aspects of crisis management

Slovakia has been a member of the euro area since 2009 and has thus lost sovereignty over its monetary policy, which is an exclusive competence of the EU according to Art. 3 para.(1) of the TFEU. Unlike before 2008, when the NBS was the monetary authority in Slovakia, as of 1 January 2009, the NBS participated only in the common monetary policy of the EU, which is defined by the ECB for the Eurozone. The Governor of the NBS is a member of the Governing Council, the decision-making body of the ECB, which is responsible for formulating monetary policy for the Eurozone. According to the founding treaties, the primary objective of a single monetary policy is to maintain price stability, thereby contributing to a favourable economic environment and creating conditions for higher employment and sustainable economic growth in the medium term. Therefore, the monetary policy power of the NBS is limited.

Nevertheless, the NBS still has certain powers. For example, it can issue banknotes and coins to manage the circulation of money in Slovakia or impose sanctions. However, in terms of monetary policy in times of crisis, whether triggered by the COVID-19 pandemic, armed conflict in Ukraine, or inflation, Slovakia has applied EU measures.

The ECB’s main monetary policy instrument is the interest rate range.²³ This area has experienced relatively turbulent development in recent years, with the interest rate on the main refinancing operations and the base interest rate of the ECB remaining at 0.00% from 2016 to 2022. Since July 2022, the Governing Council has continuously decided to increase it at almost every meeting; currently, it is 4.5%.

The Governing Council’s decision to keep the interest rates unchanged at its meeting in October 2023 brought some cooling to this area. The Governing Council justified this decision by stating that the key ECB interest rates were maintained at the same levels for a sufficiently long duration, making a substantial contribution to achieving the 2% medium-term inflation target. At the same time, the Governing Council sent a clear message by stating that its future decisions would ensure that

²³ Slezáková, Slezák and Nádaský, 2018, p. 21.

the key ECB interest rates would be set at sufficiently restrictive levels for as long as necessary.²⁴

Other instruments, such as signalling the future stance of monetary policy, asset purchases, and longer-term refinancing operations, which have helped ease the constraints imposed by the existence of a lower bound on nominal interest rates over the past decade, will remain an integral part of the ECB's toolkit and will be used as appropriate.

In recent years, quantitative easing – that is, asset purchases in advance of interest rate increases in times of crisis – has emerged as an important monetary policy tool. One of the ECB's most notable examples of quantitative easing was the Asset Purchase Programme (APP), which it launched to achieve its 2% inflation target. The Governing Council decided to discontinue net asset purchases under the APP as of 1 July 2022. At the same time, however, the Governing Council indicated that it intends to continue reinvesting, in full, in the principal payments from maturing securities purchased under the APP for an extended period of time after raising the key ECB interest rates and, in any case, for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Regarding the Pandemic Emergency Purchase Programme (PEPP), the Governing Council intends to reinvest the maturing principal payments from securities purchased under this programme until at least the end of 2024.²⁵

4. Conclusions

There is no doubt that Slovakia, as a member of the euro area, has limited sovereignty in monetary policy. Joining the euro area in 2009 entailed a partial loss of monetary sovereignty for Slovakia, as monetary policy fell under the exclusive competence of the EU. However, there is no question of a complete loss of sovereignty as Slovakia, like other Eurozone countries, participates in common European monetary policy. For example, Slovakia follows the decisions of the Governing Council of the ECB (e.g. on interest rates and asset purchases), in which the governor of the NBS also participates.

In the area of banking policy, Slovakia, as a member of the euro area, participates in the first two pillars of the banking union: the SSM and the SRM. Although competencies in this area are shared between the ECB and NBS, it can be concluded that there are no major conflicts in the exercise of these competences between these (European and national) authorities.

²⁴ European Central Bank, 2023.

²⁵ *Kažimír podporuje, aby ECB ukončila kvantitatívne uvoľňovanie v lete, 2022.*

With regard to the possible conflict between European and national regulations and the relationship between competencies in the adoption of new legislation, we highlight the new regulation of cash payments in Slovakia. With effect from 1st July, 2023, Title Two of the Constitution was amended by Constitutional Act No. 241/2023 in such a way as to guarantee the use of cash as legal tender. Consequently, everyone has the right to pay for goods and services in cash – cash payments may only be refused for reasonable or generally applicable reasons. In any case, banks and branches of foreign banks do not have the right to refuse cash payments.

It follows that the National Council has systematically enshrined the right to pay cash at the constitutional level in the Constitution, which regulates fundamental rights and freedoms. Since July 2023, the right to pay cash has become fundamental in Slovakia. However, this move by the Slovak legislature raises questions about whether such a regulation might interfere with the EU's exclusive competence in monetary policy. To implement the Constitution, a special law was adopted to define the conditions and limits for the exercise of the right to pay cash. However, at present (October 2023), the only restriction in force is laid down in Act No. 394/2012, which limits cash payments to a maximum of EUR 15,000.

Although at first glance it may seem that the abovementioned constitutional provisions fall within the sphere of monetary policy, we believe that such a conclusion cannot be drawn automatically. In our view, this is essentially a question of the way in which payments for the purchase of goods and services are made without encroaching on the EU's exclusive competence for the euro area's monetary policy. At the same time, this regulation essentially confirms the *status quo* because according to Art. 128 paras. (1) and (2) of the TFEU, only banknotes issued by the ECB and national central banks have the exclusive status of legal tender within the EU. Member States may also issue euro coins subject to approval by the ECB of the volume of issue. Of course, European regulators may have a different view on the subordination of this issue to the content of the concept of monetary policy.

In any case, it should be noted that, from a substantive point of view, a similar regulation is being prepared by the EU itself, at the level of which a proposal for the Regulation of the European Parliament and of the Council on the legal tender of euro banknotes and coins was presented on 28 June 2023. The motivation for this proposal is based, *inter alia*, on a judgment of the Court of Justice of the EU of 26 January 2021 which clarified that the concept of 'legal tender' mentioned in Art. 128 para. (1) of the TFEU is a concept of EU law that must be given an autonomous and uniform interpretation throughout the EU. The Court also held that the concept of 'legal tender' as a means of payment denominated in a currency unit signifies 'that means of payment cannot generally be refused in settlement of a debt denominated in the same currency unit, at its full face value, and without any surcharges for the payer, with the effect of discharging the debt'. Finally, the Court stated that an obligation to accept euro banknotes and coins may, in principle, be restricted by Member States that use the euro for reasons of public interest and pursuant to their competences outside of the area of monetary law and policy and other exclusive EU

competences, provided that those restrictions are justified by a public interest objective and proportionate to it.²⁶

This proposal for the regulation is based on similar principles as the Slovak constitutional provision on cash payments; that is, it (i) confirms the legal tender status of euro banknotes and coins, (ii) provides for their mandatory acceptance, at full face value, with the effect of discharging a payment obligation, (iii) provides for exceptions to the principle of the mandatory acceptance of euro banknotes and coins, and (iv) establishes the obligation on Member States to ensure sufficient and effective access to cash throughout their territory in all their regions, including in urban and non-urban areas.²⁷

26 See: CJEU, 26 January 2021, C-422/19 and C-423/19, *Hessischer Rundfunk*, ECLI:EU:C:2021:63, paras. 45, 46, 67 and 68.

27 European Commission, Proposal for the Regulation of the European Parliament and of the Council on the legal tender of euro banknotes and coins, COM(2023) 364 final, p. 21.

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SLOVENIA: SLOVENIA'S MONETARY POLICY AND EXPERIENCE IN THE EURO AREA



MEJRA FESTIĆ – RADO BOHINC

Abstract

The Bank of Slovenia decided on its strategy of monetary targeting due to the stable money demand function, stable velocities, and stable monetary multipliers, and balanced the approach with limited exchange rate flexibility. Inflation was proven to be conditioned by trade margins, accounting for 39% of the variance in inflation in the 18 months after the introduction of the euro in Slovenia. The 2008 banking crisis required a new approach to the recapitalisation of Slovenian banks. Privatisation laws were in full swing throughout the overheating of the Slovenian economy between 2004 and 2008. Slovenia decided to transfer bad banking claims to a bad bank (DUTB); however, the project was executed too late at the deepest point of the economic cycle. The difference between the Slovenian specifics and the EU terms was that the banks in Slovenia were primarily owned by the state, and thus the state stepped into the recapitalisation process as an owner and not a state. All regulations and directives of the euro area were implemented under national laws. The Bank of Slovenia, similar to the entirety of the Eurosystem, implemented the Pandemic Emergency Purchase Programme and other non-standard monetary policy instruments.

Keywords: *monetary policy, euro, inflation, banking crisis, state aid rules, directives and regulations of the euro area, non-standard monetary policy instruments*

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1. Introduction

A key issue for macroeconomic reform programs in transition countries is whether the persistence of moderate inflation resulted from the traditional causes of insufficiently tight financial policies and wage pressures or from the sizeable adjustment of relative prices necessary for the transition to a market-based economy. The following key variables explain the stickiness of inflation in transitional economies:¹ (i) inflation inertia reflects explicit or implicit wage indexation and slow adjustment of inflation expectations; (ii) wage increases are not in line with productivity gains;² (iii) monetary growth is fuelled by fiscal obligations; (iv) underlying pressure for the appreciation of the real exchange rate coupled with a policy of resisting nominal appreciation through official intervention in foreign exchange markets; (v) insufficient stimulation of foreign capital investment;³ (vi) relative price adjustment combined with downward price rigidity; (vii) the persistence of relative price variability may reflect the limited speed of structural reforms.

The establishment of the Maastricht convergence criteria also encouraged the achievement of realistic conditions during the adjustment period for entry into the optimal currency area. Slovenia had to solve the problems arising from the inferiority of the Slovenian economy,⁴ obtain stability in the real sector, lower the inflation rate, and develop a strategy for institutional, monetary, and fiscal accommodation.⁵ While shocks were symmetrically distributed across all European Union (EU) economies,⁶ the loss of an independent exchange rate or monetary policy at the national level would not have impeded the ability of such countries to adjust to them.⁷ With the possibility of exchange rate changes among countries no longer under the European Monetary Union, adjustments in labour mobility and wages played a larger role and should have absorbed the shocks. Ultimately, Slovenia independently implemented its monetary policy.

1 IMF, 1998, pp. 241–244; Festić. 2002; Inotai, 1994.

2 Festić, 2000.

3 See: Babetskii, 2004

4 See: Ribnikar, 1994.

5 For more details, see: Festić, 2001b.

6 For more details, see: Borowski, 1999.

7 For more details, see: Cukierman, 1995.

2. Lessons related to the introduction of the euro: Experience in the Eurozone and pros and cons regarding the common currency

In general, the central bank can only regulate base money, whereas the monetary aggregates M1, M2, and M3 are endogenous variables.⁸ To increase policy transparency, it would be useful for authorities to produce a clear statement on how deviations from the target would be dealt with.⁹

The instruments used by the Bank of Slovenia (BS) were subordinated to the intermediate target and oriented towards the chosen final goal (price level stability and lower inflation rate per annum) and base money growth.¹⁰ Until 1996, the BS targeted the monetary aggregate, M1 (as an intermediate target). Subsequently, the BS followed restrictive monetary policy and announced M3 annual targets in 1997. The BS originally chose the M3 target because this aggregate was fairly stable, primarily because of the movements between the tolar and foreign currency deposits included in the M3 aggregate.¹¹

The BS partially reached its final goal indirectly through the exchange rate. Formally independent (exogenous) monetary stock (base money) control is inferior to formally dependent (endogenous) exchange rate formation. Owing to the transition and unclear and inadequate social ownership, it was impossible to introduce full capital liberalisation and clean floatation. In addition, because of the openness of the Slovenian economy and appreciation pressures, there was a need for an exchange rate policy, with the BS intervening in the foreign currency market within the limits of the chosen monetary target.¹² According to Ribnikar, existing systems react favourably to basic macroeconomic events.

2.1. The Maastricht convergence criteria and Slovenia's economic compliance

To understand the former Slovene monetary system and its ability to fulfil the Maastricht criteria, we must first establish the reasons for appreciation pressure in Slovenia:¹³ (i) a current account surplus, with exports increasing foreign currency inflows; (ii) inflation and real appreciation movements due to prices in non-tradable sectors (especially services) continuously increasing faster than prices in the tradable sector (price increases in the non-tradable sector have been a consequence of high labour costs and increasing controlled prices);¹⁴ (iii) a slower nominal depreciation

8 See: Cassel, 1995; Pfister, 1997.

9 See: Fischer and Dueker, 1996.

10 Cecchetti and Bryan, 1994.

11 See: Festić, 2001a; Ovin, 1998; Bekő and Festić, 2006; Bekő, 1997.

12 See: Ovin, 1998; Ribnikar, 1993.

13 Bekő, 1997, pp. 173–179.

14 Festić, 2000.

behind relative inflation, which means that the nominal exchange rate in the market lagged behind purchasing power parity; (iv) higher added value improved the terms of trade for transition economies;¹⁵ (v) better capacity utilisation and increased productivity;¹⁶ (vi) foreign currency inflows resulting from high returns on tolar portfolio investments due to structural–transitional reasons, high real interest rates, and the expected high profitability of medium-term portfolio investments. In addition, such inflows were determined by the difference between the expected nominal exchange rate increase (depreciation rate), domestic inflation, and the revaluation of the interest rate;¹⁷ (vii) the higher tolar interest rate meant that loans granted abroad were more attractive, leading to exchange rate pressure (appreciation); this was due to short-term foreign currency inflows to the household sector, along with increased indebtedness of banks, enterprises, and the public sector;¹⁸ (viii) lower prices in Slovenia (e.g. for oil derivatives and related products) drove early foreign currency inflows.

In the case of the BS, commercial papers have always been more important than base money.¹⁹ Base money is important for control of the monetary stock, whereas commercial paper is crucial for exchange rate control. Commercial papers have been nominated in both foreign and domestic currencies. The BS can be said to have had multiple goals, including the management of M3 and the exchange rate.

As the BS did not have sufficient foreign assets, it issued short-term commercial papers. Foreign currency reserves are formed through the issuance of commercial paper in foreign currencies and the use of base money. For commercial papers in foreign currency, the central bank received foreign currency used for foreign deposits abroad, base money creation, and purchases of foreign securities. By issuing commercial papers in foreign currency, the BS was able to obtain assets that enabled it to mediate capital outflows to prevent capital inflows from representing net capital inflows (i.e. capital imports).

The BS can be said to have had three functions. First, it is the monetary authority responsible for monetary policy, evident in its creation of base money by credits. Second, it is also responsible for implementing an exchange rate policy; specifically, it carries out this function by issuing attractive commercial papers in foreign currency, depositing foreign assets obtained by commercial papers in foreign banks (long-term commercial papers in foreign currency), and requiring 60% of the minimum reserve requirements to be held in commercial papers (short-term commercial papers in foreign currency). Long-term commercial papers in foreign currencies and short/

15 Halpern and Wyplosz, 1996, pp. 13–14.

16 Grafe and Wyplosz, 1997. This text explores the problem of real wages in transition economies. Increased production costs (due to higher productivity) depreciated and thus increased wages in transition economies did not endanger export competitiveness from 1995 to 1996 in Slovenia.

17 Bole, 1997.

18 Ovin, 1998.

19 See: Festić, 2002.

long-term tolar commercial papers reflect the BS's sterilisation policy; this is why the tolar did not appreciate.²⁰

Slovenia has dismissed non-market instruments of monetary policy, replacing them with new ones; namely: open market policy, Lombard loans, minimum reserve requirements, bills with warrants, twice bills, and foreign currency bills. In Yugoslavia, the central bank's reaction was stochastic. The relationship between government-owned enterprises and their financial needs requires strong discretion in monetary policy.²¹

Foreign currency reserves at the BS were formed partially by indebtedness abroad and the balance of payment flows. The BS absorbed part of the foreign currency money stock directly from the non-banking sector (i.e. foreign currency deposits of the government at the BS) and indirectly from commercial banks through commercial papers or direct purchases.²²

The factors influencing M3 can be divided into factors linked to demand (e.g. income, transactions, interest rates, inflation) and supply (balance of payments behaviour of commercial banks, monetary policy instruments). Commercial banks issue money through two main channels:²³ (i) net foreign assets; (ii) domestic assets.

Commercial banks use disposable base money to monetise foreign currency (monetisation of foreign currency inflows from the non-banking sector) and extend credit (e.g. domestic loans, purchasing securities). Domestic portfolio investments are represented by loans, capital investments, and securities portfolios in the domestic non-banking sector. The issuance of M3 over net foreign assets was reduced for foreign asset deposits of the government at the BS and increased for both domestic portfolio investments in foreign assets (e.g. loans, government bonds) and commercial papers outside banks.²⁴

The balance between payment movements and domestic credit creation prevailed in the creation of M3. The inflow of foreign currency increased M3 through the conversion of foreign currency into domestic currency.

Commercial banks fulfil their minimum reserve requirements for foreign currency deposits abroad, cash, interbank foreign currency liabilities, commercial papers of the BS nominated in foreign currency, different securities, and special rights to purchase foreign currency. From 1996 onwards, banks were required to hold 60% of their foreign currency reserves in short-term commercial bills.²⁵

Overnight liquidity facilities are offered to net borrowers in the interbank market at uniform interest rates. The quantity of regular loans granted to banks is contingent on both their share in the foreign currency's total position and the overall volume of loans provided. The interest rate aligns with that for short-term bills of a comparable

20 See: Ribnikar, 1999; Festić, 2001a.

21 For more details, see: Ribnikar, 1993.

22 See: Festić, 2002; Festić, 2001a.

23 Ribnikar, 1999.

24 See: Košak, 1997.

25 See: Festić, 2000; Festić, 2001c, pp. 31–39.

maturity (of no more than three months).²⁶ Lombard loans have rarely been used as instruments of monetary policy; commercial banks may obtain a five-day Lombard loan based on the commercial papers of the BS and treasuries.²⁷

Foreign currency bills are transferable, registered securities that are not issued in series. They are offered on a permanent basis and could be purchased by the banks themselves or by other legal persons through the banks. Bills with warrants are short-term bearer securities issued in series in paper form with a nominal value of half a million tolar; they are purchased in tolar at a discount and have a nominal interest rate. The warrants attached to securities hedge against inflation and exchange rate depreciation at rates higher than officially projected.²⁸ The tolar segment is revalued using a tolar revaluation clause.

Košak²⁹ found that the structural position of the money market showed a trend of high variability in the short term and one of decreasing variability in the long term. The disadvantage of high structural variability in the money market requires the BS to react intensively and promptly to changes in the money market and movements derived from autonomous transactions.³⁰

Excess liquidity in the money market caused an increase in the demand for commercial papers issued by the Bank of Slovenia, which enabled a decrease in real and nominal interest rates in 1998.³¹ The reversible instruments enabled the permanent flow of base money between the BS and commercial banks. In doing so, money market conditions were regulated, and the ultimate objective was successfully achieved.³²

2.2. Pros and cons of accession to the Eurozone

At the money market level, the BS defined suitable short-term operational aims for bank liquidity and money market rates, which made the attainment of the annual money stock and key economic target variables possible in the longer run.³³ At the intermediate target level, represented by the annual target for M3 growth, the BS more or less continuously examined throughout the year, whether, when, and to what

26 See: Festić, 2001c, pp. 34–48.

27 See: Festić, 2001c, pp. 31–39; Festić, 2000, pp. 13–15.

28 See: Festić, 2000.

29 Košak 1997, p. 30.

30 Ribnikar, 1999. The positions that represented autonomous transactions included net foreign assets (foreign currency reserves), net government deposits (i.e. the difference between the deposits of the government and eventual loans to the government), currency in circulation, and other net liabilities.

31 See: Ovin, 1998.

32 In Slovenia, big banks also obtained liquid assets in transactions with the BS when the BS had been taking money from circulation. Liquid assets were poured out of small banks in favour of big banks. Medium-sized banks accessed less liquidity from the BS than big banks. Medium-sized banks were active in giving inter-bank loans. The BS increased base money over the group of big banks and decreased base money over small and medium banks. In 1996, the BS started to withdraw base money from circulation across all three groups of banks. See: Košak, 1997, pp. 31–36

33 For more details, see: Amano and Wirjanto, 1996; Blinder, 1994; Cukierman and Leviatan, 1992.

extent deviations in M3 from the target path were corrected by adjusting the conditions of the money market³⁴ and other financial markets.³⁵ The BS used a monetary targeting policy owing to the stability of velocity, monetary aggregate multipliers, and stable money demand. Stable money demand coincides with stable velocity.³⁶

The BS's approach was unique. Their exchange rate targeting method involved monetary intervention (in foreign currency markets) and sterilisation – the BS purchased and sold foreign currencies and changed the quantity of the base money. Autonomy was evident here: the monetary policy caused changes in the domestic money stock over induced changes in foreign currency reserves (the balance of payments component of the money stock) in the case of fixed exchange rates.³⁷

International integration and capital mobility require continual intervention by the BS to maintain the exchange rate at the targeted level. Similar to the disadvantages of interest rate regulation, 'artificial' exchange rate regulation could not be successful in an open economy given open financial markets and a high substitution rate between domestic and foreign assets.³⁸ Small open economies are influenced by the movements of foreign economies and thus by foreign monetary shocks.³⁹ Arguments against the fixed exchange rate regime, according to the specifics of the Slovenian economy, include:⁴⁰ (i) a surplus supply of foreign securities and excess demand for domestic securities can lead to a decrease in domestic interest rates, necessitating central bank intervention; (ii) when economic subjects expect foreign currency appreciation and demonstrate a preference for foreign securities, demand for foreign currency will increase, compelling the devaluation of the domestic currency; this also requires central bank intervention;⁴¹ (iii) in small open economies, domestic prices are related to foreign price levels, and the relative prices between tradable and non-tradable sectors change;⁴² (iv) if economic entities anticipate foreign currency depreciation in the presence of unstable money demand and substitution effects, the domestic currency will appreciate.

The flexible exchange rate was a more suitable and less rigid approach because the BS was in a position⁴³ to choose between different strategies, such as: (i) stabilising the base money by absorbing external shocks through exchange rate and interest rate movements; (ii) stabilising the exchange rate after a monetary shock by manipulating the interest rate; (iii) stabilising the interest rate after a shock by

34 See: Cukierman, 1995.

35 See: Festić, 2001a; Festić 2001b.

36 Festić, 2002; Cimperman, 1996. The growth of the money stock should vary less than the movement of actual production. Changes in the velocity of the circulation of money do not simply reflect the business cycle. For more details, see: Cassel, 1995, pp. 139–145; Büttler et al., 1979.

37 See: Pfister, 1997, pp. 103–111.

38 See: Bekő, 1997.

39 See: Borowski, 1999.

40 For more general details, see: Cassel, 1995, pp. 139–145; Siebke, 1995, pp. 36–50.

41 For more details, see: Ovin, 1998.

42 See: MacDonald and Wójcik, 2004.

43 Bole, 1997; Ovin, 1998.

manipulating the exchange rate (notably, this technique has demonstrated strong effects than stabilising the money stock); (iv) a combination of money stock, interest rate, and exchange rate movements.

In the absence of productivity disturbances and supply shocks, inflation-rate targeting worked extremely well, since there was no trade-off with employment stabilisation.⁴⁴ When changes in the money stock are transmitted quickly to changes in the price level, inflation targeting is relatively easy to implement.⁴⁵ However, the lack of predictability poses two important problems for inflation-targeting strategies.⁴⁶ Thus, it is difficult to directly confirm the link between inflation and economic performance. Here, it is important to remember that inflation is an endogenous variable.⁴⁷

The BS chose the strategy of monetary targeting⁴⁸ and balanced the approach with limited exchange rate flexibility.⁴⁹ The arguments against inflation targeting in Slovenia are as follows:⁵⁰ (i) transition economies were required to solve the problems that initially resulted from inferior development; this requires the central bank to obtain the credibility required to influence inflation expectations; (ii) theoretically, inflation targeting is suitable when the real sector is stable, and Slovenia did not meet this requirement in the 1990s; (iii) the inflation targeting approach contained a considerable degree of what economists term 'policy discretion', which is not suitable for a region that needs to establish a stable economic environment; (iv) the central bank's flexibility can be understood as its accommodation of intermediate M3 targets for money demand and potential output movements;⁵¹ (v) a small, open economy depends on cyclical movements in foreign economies; therefore, supply shocks represent potential disturbances – inflation targeting is unsuitable for supply shocks; (vi) inflation targeting is suitable in cases with very high annual inflation rates per annum; however, inflation rates were not very high in Slovenia (less than 10% per annum) and the monetary authorities did not pay any attention to the surprise creation of base money; (vii) monetary aggregates (base money, M1, M2, and M3) are easier to control than the inflation rate because inflation is an endogenous process; (viii) the time series was too short at the end of the 1990s in Slovenia, and the econometric results tended to be questionable; a tradeoff between inflation and unemployment was observed in the long term; (ix) the Granger causality from domestic household loans to real domestic consumption, as well as the Granger causality from real domestic consumption to real GDP, could be understood as evidencing the

44 See: Bernanke and Mishkin, 1997; Festić, 2003.

45 See: Archer, 1995.

46 Cukierman and Liviatan, 1992, pp. 439–458.

47 Fischer and Dueker, 1996.

48 See: Festić, 2001c.

49 For more details, see: Festić, 2001a; Festić, 2001b; Festić, 2002.

50 See: Festić, 2001b; Festić, 2001c; Festić, 2003.

51 For more details, see: Cukierman, 1995.

indirect influence of monetary aggregates on real GDP; this may be recognized as an insignificant 'trade-off'.⁵²

The following facts were considered in Slovenia when policymakers discussed developments after 2000:⁵³ (i) institutional conditions enabled a less flexible and competitive labour market; (ii) the dynamics of wages in the non-tradable sector were transmitted into the costs (i.e. wages) of tradable goods; (iii) nominal wages were determined for a longer period, and labour costs did not react to increased unemployment; (iv) labour market laws (e.g. regulations concerning redundancy, early retirement schemes, part-time work) have not been sufficiently developed;⁵⁴ (v) labour force productivity increased as a consequence of the dismissed labour force in the initial period of transition and due to intensive capital investment in advanced technology, with technical improvements giving rise to intensive capital production (investment imports in Slovenia increased); (vi) productivity increased faster in industry than in the service sector, but wages in both sectors increased at the same pace, increasing inflation; (vii) the former Yugoslavia faced the phenomenon of 'hidden' unemployment, with too many employees with low productivity; (viii) the labour force was not prepared to accommodate itself to new market conditions or improve the value of human capital; (ix) unsolved problems related to social, health insurance, and pension funds inhibited decreases in labour costs; (x) the difference between gross and net wages was high (about 45% of gross tolar wages were contributions and duties); (xi) Slovenia has one of the highest rates of employees taking sick leave of all economies; (xii) structural unemployment problems increased; (xiii) the government stimulated an increase in employment (particularly in the public sector); (xiv) the number of strike actions by workers increased in the pre-election period; (xv) an important indicator of cyclical movements in the labour market was the rate of workers who were not searching for work because they believed that there were no jobs (i.e. no labour demand); consequently, they did not contribute to lowering the registered unemployment rate in Slovenia.

2.3. Before and after the Eurozone

The experiences of EU Member States that were the first to introduce the euro indicated that after its introduction, the divergence of inflation rates, as well as the inflation rate itself, increased due to the adaptation of relative prices and as a consequence of asymmetrical shocks.⁵⁵ Internal factors contribute to inflation due to weak competition in particular sectors and an increase in demand in Slovenia.

Producer prices did not essentially affect the rise of the harmonised index of consumer prices (they even slowed down the growth of the common price level),

⁵² See: Festić, 2003.

⁵³ See: Festić, 2000; Festić, 2001a.

⁵⁴ See: Festić and Romih, 2009.

⁵⁵ See: Horvath and Rátfai, 2004.

while retail prices, together with the increase in trade margins, contributed to the start of the inflationary spiral in 2007, when economic growth was favourable in Slovenia.⁵⁶

At the end of 2007, the price growth trend reached 9.3% in December 2007 and 9.9% in January 2008; price growth slowed down at the end of the first quarter of 2008 and reached 6.3% in May 2008 (UMAR 2008). The econometric analysis showed that 39% of the variance in inflation was conditioned by trade margins 18 months after the introduction of the euro.⁵⁷

The dynamics of price trends in the euro area corresponded to the dynamics of price trends in Slovenia, but the level in the euro area was lower. In the state administration, the growth of wages and salaries strengthened the pressure on labour costs, which had otherwise stabilised over the previous year.⁵⁸ The growth in loans decelerated, while the surplus of loan repayments over the increase in new loans contributed to uncertainty in financial markets.⁵⁹

The price increase of primary consumer goods resulted in a decline in average purchasing power.⁶⁰ Until May 2008, Slovenian inflation overtook euro area inflation by 2.58 %, with the largest differences observed in the price growth of food, housing costs, and tourist services.⁶¹ The pressure of price growth in Slovenia was above average, corresponding to a cumulative difference in inflation between Slovenia and the euro area in food prices (2.85%), prices of clothing and footwear (0.62%), housing costs (4.05%), housing equipment (0.85%), recreation and culture (1.17%), tourism (3.2%), and services (0.30%). In comparison to the euro area, Slovenia had lower price growth, with only transport services lagging behind by 3.7%. Notably, food price growth triggers an increase in prices in other sectors and strengthens inflationary inertia.⁶²

The reasons for the banking sector crisis after 2008, which required both state aid intervention⁶³ and a change in the central bank's supervisory practices,⁶⁴ were endogenous in Slovenia. Privatisation laws were in full swing during the overheating of the Slovenian economy between 2004 and 2008. The intertwined ownership relationships of companies and privatisation through holding companies also contaminated healthy companies within the real sector. The base for the crisis in the banking sector was derived from the privatisation laws introduced in the late 1990s in Slovenia.⁶⁵

56 See: Festić et al., 2009.

57 Festić et al., 2009.

58 See: UMAR, 2008.

59 See: Festić, Repina and Kavkler 2009; Festić and Križanič, 2011; Festić, Kavkler and Repina, 2011.

60 Festić and Križanič, 2011.

61 Festić et al., 2009.

62 For more details, see: Festić, et al. 2009.

63 Festić, 2011.

64 See: Festić and Glogovšek, 2008; Festić and Bekő, 2008, 2009.

65 Festić, 2013.

The *Investment Funds and Management Companies Law* (ZISDU 1999⁶⁶), adopted in the 1990s, created the conditions for the establishment of investment funds for collecting privatisation certificates by Special Investment Companies (PIDs) and for the transformation of state industrial property, which situated investment funds as private entities. The legal form of the PIDs was that of a publicly limited company classified as a closed investment fund.⁶⁷

Citizens who invested their ownership certificates in PIDs were able to raise more than half of all the certificates in funds and, in doing so, held a majority in the ownership structure. In addition, there was a difference between the value of the issued certificates and the value of the state assets intended for privatisation – the so-called ‘privatisation gap’ – and this was the main reason why the period for the compulsory conversion of PIDs into another type of legal entity was extended until the end of 2003.⁶⁸ Meanwhile, many PIDs transformed into regular stock companies, resulting in fewer assets being transformed into real investment companies and mutual funds.⁶⁹

By the end of 2003, PIDs had to be transformed into investment companies and mutual funds (ZPSPID 2005) or ordinary publicly limited liability companies called ‘financial holding companies’.⁷⁰ Investment funds took over the market portfolio, whereas financial holding companies made fewer liquid investments in management to increase their value in the long run.⁷¹

The chosen model of the privatisation of state assets through the so-called ‘PIDs’ allowed for the creation of holding companies – the least-regulated entities in terms of investment structure. In the initial stage, their ownership structure was highly dispersed. Stakeholders had access to all information on the value of PIDs’ investments or holding company portfolios, which helped them make informed decisions. A small, well-organised interest group could easily establish leadership in the assembly⁷² and redeem their own securities at a discount price from citizens without this information (this speaks to the problem of information asymmetry and the consequent misuse of internal information).

Moreover, poor liquidity in the securities market led to market manipulation with the aim of minimising prices prior to planned equity consolidation. Holding companies have proven to be long-term unsuitable indirect owners of companies in the ownership structure of financial holding companies, as they were not developmentally oriented, but only required capital and dividend returns in the short run. As a rule, holding companies financed their investment portfolios by borrowing from

66 ZISDU – Zakon o investicijskih skladih in družbah za upravljanje, Official Gazette No. 26/99, 56/99.

67 Festić, 2013.

68 See: ZPSPID – Zakon o prvem pokojninskem skladu Republike Slovenije in preoblikovanju pooblaščenih investicijskih družb, Official Gazette No. 26/05.

69 For more details, see: Festić, 2013.

70 See: ZGD – Zakon o gospodarskih družbah, Official Gazette No. 65/09.

71 For more details, see: Festić, 2013.

72 Festić, 2019a, 2019b.

banks (owned by the Republic of Slovenia) and, to a lesser extent, from their own capital.

Intertwined corporate ownership relationships were linked to the difficulties faced by banks and companies, with leverage ratios higher than 136% in 2008 and subordinated companies being overdebted with takeover loans, with mostly healthy business models. Privatisation had depleted real sector companies through the holding structure and ruined the business models of real sector companies.⁷³ The poor creditworthiness of companies was transferred to the problems of the banking sector, something which also added to the crisis of the construction sector, which was most prone to cyclical fluctuations. This gave rise to a need to recapitalise state-owned banks.⁷⁴

2.4. Slovenia's experience in the European Banking Union

The banking crisis of 2008 required a new approach towards both the recapitalisation of Slovenian banks and monetary policy instruments.⁷⁵ A series of EU regulations and directives have been transposed into the Slovenian legal order.

The Bank Recovery and Resolution Directive⁷⁶ was intended to treat creditors in an equitable manner when covering bank losses:⁷⁷ the bail-in toll to liabilities had the potential to destroy asset values.⁷⁸ The resolution authority needed to be able to exclude partial/total liabilities when necessary to avoid widespread contagion and systemic financial instability.⁷⁹

Notably, subordinated debt holders participate in annual losses to restore the issuing capital, and contractual loss sharing can be triggered before an institution fails. Creditors are paid before shareholders receive equity.⁸⁰

73 See: Festić, 2013; Bohinc, 2015; Bohinc, 2022.

74 See: Festić, 2011.

75 For more details, see: Festić and Krüger, 2009; Festić and Borak, 2019.

76 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173, 12.6.2014, 190–348 (BRRD).

77 Schelo, 2015, p. 86.

78 These concerns are the drivers for total loss absorbing capital (TLAC), gone concern loss absorbing capital (GLAC), and minimum required equity liabilities (MREL). It is also possible to offer more equity to creditors with a deeper haircut. See: BRRD.

79 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225, 30.7.2014, 1–90.

80 For more details, see: Tanzer, 2012.

The BS,⁸¹ carrying out the tasks of the Bank Resolution Authority, governs resolution planning procedures and measures to force winding-up procedures.⁸² The BS ensures the immediate availability of funds to finance compulsory liquidation measures for a single bank.⁸³ It also provides a mechanism for collecting and transferring contributions from banks established in the Republic of Slovenia to the Single Resolution Fund, in accordance with Regulation EU No 806/2014 of the European Council and the Agreement on the transfer and reciprocity of contributions under the Single Resolution Fund (Regulation 2010, 2012, 2013, 2014).

2.5. Slovenia as a Eurozone Member State

In 2013, Slovenia transferred bad banking claims to a bad bank. According to bad banks' best practices, bad banking claims should be transferred at the beginning of a recession. The Law on Measures to Strengthen the Stability of Banks (ZUKSB) and the Law on Banking (ZBan1, ZBan2, and ZBan3) were consistent with the criteria for transferring bad banking claims to bad banks in the ECB and EC guidelines. However, unlike the EU's terms, banks in Slovenia were mostly owned by the state. Therefore, Slovenia entered the recapitalisation process as an owner rather than a state.

The practice and trends in the euro area reflect the increased role of central banks in guiding banks in restructuring and other supervisory measures that interfere with financial stability. Alternatives to strengthen financial stability in light of good foreign practice (e.g. setting up banks or other capital participants to cover losses, transferring the bad banking claims of the special purpose vehicle (SPV), selling claims at a discount, transferring claims to a revitalisation centre within a bank, and transferring banks' assets/liabilities to SPVs, contractually settling creditor-debtor relationships in banks, and debt/equity swaps) arose from the criteria of transferring the bad banking claims in accordance with economic logic in terms of the supervisory function of the central bank and the necessary strengthening of banks' capital.

However, it is essential that banks first recognise losses and cover them against existing or available capital and subordinated debt. By eliminating bad claims and identifying banks' capital needs (based on an appropriate valuation of assets and market value), measures (e.g. disinvestment, reducing costs, improving bank governance and organisation, revitalising debtors) aimed at improving financial

81 ZRPPB – Zakon o reševanju in prisilnem prenehanju bank, Official Gazette No. 97/14, 91/15, 44/16, 71/16, 92/21; ZOSRB – Zakon o organu in skladu za reševanje bank, Official Gazette No. 97/14, 91/15, 44/16, 27/17.

82 This law transposes Directives 2001/24/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EC into Slovenian law. BRRD.

83 ZRPPB and ZOSRB do not apply to The Law on the Slovenian export and development bank (ZSIRB – Zakon o slovenski izvozni in razvojni banki, Official Gazette No. 20/09.).

stability contributed to banks' long-term capacity to support the economy with national savings (their primary function).

Such good practices further confirm that the measures pertaining to financial stability also have a precise timeline (three to five years) for the state's disinvestment and exit from the bad bank (in Slovenia, the DUTB). This timeline has proven to be too short for the financial restructuring of the assets transferred to the bad bank in Slovenia, and was therefore prolonged (this was done through the Law on Measures to Strengthen the Stability of Banks 2017, 2020).

We must not ignore the fact that problems exist within the real sector in Slovenia. Foreign practices have demonstrated that bad banking claims could not be transferred to the agency without simultaneously engaging in remediation in the real sector. Foreign examples of good practices (e.g. in Sweden, Securum and Retriva) point to the best use of the transfer of bad banking claims to bad banks in co-operation with the banks. The success of Sweden's Securum and Retriva was greatly influenced by their ability to acquire skilled experts in managing (bad) claims as well as specialists with industry-specific knowledge in restructuring and refining bank business models. After more than ten years, Securum and Retriva were completely sold off to strategic investors. Notably, corporate debts were transferred from banks to Securum and Retriva during the initial period of the crisis, which was unfortunately not the case in Slovenia in 2013.⁸⁴

In addition to the endogenous crisis in Slovenia, we cannot discuss a 'balance sheet recession' in which the debt/EBIT ratio decreases; this did not apply in Slovenia. Corporate indebtedness can decrease only with positive growth in revenues and profits, a condition that is unattainable during a recession. Consequently, it is difficult to manage the crisis. The average coverage of banking claims from insolvency procedures was estimated to be approximately 50%. Since there were no strategic investors interested in buying insolvent companies, the recovery of bad banking claims was difficult in Slovenia.⁸⁵

It is important not to ignore that (i) countries in which the majority of systematically important banks were state-owned did not start bank recoveries because they did not want to recapitalise them; (ii) these countries felt it was more important to try to save companies by transferring bad debts (bad banking claims); and (iii) when a state replaced non-performing loans with bank bonds in situations in which the state was not the sole owner or guarantor of the non-performing loans, the state increased the capital of other owners.⁸⁶ In the case of the recapitalisation of banks in Slovenia in 2013, subordinated bonds were deleted because the banks' capital was assessed as negative. However, it must be said that their valuations of loan collateral

⁸⁴ For more details, see: Festić, 2013.

⁸⁵ For more details, see: Festić, 2011.

⁸⁶ See: Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, OJ L 172, 26.6.2019, 18–55.

change depending on whether the economy is doing well or poorly. Thus, excess impairments (and provisioning for loan losses) created in bad times can be released in good times, increasing banks' extraordinary revenues. These revenues from the released impairments should first be used to repay state aid and then deleted subordinated bonds, regardless of the bank's current ownership.⁸⁷

In the case of Slovenia, the law on the recovery resolution and compulsory winding-up of banks (ZRPPB), which was already in force in 2015, was not respected when state-owned banks were sold (in a "fire-sale") with the clause that holders of subordinated bonds would be repaid by the state. Thus, the issue of deleted holders of subordinated bonds remains open to the European Court as the country did not reach a settlement agreement on the reduced share of the value of the deleted subordinated bonds in 2013.

2.6. Slovenia's monetary policy tools and their efficiency in the Eurozone

A notable macro-prudential instrument in this context is the gross loan-to-deposit flow ratio (GLTDF), which reflects annual changes in the balance of gross loans to the non-banking sector before considering impairments and annual changes in the position of non-bank sector deposits. Banks with a positive annual increase in non-bank sector deposits were recommended to have a negative annual increase in loans to the non-banking sector. The instrument was introduced in June 2014 to slow the dynamics of the reduction in the loan-to-deposit ratio in the banking sector. The GLTDF remained in force to prevent the excessive use of unstable wholesale financing. Credit activity notably declined due to reduced demand for credit given the deterioration of economic conditions during the COVID-19 pandemic.⁸⁸ In the context of declining demand for loans, the instrument was limited to asking banks to continue to renew the loans that companies were using to finance their current costs. In October 2021, Slovenia decided to terminate the GLTDF.

The decision on macro-prudential restrictions on consumer credit adapted the macro-prudential constraints already imposed by previous decisions; namely, the decision on macro-prudential restrictions on consumer lending and the decision on macro-prudential restrictions on consumer credit. This measure aimed to mitigate and prevent excessive growth in lending and leverage.⁸⁹

Slovenia, as part of the Eurosystem, implemented non-standard measures from the financial crisis onwards and during the COVID-19 crisis to offer support to individual market segments. In August 2012, the Governing Council of the ECB adopted the Outright Monetary Transactions Program on Secondary Government Bond

⁸⁷ See: Festić, 2011; Festić, 2013.

⁸⁸ For more details, see: Brežigar et al., 2020.

⁸⁹ Sklep o makrobonitetnih omejitvah kreditiranja prebivalstva (2022), Official Gazette No. 64/19, 75/20, 60/22 (valid till 30 June 2023); Sklep o makrobonitetnih omejitvah kreditiranja potrošnikov (2023), Official Gazette No. 60/22, 63/23; Sklep o določitvi zneska minimalne kreditne sposobnosti potrošnika (2023), Official Gazette No. 63/23.

Markets to ensure the proper transmission of monetary policy. Between Autumn 2014 and the end of 2018, the Eurosystem purchased debt securities through a securities purchase programme (specifically, the Asset Purchase Programme; APP), which was limited to the reinvestment of the principals of maturing securities from 1 January to 31 October 2019. To maintain favourable financing and prevent the negative impact of the pandemic on inflation trends, the Eurosystem also began implementing the Pandemic Emergency Purchase Programme in March 2020. Purchases included all eligible investment classes from the existing APP programme and certain short-term debt securities. The programme was continued until the end of March 2022 and the Eurosystem fully reinvested the principal amount of mature securities purchased under the APP programme until the end of February 2023; additionally, the principals of the maturing securities purchased under this programme will continue to be reinvested until at least the end of 2024.

The ECB increased interest rates for the first time at the end of July 2022. In its June report, it mentioned that high inflation posed a challenge to everyone. High price growth in May 2022, which was significantly driven by high energy and food prices, intensified due to the war in Ukraine. In 2022, the ECB began raising interest rates in the wake of the US Federal Reserve's own hikes. Ultimately, strong expansionary monetary policy, the start of easing and economic recovery, and disrupted supply chains and energy markets all contributed to inflation.

3. Conclusion

The establishment of the European Monetary Union required a long adjustment period during which economic policies were gradually unified and the macroeconomic environment became comparable. By increasing the integration of economies through uniform economic policies – particularly monetary policies – supply and demand shocks have become symmetrical. The comparability of inflation, interest rates, government debt, and the general government deficit established the conditions for lowering the exchange rate fluctuation interval.

Meanwhile, the adoption of the common currency eliminated exchange rate risks, while inflation increased after the introduction of the euro in countries that lagged slightly behind the leading euro area countries. Slovenia introduced Eurozone regulations and directives into national laws and thus established a comparable macroeconomic and banking environment.

Bank recovery took place in 2013 under state aid rules and European Commission requirements. As part of the Eurosystem, the Bank of Slovenia lost sovereignty over its monetary policy, while simultaneously establishing a commitment to the euro area's policy, thus becoming an equal member of the single currency area.

Slovenia's experience with the EU and euro area is positive, as the international production chain of value and exports requires greater integration of the economy in the monetary field, which is especially evident through a common monetary policy. This makes it easier to control inflation and comparable lending rates and is a sign of a comparable level of development and GDP structure. The integration process resulted in a comparable GDP structure, a single monetary and coordinated fiscal policy, and insignificant speculative capital flows, which further strengthened the potential for stable interest rates, export competitiveness, and national economic accumulation (savings), which can, in turn, finance Slovenia's own development.

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PART V

CONCLUDING
REMARKS

REFLECTIONS ON ECONOMIC GOVERNANCE IN THE CENTRAL EUROPEAN COUNTRIES



ZOLTÁN NAGY

The integration of the European Union is constantly evolving and changing. The economic integration process is becoming increasingly extensive. However, linking national economies to a single system through economic integration involves economic and regulatory problems.¹ Coordinating fiscal and monetary policies raises many problems for national, macroeconomic, and European Union (EU) economic policies. These conflicts are reflected in the regulatory level. As economic and social processes change, the integration processes are also in flux. The strengthening or weakening of national sovereignty influences both the deepening and weakening of conflict. However, integration processes must achieve the objective that the primary goal of integration is to ensure security, efficiency, and prosperity for the societies involved.²

The European Council defines what economic governance means. Economic governance is a system of institutions and procedures established to coordinate economic policies and achieve the objectives of the European Union. Therefore, for the EU to maintain a balanced economic situation, Member States' economies must also be free from imbalances. The fundamental aim is to ensure the regulatory framework is conducive to economic growth and low unemployment. This requires ensuring sustainable public finance management and economic growth. The regulatory framework that ensures this impacts the macroeconomic policies of individual Member States; that is, monetary and fiscal policies. Member States need to build rules and mechanisms to meet EU objectives. At the same time, this naturally limits the economic policy of the Member States so that responsibility

1 Halmi, 2020, pp. 13–16.

2 Palánkai, 2019, pp. 27–29.

Zoltán Nagy (2024) 'Reflections on Economic Governance in the Central European Countries'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries*, pp. 845–879. Miskolc–Budapest, Central European Academic Publishing.

remains with those who manage national economic policy, since the Member State is responsible for the well-being, economic and social development, and the performance of public tasks in the society concerned. Given this background, disputes over the use of economic governance instruments emerge. The situation is further complicated because Member States with different levels of economic development participate in the union and are, therefore characterised by different economic and social priorities. EU resources are helping to solve these problems, but there is still a long way to go for individual Central European countries to reach the economic development of Western European societies. To preserve competitiveness and ensure sustainable public finances, changes should also be introduced in the EU rules, reforming the fiscal and monetary frameworks while maintaining the previous main frameworks. National budgetary situations, debt levels, and economic challenges differ across the EU countries. Therefore, the gradual reduction of public debt and deficits, protection of investment, provision of sufficient room for manoeuvring anti-cyclical fiscal and monetary policies, and management of macroeconomic imbalances are important objectives. Thus, the central element of the reform was the sustainability of public debt, with a prudent level of 60% of the GDP and a budget deficit below 3% of the GDP. At the same time, a differentiated approach for each Member State will be allowed through the introduction of national medium-term budgetary structural plans in which Member States would set out measures to address imbalances and reform ideas to ensure sustainable economic growth for at least four years. Member States can request a longer adjustment period if they make investments that increase economic growth and support the achievement of sustainable budgets. To achieve this adjustment, the Commission sends a risk-based, differentiated technical roadmap based on net expenditures to Member States that do not meet debt and deficit benchmarks, ensuring an annual reduction in debt and deficit.³

Therefore, an important question for Central European states is how EU regulations affect their domestic fiscal and monetary arrangements, whether they fully comply with EU requirements, and whether they can meet the expected macroeconomic standards in their monetary and fiscal policies. From this perspective, the book examines the fiscal and monetary regulations in seven member states and one state from the perspective of the challenges faced by the Serbian state in meeting these requirements if it wishes to become a member of the European Union. The analysis covers three areas of fiscal policy from the perspective of EU regulations: the definition of sustainable fiscal frameworks, aid policy issues, and taxation issues. In monetary policy, several research questions have arisen regarding the monetary aspects of the introduction of the euro, banking unions, and crisis management. In this chapter, I briefly summarise the experiences of the regulatory and EU-focused

³ *Economic Governance Framework* [Online]. Available at: <https://www.consilium.europa.eu/hu/policies/economic-governance-framework/> (Accessed: 20 January 2024).

analyses of the eight countries based on the chapters in the book, pointing to regulatory responses and solutions.

1. Sustainable public finance management and fiscal governance

EU regulations are implemented through several pieces of legislation. The EU chapter of this book points out that the Treaty on the Functioning of the EU sets the reference values that Member States should respect (3% of GDP for government deficit, 60% of GDP for government debt), the Stability and Growth Pact sets out the fiscal surveillance procedure and influences the achievement and maintenance of the reference values through preventive and corrective rules. This is complemented by the ‘six-pack’ and the ‘two-pack’, which consist of a series of regulations and directives. These two packages helped develop the European Semester, which combines economic and budgetary policy coordination in a single framework. Under the European Semester, Member States align their fiscal policies with the EU rules.⁴

An important question is how these rules are incorporated into national legislation and the level at which they are regulated. EU rules do not always take the form of legislation but of other non-automatic rules that have to be incorporated into the national legal system. The highest level of public finance regulation is constitutional. The depth of the regulation varies from one Member State to another. The most extensive regulation is found in the Hungarian Fundamental Law, but there are also detailed regulations in the Polish and Slovak constitutions. In the Czech Republic, the constitutional framework is not provided by a single law but by two constitutional laws.⁵ A general feature of all constitutional arrangements is that they lay the foundation for public finance regulation. The basic institution of public revenue law is public taxation, which is the basis of taxation and is found in the constitutions of all countries (in the case of the Czech Constitution, two separate acts can be considered a constitutions). Adopting the budget is the responsibility of the parliament as the main basic document for public management, which sets the framework for public finances, typically for one year. Typically, there are rules on budgetary procedures, particularly on implementation and control.

In detailed constitutional legislation (Hungarian, Polish), there is a separate chapter on public finance, where detailed rules on budgetary procedures and sustainable budget management are found at both the central and local levels.

⁴ Szegedi and Teleki, 2024a.

⁵ Radvan and Tomášková, 2024.

A separate Public Finance Act regulates detailed rules on the budget, the Budget Act. However, some countries (Hungary, Slovenia, and Slovakia) have two-tier constitutionality of public finances; constitutional rules are set out in detail in separate laws, also adopted by a two-thirds majority. Consequently, constitutional rules are more detailed in these countries.

One of the most important cornerstones of compliance with EU rules is the level of public debt and budget deficits. The 60% GDP ratio of public debt and the 3% budget deficit have not changed in recent EU negotiations, but rather, the timetable for returning to a sustainable fiscal path is adapted to the specific economic situation of each country. Central European countries have also introduced these criteria at the constitutional level, in their public finances, or through related public finance laws. The Maastricht criteria are typically regulated at the level of public finance (Romania, Slovenia, Croatia, Serbia, and the Czech Republic); however, in Hungary and Poland, they are sometimes enshrined in the constitution. In the case of Slovak legislation, the EU criteria are not laid down in the constitution, but the law on fiscal responsibility is constitutional.⁶

Therefore, it is clear that only a few states have taken the opportunity to raise the EU criteria to the constitutional level. Not all states have stuck to the 60% level of public debt but have set a lower level. Hungarian and Slovak laws set the level of public debt at 50%. Both countries' debt currently exceeds this expected level (73.5% in Hungary and 57.5% in Slovakia by 2023). What is the purpose of setting the lower rate? Essentially, these rules bring forward mechanisms that will curb further indebtedness so that it may be possible to avoid debt reaching the EU level (except Hungary, which has not reached this level since the rule was introduced).

In addition to setting the rate, some countries have defined specific mechanisms to reach the target. There are solutions in which the legislator sets standards adjusted to the level of debt (e.g. the Slovak and Polish legislation) or sets corrective measures not for each debt level but for the expected debt level (Hungarian, Slovenian, Romanian, Croatian, and Serbian legislation).

Among these, the Slovak regime, which sets the reference value for public debt at 50%, introduces measures to prevent the increase in public debt from as low as 40% and imposes increasingly stringent measures as debt increases, for example, if the debt increases between 45% and 47%, the Ministry of Finance can freeze 3% of the central budget expenditure. However, the rule is softened because the rates are more favourable and will only be applied more strictly from 2027.⁷

In general, an increase in public debt is generated by a budget deficit; therefore, the set of rules focuses on the budget deficit in addition to the government debt indicator. The absolute objective of the rule is budget balance – that is, the balance between expenditure and revenue. However, the short-term objective is to reach the EU's 3% budget deficit target. In several Central European countries examined,

⁶ Štrkolec, 2024a.

⁷ Štrkolec, 2024a.

government debt and budget deficits have exceeded the EU criteria in recent years (Slovenia, Hungary, and Croatia); therefore, rule-based fiscal rules have performed well. Therefore, high rates are typical in countries with high public debt.

The level of public debt is also influenced by local government debt, which is why countries limit the indebtedness of their local governments. Debt limitation mainly restricts the incurrence of long-term debt and not borrowing for temporary liquidity problems within the year. The rules generally discourage local governments from financing their current expenditure through borrowing, as this would lead to permanent indebtedness. To avoid excessive indebtedness, countries impose balanced budgets. The purpose for which a loan can be taken out is defined among the regulatory solutions. For example, the Polish and Hungarian regulations specify four objectives for borrowing: a temporary budget deficit for the municipality, payment of previous liabilities, and pre-financing of EU programs. The latter is generally preferred in other countries because the increasing use of EU funds requires both the pre-financing of programs and the financing of their resources. In the development case, the legislature is more permissive and allows using loans.⁸

Debt ceilings are defined differently. In general, the debt brake applies to municipalities; however, in the past, for example, in Hungary, it has led municipalities to finance their current expenditures with loans and to incur debts through municipal enterprises that perform public tasks, which later burden the municipality in the same way. Consequently, the debt brake applies to municipal entities and enterprises in several countries (Hungary, Croatia and Poland).

In general, the government or the minister of finance has the power to authorise municipal borrowing in the case of municipalities. Borrowing rules are diverse. Slovenian legislation captures the amount of borrowing at 5% of the municipal budget, whereas Croatian legislation takes the previous year's revenue as a basis and allows borrowing up to 20% of this amount. Slovak regulations separate the maximum total debt (maximum 60% of current revenue) from the maximum loan repayments in the financial year (25% of the current revenue).⁹ Hungarian regulations allow a maximum amount of debt to arise from transactions, generating up to 50% of the municipality's revenue in the current year.

The basic aim of the debt brake is to ensure that local authorities self-finance based on their revenue and the resources provided by the state. This is reinforced in Hungarian legislation, where the government contributes to debt relief operations if the municipality introduces a local business tax, property tax, or municipal tax on individuals.¹⁰

The characteristic feature of all these schemes is that they provide an exception to strict rules for exceptional situations. This was also the preference of the European Union when it suspended the Maastricht criteria in response to recent crises.

⁸ Mikos-Sitek, 2024a; Nagy, 2024.

⁹ Štrkolec, 2024a.

¹⁰ Nagy, 2024.

In dealing with the crisis, states launched programs that meant higher fiscal expenditures, increasing the size of the budget deficit. In general, fiscal and monetary measures taken under exceptional circumstances have reduced the negative economic and social impacts of economic crises. However, this incurs a significant budget cost. The budget deficit increased significantly, and consequently, the level of public debt rose. All the countries sought to reduce unemployment and safeguard jobs through specific business programs. Temporary tax cuts, deferrals, and suspension of payments further aggravated the situation. Thus, while revenues fell, expenditures on state budgets increased. For example, the Hungarian legislature responded to the revenue shortfall by introducing special sectoral taxes, including in the public tax burden economic sectors that had been making high profits, even during the crisis.¹¹

An important challenge for Central European countries ahead is to return to the EU and domestic fiscal rules and close the loopholes provided by the exceptional rules. This is also important because the EU's binding fiscal rules could trigger an excessive deficit procedure and the associated sanctions.

2. National State aid and subsidies

As part of the European Union's competition policy, the Treaty on the Functioning of the European Union (TFEU) has special provisions prohibiting unlawful State aid. Such rules can also be connected to the most important economic objective of the European Union, namely, the realisation of a single market. In order to have a well-functioning single market where production inputs (labour and capital) and outputs (goods and services) can flow freely without significant distortions, rules are needed to ensure that government interventions cannot bring about these distortions by means of subsidising certain enterprises or certain productions. Besides laying down the prohibition of unlawful State aid and certain exceptions to this rule, the TFEU does not elaborate on the interpretation of the concept. It was left to the Court of Justice of the European Union (CJEU) to provide for guidance regarding the correct interpretation of State aid rules regarding scope and content. The European Commission is in charge of monitoring the subsidy systems of Member States and carrying out investigations if necessary. If the Commission and the Member State concerned cannot agree on the lawfulness of a subsidy measure, the Commission will make a negative decision, obliging the Member State to recover aid from subsidised enterprises. The Member State has the right to appeal against the negative decision to the CJEU, where the procedures entail two instances: the first-instance judicial body in State aid cases is the General Court,

¹¹ Nagy, 2024.

while the Court of Justice says the final word. As State aid rules form part of the corpus of the law of the EU from its conception, the CJEU's jurisprudence is very extensive on this topic.

In the Economic Governance research project, questions revolving around the functioning of national subsidy policies embedded in the EU's legal framework formed one of its pillars. In the section of the national chapters concerning State aid, the authors provide an overview of their national subsidy policies, including the main features of their system. In doing so, they highlighted the main aspects of the direct and indirect subsidy systems prevailing in the examined jurisdictions and the special characteristics related to socioeconomic crises, such as the Russo-Ukrainian war and the COVID-19 pandemic. As the European Union has a well-developed State aid regime that forms part of its competition law, the interaction between Union law and national subsidy policies is unavoidable. The national chapters paid special attention to this type of interaction, highlighting the leeway of designing their subsidy policies within the framework given by the EU rules and demonstrating the problematic fields where a conflict has arisen due to the coexistence of European Union State aid rules and national rules.

In most countries, one can find national legislation in place that governs State aid control at domestic level, often establishing a special body or office that helps to monitor aid measures (e.g. Hungary,¹² Poland,¹³ the Czech Republic,¹⁴ Slovenia,¹⁵ and Serbia¹⁶). These institutes are also responsible for preparing an annual report and fulfilling the transparency requirements related to State aid rules. National legislation typically takes the form of an act (as in Croatia,¹⁷ Poland,¹⁸ the Czech Republic,¹⁹ Slovakia,²⁰ Slovenia,²¹ and Serbia²²); however, in other Member State the issue, that is, the implementation of State aid control required by EU law, is regulated in the form of a government decree (Hungary²³).

It is also noteworthy that the State aid rules of the EU have an influence that goes beyond the territory of Member States. This affects national subsidy rules in the case of countries that intend to become a Member State long before their accession. Croatia²⁴ (recently joined the EU in 2013) and Serbia²⁵ (a country that intends to

12 Kecő, 2024.

13 Mikos-Sitek, 2024b.

14 Tomášková and Radvan, 2024a.

15 Bratina and Bohinc, 2024.

16 Popović, 2024b.

17 Žunić Kovačević and Gadžo, 2024.

18 Mikos-Sitek, 2024b.

19 Tomášková and Radvan, 2024a.

20 Štrkolec and Vartašová, 2024.

21 Bratina and Bohinc, 2024.

22 Popović, 2024b.

23 Kecő, 2024.

24 Žunić Kovačević and Gadžo, 2024.

25 Popović, 2024b.

join the EU in the future) serve as good examples of this phenomenon, as these countries adjusted their subsidy policies to synchronise and align them with the legal framework of the EU. Such an alignment is even required from the candidate countries.

As State aid can be constituted by grants distributed based on geographical location (regional aid), Member States shall prepare a so-called regional aid map subject to the European Commission's approval. In most Member States, the intensity of the State aids varies across the country region-by-region. However, this does not automatically mean that the least developed regions can receive the most subsidies. Paradoxically, the opposite was true in Slovakia.²⁶ This can be problematic as regional aid targets the elimination of regional disparities. Similar discrepancies can also be discovered in Slovenia, where the more developed region receives more subsidies to the detriment of the poorer region.²⁷ With respect to the regulation of regional aid, Serbia is still in need to achieve further progress before its accession as the country needs to adopt its regional aid map.²⁸

In the case of individual aid (subject to the approval of the Commission following its notification), Member States typically subsidise participants in certain industries important to the national economy. For instance, a large bulk of the notified aid in Hungary was related to enterprises carrying out economic activities in the automotive and battery manufacturing industries.²⁹ The Slovak subsidy policy focuses on manufacturing motor vehicles, trailers, and semi-trailers and developing strategic parks.³⁰ However, other Member States, such as Slovenia, attempt to use horizontal (i.e. not sector-specific) aid to dominate their subsidy policies.³¹ Horizontal aid schemes, which apply across many sectors, are deemed less distortive to competition and are generally allowed without prior notification by the European Commission in light of its General Block Exemption Regulation.

An interesting aspect of the overlap between investment arbitration and EU State aid rules has been raised in the Czech Republic, especially in subsidising renewable energy.³² The European Commission's general stance is that EU State aid law precludes the finding that the investor's legitimate expectations were infringed upon by amending or eliminating subsidies not approved by the Commission. This position can also interfere with investment arbitration cases, in which foreign investors have been awarded compensation for the withdrawal of subsidies or other benefits. If the European Commission considered that the original advantage was granted in contravention of EU state aid law, it would object to the compensation. The Commission argued that EU law precludes the finding of legitimacy in such circumstances.

²⁶ Štrkolec and Vartašová, 2024.

²⁷ Bratina and Bohinc, 2024.

²⁸ Popović, 2024b.

²⁹ Kecső, 2024.

³⁰ Štrkolec and Vartašová, 2024.

³¹ Bratina and Bohinc, 2024.

³² Tomášková and Radvan, 2024a.

It is clear from the early stages of the integration process within the EU that State aid can also be granted through tax concessions rather than via the direct transfer of funds. This does not mean that any distinction caused by tax measures among taxpayers is susceptible to constituting unlawful State aid. The Commission itself highlighted in its Notice some aspects of tax systems that should not create unlawful aid. It encompasses general tax measures of a purely technical nature (e.g. the determination of tax rates, depreciation rules, and rules on loss carry-overs; provisions to prevent double taxation or tax avoidance) and measures pursuing general economic policy objectives through a reduction in the tax burden related to certain production costs (research and development, environment, training, and employment). Despite this fact, nowadays, one can observe a significant trend in which the Commission's State aid investigations target national tax measures. Indeed, looking at the most important tax-related case law of the CJEU, an unusually high percentage concerns the compatibility of national tax measures with State aid rules.

A very interesting line of cases developed on whether turnover-based business taxes designed with a progressive tax rate structure were compatible with EU State aid rules. The Commission was of the opinion that these taxes, such as the Hungarian advertisement tax or the Polish retail trade tax constituted unlawful State aid.³³ The Commission argued that low-turnover enterprises that fell within an exempted tax band or in a tax band with a low tax rate were in an objectively comparable situation with high-turnover undertakings that fell within higher tax bands and, consequently, were subject to higher average tax rates. Due to comparability, the differential treatment constituted prohibited State aid for the low-turnover undertakings according to the Commission. However, the General Court and later, in the second instance proceedings the CJEU annulled the decisions of the Commission. The CJEU held that high- and low-turnover undertakings were not in a comparable situation on account of their different abilities to pay taxes because turnover is a relevant and neutral indicator for measuring the financial capacity of undertakings, irrespective of the fact that such an indicator does not consider the costs of the enterprises. Furthermore, as to the CJEU, the Commission failed to prove that the tax systems at issue were inherently and manifestly discriminatory despite the fact that it was demonstrated that the tax burden was spread in a very asymmetric and disproportionate manner among the market participants.

In the context of turnover-based business taxes, the Slovak special tax on retail chains should also be mentioned.³⁴ The tax applied to retail chains as a group of retail establishments operated by the same entrepreneur if they were food traders, had establishments in at least 15% of all districts, generated at least 25% of their net turnover from the sale of food to the final consumer, and their establishments had

³³ Kecsó, 2024; Mikos-Sitek, 2024b, respectively.

³⁴ Štrkolec and Vartašová, 2024.

a uniform design, common communication and common marketing activities. The basis of assessment for the tax was the net turnover, excluding the turnover of establishments in the least developed districts with a maximum of ten employees and municipalities with a maximum of three establishments selling food to consumers. The rate was 2.5%. However, the tax was almost immediately abolished following its entry into force as a result of an in-depth investigation by the Commission that concluded that the tax constituted State aid because the retail turnover tax was selective since it favoured categories of enterprises that were not subject to the tax according to the established criteria, compared to enterprises that were obliged to pay it. Slovakia abolished the tax and did not appeal to the Commission's decision, so it is uncertain how the CJEU would have decided. Here, a single tax rate was applicable, contrary to the Hungarian and Polish taxes; however, the design of the tax introduced differentiations based on the geographical spread of the retail chains and their size; therefore, the CJEU judgments concerning the former were not conclusive to the latter.

The Frucona case from Slovakia demonstrated the importance of the private creditor test in State aid analysis and its difficulties.³⁵ The case concerned the write-off of tax debt in the course of a procedure of arrangement with creditors of the company. Although the Commission found this act as unlawful State aid, later on the CJEU annulled its decision with reference to the fact that the Commission failed to explore the relevant circumstances that were necessary to decide whether the conditions of the private creditor test have been fulfilled.

While the tax measures of certain Member States in the context of State aid rules stirred significant debates before the CJEU, in the case of other Member States, such conflict is not typical and is not contemplated either (e.g. Croatia³⁶). This can be explained by the fact that, first, in these countries, tax incentives are not intensively used to attract investments and subsidy policies are fuelled primarily through direct grants and transfers. Second, tax incentives in these countries are generally in line with horizontal goals and compliant with the General Block Exemption Regulation (GBER), such as R&D tax incentives or employment-related incentives (Czech Republic³⁷).

In the case of Serbia,³⁸ a candidate country for becoming a Member State of the EU, there were significant differences in terms of the approach towards fiscal aids. In order to eliminate this discrepancy, in March 2022, the Commission for State Aid Control of the country issued a Notice on the obligation and manner of alignment of State aid schemes within the competence of the Ministry of Finance. Under this Notice, the following fiscal schemes were designated as incompatible: (i) four schemes under the Corporate Income Tax Act: tax exemption for concession

³⁵ Ibid.

³⁶ Žunić Kovačević and Gadžo, 2024.

³⁷ Tomášková and Radvan, 2024a.

³⁸ Popović, 2024b.

grantors, tax holidays for large investments, tax exemption for employment of persons with disabilities, and tax credit for risk investment; (ii) wage tax refund under the Personal Income Tax Act; (iii) refund of social security contributions under the Mandatory Social Security Contributions Act; and (iv) exemption from tax and other duties under the Free Zones Act. The Commission for State Aid Control emphasised that state aid under the designated fiscal schemes must be assessed in the context of a particular category of State aid to which it belongs, which is either horizontal or sector specific aid. Alternatively, some aid may be granted as *de minimis* aid.

The COVID-19 pandemic has led to EU-level solidarity measures, especially the creation of the EU's NextGenerationEU recovery instrument, with approximately EUR 800 billion temporary funds to support economic recovery. The core of the NextGenerationEU is the Recovery and Resilience Facility (RRF), in which the Commission raises funds that are then available to the Member States to carry out several reforms and investments in the fields of green and digital transition, implement country-specific recommendations under the European Semester framework of economic and social policy coordination, and execute the RePowerEU plan as the Commission's response to the socioeconomic hardships and global energy market disruption caused by the post-coronavirus Russo-Ukrainian war.³⁹ In the context of the war, the Commission adopted yet another regulatory framework, the Temporary Crisis and Transition Framework, which brought about new possibilities for Member States in addition to existing ones. Within this framework, the Commission approves measures that aim to facilitate energy management, such as promoting energy from renewable sources and digitalisation, and most of the examined Member States used this opportunity.

The Commission reacted quickly to the crisis by partially suspending and reinterpreting State aid rules and, in parallel, making further changes to the framework that widened the scope of lawful aid (State Aid Temporary Framework or SATF). The SATF enables Member States to use state aid rules flexibly to support the economy during the slowdown due to the coronavirus outbreak. With some exceptions, it has not been extended beyond the expiry date of 30 June 2022. In particular, investment and solvency support measures could remain effective until 31 December 2022.

All Member States have utilised this option to some extent. A dominant objective of the measures of Member States underlying COVID-19-related expenditures was the remedy for a serious disturbance in the economy under Art. 107 para. (3) point (b) of the TFEU. The approach of the Commission regarding aid pertaining to this objective and to the facilitation of energy management is rather supportive *vis-à-vis* the Member States. For example, Hungary adopted 23 measures under the Temporary Framework related to COVID-19 and 13 under the Temporary Crisis and Transition

³⁹ Szegedi and Teleki, 2024b.

Framework, and the Commission considered all of them compatible with a single market.⁴⁰

Member States have used this possibility to support areas that were hit by the crisis in particular. For instance, Croatia primarily subsidises tourism and transportation through various aid measures, including zero- or low-interest loans, guarantees, and wage subsidies.⁴¹ In the context of war crises, most Member States introduced new subsidies, focusing significantly on energy management and agriculture (Croatia).⁴² Within this framework, Poland implemented a comprehensive set of measures to support small and medium-size enterprises in the midst of the crises and for this purpose a special aid program has been developed.⁴³ Air traffic is also an industry that has suffered a lot from crises and has generally been subsidised in most Member States. The Czech Republic provided subsidies related to the payment of social contributions, rent reduction for small and medium-sized enterprises, and various aid measures for self-employed people.⁴⁴ Among the sector-specific subsidies, the Czech Republic supported tourism, agriculture, and media.⁴⁵ Slovakia has focused on tourism, transportation, sports, and R&D-intensive sectors following the pandemic outbreak.⁴⁶ In addition to the typical areas where subsidies flow (employment and R&D), subsidies related to environmental protection goals are particularly significant in Slovenia.⁴⁷

Member States can also be distinguished based on the intensity of the use of State aid measures in their economic governance policies. Some Member States rely on this instrument more heavily (e.g. Hungary⁴⁸ and Slovenia⁴⁹), while others put less emphasis on this aspect of economic policy (e.g. Slovakia⁵⁰).

Regarding the maintenance of the State aid rules at EU level, it seems that most of the Member States are interested in keeping them instead of instituting a free aid competition among the Member States. For example, the Hungarian author highlights that Hungary's budget would be too tight to get a good result in free competition among Member States if State aid were not forbidden by EU law, according to the general rule.⁵¹ For this reason, Hungary has a strong interest in maintaining an effective prohibition of State aid and making the most successful use of exceptions

40 Kecső, 2024.

41 Žunić Kovačević and Gadžo, 2024.

42 Ibid.

43 Mikos-Sitek, 2024b.

44 Tomášková and Radvan, 2024a.

45 Ibid.

46 Štrkolec and Vartašová, 2024.

47 Bratina and Bohinc, 2024.

48 Kecső, 2024.

49 Bratina and Bohinc, 2024.

50 Štrkolec and Vartašová, 2024.

51 Kecső, 2024.

to the main rule. Similarly, it is also expected in Slovakia⁵² and Slovenia⁵³ that, following the end of the crisis period, a return to the general State aid rules (i.e. the repeal of the various temporary frameworks) will occur. Furthermore, maintaining State aid rules can contribute to fiscal discipline and improve public expenditure choices. Thus, it can be deduced from the national reports that although the Member States found it very important that strict State aid rules be waived by the Commission to enable them to intervene with public funds in the crisis and mitigate its effects, the comeback of ordinary State aid rules under ordinary times is desirable. This outcome is logical in the light of the fact that the examined Member States in the Eastern-Central European region are rather small economies compared to Western European countries, and their position in an EU-wide subsidy competition would be weak. Nevertheless, it can be considered to make regional differentiation and allow for applying a more lax State aid regulatory framework for poorer regions to catch up. However, applying lawful State aid to the cases in which it was intended is very important. A report by the Supreme Audit Office of the Czech Republic demonstrates that Member States tend to subsidise ‘national champions’, that is, large national enterprises, to the detriment of smaller ones.⁵⁴ In some problematic cases, the same phenomenon can be observed, even when aid should be granted only to small and medium-sized enterprises.

3. Taxation and tax harmonisation issues

The sovereignty of states also encompasses fiscal sovereignty, of which tax sovereignty forms a part. Tax sovereignty could be defined at a high level, as it entails the liberty of the states to design their tax systems in a way that they see fit and spread the tax burden across the tax subjects in a manner that they find the most equitable and efficient. However, this liberty does not come without constraints. Tax sovereignty has voluntary and involuntary limitations. An example of an involuntary limitation is competition between states to make their tax systems attractive to investors. If a state finds itself in a position where other states provide for a much more investor-friendly tax environment, then it might be forced to adjust its tax system to keep up with the competitiveness of others. Voluntary limitations are, for instance, international agreements whereby states choose to cooperate and refrain from introducing certain tax rules; in exchange, they can benefit from enhanced trade and economic relations. From a tax perspective, the most relevant types of

⁵² Štrkolec and Vartašová, 2024.

⁵³ Bratina and Bohinc, 2024.

⁵⁴ Tomášková and Radvan, 2024a.

agreements are double-tax treaties, investment treaties, and the World Trade Organisation Agreement.

Another voluntary limitation of fiscal sovereignty is participation in regional integration systems. The establishment of the European Community, now the European Union (EU), achieved one of the most significant integrations. This entails the allocation of competencies between the EU and its Member States. EU competencies can be exclusive, shared, supportive/coordination. The competences regarding the area of taxation are not explicitly allocated. However, taxation falls within the scope of the single market objective, the achievement of which belongs to the category of shared competences between the EU and its Member States. This implies that Member States are free to regulate their tax systems insofar as the EU does not exercise its competence. If such competence is exercised with regard to a specific field at EU level (i.e. harmonising measures are adopted), then the Member States lose their freedom to act in the given field unilaterally.⁵⁵

Thus, the issue of tax sovereignty becomes a particularly delicate question. On the one hand, there is an interest that the single market within the EU should function properly without significant distortions. This important aim is one of the cornerstones of the EU's economic goals. This could be compromised by the coexistence and interference of diverging national tax systems that are capable of distorting the competition within the single market and the allocation of production factors. It is certainly a legitimate aim to mitigate these negative effects at the EU level by harmonising tax rules.

On the other hand, taxation is a sensitive part of the sovereignty of Member States because the collection of tax revenues enables them to provide public services and operate the country. Furthermore, taxation can also serve as a useful tool for the Member States to support their economic policies and attract foreign investment. This holds especially for direct taxation. First, this is a field where, in contrast to indirect taxes, harmonisation took place only sporadically, and consequently, Member States are more adamant in relinquishing their right to shape their direct tax systems. Second, direct taxation levied on yields derived from economic activities is more susceptible to affect business decisions. However, in the last decade, Member States have reached a consensus concerning two fundamental aspects of corporate taxation. In 2016 and 2017, respectively, the Anti-Tax Avoidance Directives (ATAD 1 and ATAD 2) were adopted, and by the end of 2022, the agreement on a global minimum tax was legislated at the EU level as a directive (Globe Directive). These developments materially affected the sovereignty of Member States and added interesting aspects to the discussion.

In the national sections concerning taxation, the authors highlight the main aspects of the tax sovereignty of a given country. Except Serbia, all the examined countries are Member States of the European Union, and the abovementioned interfering interests must be resolved in one way or another.

⁵⁵ Károlyi, 2024a.

This chapter aims to show the similarities and differences in the approaches of the examined states towards the interpretation of the concept of tax sovereignty, with special regard to aspects of tax competition. Moreover, Member States' position *vis-à-vis* harmonisation in the field of taxation will be compared, including observing the prevailing tax policies and the compliance with the obligation to transpose harmonising measures. Finally, the domestic tools against tax avoidance are summarised. Tax avoidance also affects states' tax sovereignty, as it implies that tax revenues meant to be collected are lost. Consequently, it is worth examining how the states implemented relevant EU legislation, including substantive and procedural (exchange of information, mandatory disclosure rules) and unilaterally legislated domestic anti-avoidance rules.

In most Member States involved in the scope of the research, the original concept of tax sovereignty entails the right to regulate tax matters independently from external (and from internal, non-state) factors and to impose, collect, and enforce taxes and spread the tax burden in a way that they find the most appropriate. However, tax sovereignty significantly changed with the integration process within the European Union, and this change, that is, the fact that in many fields, Member States conferred competences on the European Union, has gained constitutional acknowledgement. This does not give rise to disputes, as opposed to the extent and scope of such a conferral. As indirect taxes have been vastly harmonised since the integration process, Member States have become more reluctant to give up their tax sovereignty in the field of direct taxation, which has largely remained in Member States' hands. The concept of direct and indirect taxes is often difficult to disentangle (e.g. a vehicle tax with environmental protection objectives). Taxes not levied on transactions connected to goods and services remain the competence of Member States, such as income and property taxes. Most Member States also consider participation in tax competition as part of their tax sovereignty (Hungary,⁵⁶ the Czech Republic,⁵⁷ and Slovenia⁵⁸), although there are diverging views on whether tax competition can be regarded as a positive or a negative phenomenon. On one hand, it serves as a useful tool to attract and encourage foreign investment and boost the country's economic life. On the other hand, harmful tax competition can result in a 'race-to-the-bottom' where countries might end up with insufficient tax revenues due to the overly low level of taxation forced by fierce competition. Each Member State must assess the pros and cons of tax competition, and some are more in favour of it (e.g. Hungary,⁵⁹ Slovakia,⁶⁰ and the Czech Republic⁶¹), while

56 Károlyi, 2024b.

57 Radvan, 2024.

58 Bohinc and Jovanovič, 2024.

59 Károlyi, 2024b.

60 Vartašová, 2024.

61 Radvan, 2024.

others do not consider that its advantages necessarily outweigh the disadvantages (e.g. Slovenia⁶² and Croatia⁶³).

Several authors have raised problematic issues regarding property taxation. Property taxes are currently out of the scope of any harmonisation activities of the EU, although a more comprehensive and coordinated action is contemplated in this field at the international level; thus, it belongs to the tax sovereignty of Member States. However, it is not properly used to pursue equity considerations, and property taxation is generally very low in the Eastern-Central European region, often distorted, and left to the discretion of municipalities whether they wish to levy it (the Czech Republic,⁶⁴ Slovenia,⁶⁵ and Slovakia⁶⁶).

Croatia is a rare example where concerns about the restriction of tax sovereignty with accession to the EU are absent.⁶⁷ This can be explained by the fact that accession was a strategic goal on which most political actors agreed and that the national economic policy never contemplated creating a tax-haven environment in the region. This stance is also reflected in the approach to harmonisation measures in the field of taxation, which has been carried out without any significant debate. Another example of a relatively conflict-free relationship with the EU in the field of taxation is Slovenia, where the national tax policy is generally aligned with the proper functioning of a single market.⁶⁸

Besides harmonisation, tax sovereignty in the field of direct taxation might be very well affected by primary EU law. More specifically, domestic tax measures must comply with the criteria set out by the TFEU's fundamental freedom and State aid rules. Although these two sets of rules differ in terms of their scope and application, their convergence can be witnessed in tax matters, as they both boil down to a type of non-discrimination test. Thus, discriminatory domestic tax measures might fall short of fundamental freedoms and State aid rules without proper justification.

In academic discussions and the CJEU jurisprudence, a recent development was the challenge of turnover-based business taxes (Poland⁶⁹ and Hungary⁷⁰) in light of both fundamental freedoms and State aid rules. These taxes were levied not on the income of enterprises engaged in certain economic sectors (retail trade, telecommunications, and advertising) but on their turnover derived from the given economic activity. Although these taxes applied to all economic operators in the sectors, the tax rate structure was designed in an (often steeply) progressive manner, resulting in *de facto* exoneration from the taxes of smaller, typically domestic enterprises and

62 Bohinc and Jovanovič, 2024.

63 Žunić Kovačević, 2024a.

64 Radvan, 2024.

65 Bohinc and Jovanovič, 2024.

66 Vartašová, 2024.

67 Žunić Kovačević, 2024a.

68 Bohinc and Jovanovič, 2024.

69 Oktaba, 2024.

70 Károlyi, 2024b.

the heavy taxation of foreign multinationals. The gist of the cases that the CJEU had to decide was whether turnover as the basis of assessment of the tax could be an appropriate indicator for pursuing the principle of the ability to pay, thus enabling progressive taxation. The CJEU answered this query affirmatively, holding that the level of turnover constituted an objective and neutral indicator of taxpayers' financial capacity. Furthermore, it ruled that taxes did not inherently discriminate between foreign and foreign-owned taxpayers. Consequently, regarding the CJEU, progressive turnover-based business taxes did not violate the fundamental freedoms and State aid rules as a principle.

The Romanian transfer pricing rules have been challenged by a taxpayer in the light of the freedom of establishment on the grounds that it applied only in a cross-border setting while it did not apply to transactions between a domestic head office and its domestic branch⁷¹. The CJEU ruled that even though such legislation was liable to make the freedom of establishment more burdensome, it could nevertheless be justified by the balanced allocation of taxing rights and the measure did not go beyond what was necessary to ensure such aim as the balanced allocation of taxing rights was not endangered in a purely domestic situation.

Yet another Romanian case concerned the limitation period for filing a claim for reimbursement due to a stamp duty, the imposition of which was declared to violate EU law⁷². The limitation period for such claims was one year, whereas in the case of similar domestic claims due to violation of national law, there was a longer five-year limitation period. The CJEU interpreted the principles of effectiveness and equivalence in conjunction with the principle of sincere cooperation and held that even though the determination of a one-year limitation period did not, in itself, amount to incompatibility with EU law, the fact that the limitation period in comparable domestic situations was longer was contrary to Union law.

Minor interpretation issues arose in Slovenia concerning the correct application of EU directives, resolved in the preliminary ruling procedures.⁷³

In Serbia, which is not an EU Member States and thus is not submitted to the jurisdiction of the CJEU, one can also find non-discrimination provisions at the domestic level.⁷⁴ This originates from Serbia's double taxation conventions, which prohibit discriminatory treatment against nationals of the treaty partner country.

According to the economic literature in Serbia, corporate income tax incentives are the most important tool for attracting foreign direct investment.⁷⁵

Based on national reports, the sporadic harmonisation measures that occurred in the arena of direct taxation (the Parent-Subsidiary Directive, the Interest-Royalty Directive, the Tax Merger Directive, etc.) have been properly implemented without

71 Cîrmaciu, 2024b.

72 Ibid.

73 Bohinc and Jovanovič, 2024.

74 Popović, 2024c.

75 Ibid.

significant opposition from the Member States. It is also noteworthy that these directives have been adopted prior to the accession of most of the states located in the region of Eastern-Central Europe, so they ‘inherited’ the rules with their accession, even though later on, these directives have been amended to some extent. In Romania, the timely implementation of certain tax-related directives was problematic; however, it was rectified within the framework of an infringement procedure.⁷⁶

However, it is important to distinguish between these sets of rules and those that mark more recent harmonisation processes: Anti-Tax Avoidance Directives and the global minimum tax directive. The former group restricted to a much lesser extent the freedom of the Member States as to the design of their corporate income tax systems, basically requiring the equal treatment of domestic and cross-border intra-group payments and reorganizations (while leaving the national standard for taxation untouched). In the case of the latter group, the directives put more significant restraints on tax sovereignty, calling for introducing certain anti-avoidance rules in a given form and imposing a minimum tax level on large group companies.

The adoption of the global minimum tax at EU level demonstrates very well the difficulty of reaching a consensus in the field of direct taxation. The global minimum tax rules have already been agreed upon at an international level within the framework of the OECD/Inclusive Framework, yet its unanimous adoption at EU level in the form of a directive could only be achieved via tough political bargains. This raises the question of whether unanimous decision-making in the field of taxation is a suitable solution. On the one hand, it displays a greater level of democratic legitimacy because it ensures that harmonised measures are acceptable to all Member States, and none of them are forced to transpose rules against their will. However, this can slow decision-making, and the entire procedure often fails.

It can be seen from the national chapters, that the Eastern-Central European Member States stick to the unanimous voting mechanism and oppose the idea, that comes up more and more frequently in public and academic discussions, of switching to qualified majority voting procedure in the field of taxation. This stance holds true even for Member States that are considered to be the most compliant with EU law. For instance, Slovenia adheres to unanimity voting on tax matters to preserve equity within the EU, enabling a balance between the interests of larger and smaller Member States.⁷⁷ Indeed, unanimity is one of the strongest tools in the hands of smaller Member States to ensure that their voices are heard during decision-making process. An interesting compromise between unanimous decision-making and qualified majority voting could be to invoke the enhanced cooperation mechanism whereby some Member States, which are keen on taking further harmonisation measures could move forward without waiting for all Member States to consent.

⁷⁶ Cîrmaciu, 2024b.

⁷⁷ Bohinc and Jovanovič, 2024.

Slovakia has supported such an approach in the context of financial transaction tax, which nevertheless failed.⁷⁸

Certain Member States have perceived the introduction of the global minimum tax as a threat to their competitiveness and that of the EU in general. The attainment of a consensus on a global minimum tax is particularly remarkable in the light of the fact that all examined Member States previously objected to the introduction of the common consolidated corporate tax base (CCCTB) idea. In many aspects, the global minimum tax goes even further. However, the Hungarian example shows that due to certain aspects of the global minimum tax (the option for the application of a qualified domestic top-up tax, the scope of the covered taxes, etc.), even highly competitive corporate tax systems can be maintained without jeopardy for significant tax revenue loss.⁷⁹ Indeed, all the examined Member States used the option to introduce a domestic top-up tax so that they did not lose tax revenues, even if the effective tax rate in the given jurisdiction fell below 15% in the case of certain multinationals. Several national reporters (Poland⁸⁰ and Hungary⁸¹) have highlighted that the most severe effect of the global minimum tax on domestic corporate tax systems is that most incentive tax credit systems (e.g. related to R&D, large investments, etc.) must be overhauled and revamped.

From the national reports it can be seen that the prevention of tax avoidance and tax fraud is of paramount importance. For instance, a special public body (the Council for Counteracting Tax Avoidances) was established in Poland, which is mainly an advisory institution.⁸² Their opinions can be requested during legislative and tax procedures involving potential tax avoidance. The pivotal roles of anti-fraud and anti-avoidance can be deduced from constitutional provisions, typically the ability-to-pay principle (where it is enshrined in the national constitution). Interestingly, in Croatia, combatting avoidance schemes is also connected to the constitutional principle of equity, as tax avoidance is mostly available for high-income earners, which might compromise the attainment of vertical equity.⁸³

As far as the transposition of harmonized anti-avoidance provisions is concerned, all examined countries seem to have properly implemented the general anti-avoidance rule (GAAR) of the ATAD. Regarding the specific anti-avoidance rules of these directives, no cases have been brought before the CJEU from the Member States concerned, either in an infringement procedure or in the form of a preliminary ruling request due to their incorrect or late implementation. However, this does not mean that the transposition of these technical rules occurred without controversy. The implementation deadline expired only recently, consequently, future challenges cannot be excluded. Some minor discrepancies have already been

⁷⁸ Vartašová, 2024.

⁷⁹ Károlyi, 2024b.

⁸⁰ Oktaba, 2024.

⁸¹ Károlyi, 2024b.

⁸² Oktaba, 2024.

⁸³ Žunić Kovačević, 2024a.

detected (for instance, concerning the Hungarian CFC rules⁸⁴) by the Commission or the Czech GAAR rules;⁸⁵ however, these issues seem to have been resolved without litigation.

In Croatia, the abuse of law doctrine lays down a special procedure for ‘piercing the corporate veil’ in tax matters by means of which shareholders, board members and executive directors of a company, as well as persons associated with them, can be declared to be liable for a company’s tax debt if such a debt results from their abusive behaviour.⁸⁶ Furthermore, Croatian tax legislation includes a targeted anti-avoidance rule (TAAR). It denies the tax benefit for the reinvestment of company profits (reduction of the income tax base by the amount of the company’s capital increase made for investment and development purposes) if it is obvious that the intention of the company’s capital increase was tax evasion or tax avoidance.⁸⁷ GAAR rules in several Member States had already been implemented prior to the ATAD obligation, and the adoption of the latter, in some cases, required a revamp of the original domestic GAAR (e.g. in Slovakia).⁸⁸

On the procedural side of tackling tax avoidance, the most important rules are harmonised at the union level in the Directive on Administrative Cooperation (DAC) in tax matters, the scope of which has been constantly expanded throughout the years. In addition to the exchange of information, it also prescribes transparency and disclosure rules such as broadening the ambit of the automatic exchange of information on tax rulings and advance pricing agreements (DAC3), country-by-country reports (DAC4), access to beneficial ownership information collected under anti-money-laundering legislation (DAC5), reportable cross-border arrangements (DAC6), and tax transparency rules for reporting by digital platforms (DAC7). The compliance of Member States with their transposition obligations can be appraised as being timely and appropriate. This signals that Member States are keen to ensure that taxes that they intend to collect will indeed be collected and they do not want to use lax enforcement as a tool for attracting investments.

Some Member States went further and implemented disclosure rules to apply to purely domestic arrangements without requiring a cross-border element (Poland).⁸⁹ In Romania, a special person has been appointed to take on duties in the field of administrative cooperation to both other Member States and third countries.⁹⁰ It is also common for Member States to distinguish between taxpayers based on their tax compliance history, providing compliant taxpayers with benefits

⁸⁴ Károlyi, 2024b.

⁸⁵ Radvan, 2024.

⁸⁶ Žunić Kovačević, 2024a.

⁸⁷ Ibid.

⁸⁸ Vartašová, 2024.

⁸⁹ Oktaba, 2024.

⁹⁰ Cîrmăciu, 2024b.

and enhancing audits over formerly non-compliant taxpayers (e.g. Hungary⁹¹ and Slovakia⁹²).

In Serbia, one can find no explicit anti-abuse clause in tax legislation; however, there is a substance over form doctrine that requires an examination of whether the transaction reflects economic reality and substance.⁹³ It is debated in the legal literature whether such a doctrine can be regarded as a type of anti-abuse provision.

4. The role and challenges of monetary policy in Central European countries

One of the main goals of the chapters on monetary policy was to examine the lessons related to the introduction of the common currency, a covenant – however non-compellable in practice – under the preamble of the TEU⁹⁴ in the case of Member States inside the Eurozone and to introduce the reasons for Member States to stay outside the Eurozone, that is, the pros and cons of the common currency. To fulfil this aim, one may first examine the convergence data of Member States. Convergence reports published between 2014 and 2020 showed that while Croatia met the inflation and interest rate criteria, the criteria related to public finances were not met. Since 2018, efforts have been made to meet these criteria. In July 2020 Croatia was accepted into the exchange rate mechanism (ERM II), the forerunner of the Eurozone. The Convergence Report for Croatia, published by the European Commission in June 2022 specified that the country met the criteria for adopting the single currency, except for a high level of debt. Nevertheless, at the end of June 2022, the European Council approved Croatia's entry into Eurozone. On 12 July 2022 the Council of the European Union agreed. Croatia adopted the Euro on 1 January 2023.⁹⁵ The Czech Republic, Hungary, and Poland currently do not fulfil the Maastricht criteria. However, the inflation target of the Czech Central Bank has been 2% since 2010 the Czech Republic suffered from high rates of inflation, similar to many other EU member states. In 2021 this inflation was driven by supply-side factors, amplified by loose fiscal and monetary policies, and a tight labour market. The war-induced energy crisis also had its negative effects in 2022. In addition, the Czech Republic has breached the maximum deficit value since 2020, as the balance exceeded 5% of the GDP in 2020 and 2021 (2020 deficit 5.8%, 2021 deficit

91 Károlyi, 2024b.

92 Vartašová, 2024.

93 Popović, 2024c.

94 'Resolved to achieve the strengthening and the convergence of their economies and to establish an economic and monetary union including, in accordance with the provisions of this Treaty and of the Treaty on the Functioning of the European Union, a single and stable currency.'

95 Žunić Kovačević, 2024b.

5.1%). As the Czech National Bank reported, the Czech economic level will move slightly away from the Eurozone average by 2021. The predictions show that the Czech economy will not fulfil the Maastricht criteria in the following years.⁹⁶ The peculiar Hungarian story is that the country was closer to meeting the Maastricht criteria in 2000 than in 2006 due to the undisciplined fiscal policy of the 2000s. As pointed out by the author of the Hungarian chapter, Hungary was close to fulfilling the Maastricht criteria between 2014 and 2020 due to fiscal and monetary policy changes. However, a full convergence has not yet been achieved.⁹⁷ Poland does not meet most of the economic convergence criteria, nor does it participate in the ERM II mechanism, and the latest convergence reports of the European Commission and the European Central Bank (ECB) from 2022 indicate – just like the 2020 report –, that significant inconsistencies of national legislation with the Treaties exist and that there is a need to introduce numerous changes. Poland is expected not to adopt the Euro in the coming years or enter the Eurozone. In Poland, the European Commission noted that the country is not subject to an excessive deficit procedure. However, the economic forecast prepared by the Commission in spring 2022 was envisaged to exceed the permissible budget deficit in 2022 and 2023 (4% and 4.4% of GDP, respectively), which was supposed to be a consequence of the burden of the costs of helping refugees from Ukraine. Since 2004, the goal of the Polish Central Bank has been to maintain inflation at 2.5% with a symmetrical deviation band of ± 1 percentage point in the medium term. The inflation targeting strategy was implemented at a floating exchange rate.⁹⁸ Romania currently fulfils only one nominal convergence criterion, namely public deficit. However, these data deteriorated; in 2011–2013, it varied from 33.9% to 32.7%, whereas in 2020–2022, it moved between 46.8–47.2%. It is worth mentioning that even an excessive deficit procedure was ongoing between 2020 and 2021 and the country performs very poor in terms of real convergence as well. Legal convergence is also missing, as indicated by the fact that the 2022 Convergence Report questioned the conformity of the legislation on the independence of the country's central bank.⁹⁹ Once joining the EU, Serbia is willing to adopt the Euro as a legal tender as soon as it fulfilled the relevant Maastricht criteria. Under the Budget System Act, government sector debt, including liabilities based on restitution, should not exceed 60% of GDP, while the target medium-term fiscal deficit should represent 0.5% of GDP. The general government debt-to-GDP ratio is expected to stabilise at 55.10% by 2022. Since 2009, the National Bank of Serbia has implemented a full-fledged inflation-targeting regime. Headline inflation target for the period from January 2023 to December 2025 is set at the level of 3%, with a tolerance band of $\pm 1.5\%$.¹⁰⁰ Slovakia alone among the

96 Tomášková and Radvan, 2024b.

97 Marinkás, 2024b

98 Mikos-Sitek, 2024c.

99 Bíró, 2024.

100 Popović, 2024d.

‘Visegrad Four’ countries adopted the Euro. The change from the national currency to the Euro began on 1 January 2009. However, preparation began much earlier in 2003, that is before the country’s accession to the EU, by adopting the strategy of Eurozone accession. The strategy clearly stated that Slovakia would introduce the Euro as soon as it fulfilled all the convergence criteria sustainably. As pointed out by academics, Slovakia fulfilled the Maastricht criteria in 2008, proving the importance of strong and longstanding cross-governmental commitments if a country wishes to join the Eurozone. Some studies show that during the 2010s, Slovakia did not fulfil the Maastricht criteria, and recent data also suggest that except for the debt-to-GDP ratio, still does not fulfil them.¹⁰¹ Slovenia was the first among the ‘2004 entries’ to introduce the Euro. The country only needed two years from accession to the EU to achieve convergence with the Maastricht criteria, and according to a decision made in 2006, Slovenia introduced the Euro on 1 January 2007. Similar to Slovakia, Slovenia did not fully meet the Maastricht criteria.¹⁰²

As for the country specific reasons for adopting the Euro or dispensing with it, the decisive factor for Croatian decision-makers was that, as a small and open economy, the country’s economy was already ‘euroised’, similar to the Serbian economy. Furthermore, the Croatian currency has been tied to the Euro for a long time and, before that, to the German mark. Therefore, no significant changes were expected after adopting the common currency. Croatian decision-makers thought that adopting the Euro should be followed by benefits in business and the economy by eliminating currency risk and lowering transaction and borrowing costs. While the increase in inflation during the initial period of the transition to the Euro is already a common phenomenon, Croatia’s inflation trends show that inflation started to increase rapidly in the second half of 2022 and peaked at 13.5% before the end of the same year. From January 2023 – the time of accession –, it has decreased. In the case of Croatia, the high inflation rate has not been induced by the introduction of the Euro; instead, it has been caused by the energy crisis due to the ongoing war.¹⁰³ Unlike their Slovak counterparts, the decision-makers of the Czech Republic, Hungary, and Poland decided to keep their countries outside the Eurozone and not create so-called close cooperation with the ECB. This provides the possibility to make a comparison of the ‘Visegrad Four’ countries in this regard: while the Slovak decision-makers calculated that the advantages of the accession outweigh the disadvantages, thus identified the accession to the Eurozone as a goal, which would help the Slovak state belonging to the core, the other V4 countries ‘opted out’. The Slovak decision-makers, just like the Croatians and the Slovenians, considered the loss of monetary sovereignty a necessary, and with a view to being a small and open economy, not so high price to be paid in turn for the membership.¹⁰⁴ The Czech,

101 Štrkolec, 2024b.

102 Festić and Bohinc, 2024.

103 Žunić Kovačević, 2024b.

104 Štrkolec, 2024b; Festić and Bohinc, 2024.

Hungarian and Polish decision-makers, however, think that the sovereign monetary policy is more important than the advantages of Eurozone membership. The Czech and Hungarian standpoints are very similar; introducing the Euro is the only option when it offers more advantages than a politically motivated and premature accession to the Eurozone before reaching a certain level of real convergence. The Hungarian Central Bank set the so-called Maastricht 2.0, earmarking 90% real convergence compared to the EU average as a compass. Although Hungary still does not have an official target date announced by the government, in 2023, high-ranking officials, including the Minister of Finance, mentioned 2030 as a possible date for their statements. However, nothing is carved into the stones.¹⁰⁵ The governors of the Czech Central Bank and the Polish Central Bank expressed in their recent statements that they did not wish to introduce the Euro in their countries. In the Czech approach, despite the undeniable positive benefits of being in the Eurozone, such as savings in transaction costs or eliminating exchange rate risk, adopting the euro means giving up an independent monetary policy and the exchange rate of the Koruna as stabilising macroeconomic instruments.¹⁰⁶ Similarly, while Polish professionals acknowledge the benefits of the Eurozone, they identify the loss of monetary sovereignty as their main disadvantage. They argue that macroeconomic stabilisation, the prospect of increasing the economic growth rate, eliminates the risks and costs resulting from fluctuations in the exchange rate and exchange rates affecting the development of trade, greater security, and greater credibility in the assessment of foreign investors. However, from a Polish perspective, the concerns that arise most often in connection with the adoption of the common currency are the loss of monetary sovereignty and the related consequences of the ECB's decisions taken as part of its monetary policy, as well as the limitations of economic policy tools that are important in conditions of economic slowdown, only to fiscal instruments. The adoption of the Euro is also conditional on carrying out structural and institutional reforms aimed at fiscal, economic, and financial integration between Poland and the Eurozone.¹⁰⁷ In 2018, the Romanian Government established a National Commission to elaborate a National Plan for adopting the Euro. The plan scheduled the Euro adoption date in Romania for 2024 but was postponed until 2029.¹⁰⁸ Although the Serbian point of view is that the country should join the Eurozone as soon as possible, accession to the EU should happen before the issue of adopting the Euro could be put on the table. Based on certain calculations, the accession of Serbia to the EU and the introduction of the Euro would bring about a higher real gross domestic product, more employment, and more sustainable public finances attributable to increased productivity.¹⁰⁹ In Slovakia *ex ante* evaluations revealed

¹⁰⁵ Marinkás, 2024b.

¹⁰⁶ Tomášková and Radvan, 2024b.

¹⁰⁷ Mikos-Sitek, 2024c.

¹⁰⁸ Bíró, 2024.

¹⁰⁹ Popović, 2024d.

the ‘usual’ benefits and disadvantages of introducing the common currency: eliminating exchange risk, increasing foreign trade, etc., versus losing monetary sovereignty. However, regarding the latter, decision-makers thought that it was a price worth paying since the ability of monetary policy to stabilise the real economy was low. Ex-ante evaluations also predicted higher inflation, which did not occur based on ex-post evaluations. On the other hand, benefits were realised.¹¹⁰ Slovenia’s first years with the Euro resulted in mixed experiences: internal factors contributed to an inflation spiral in 2007 due to weak competition in particular sectors and increased demand in Slovenia. Inflation peaked in January 2008 at 9.9% and decreased during spring. By May 2008, it was 6.3%.¹¹¹

As for the support of the citizens for introducing the Euro in countries that have not yet implemented it, Hungarian public opinion seems to be the most supportive based on a 2023 Eurobarometer survey: 72% of the population were in favour of introducing it, and 62% replied that it would have mostly positive consequences. The same values were 71% and 60% for Romania. The Polish population showed less support for the introduction, with 55% and 46% thinking it would benefit the country. Czech citizens were the most against introducing the Euro: 54% said they were against it, and only 44% were in favour. Similarly, more respondents answered that the Euro would negatively affect the economy. As a reference point, 79% of respondents living in the euro area believe that having the Euro positively affects the EU, and 69% believe that the Euro has a positive effect on their own country. While 84% of the Slovak and 78% of the Slovenian respondents said introducing the Euro positively affected the country, only 51% of the Croatian respondents considered the positive effects to overwhelm the negative ones. It is worth mentioning, however, that Croatia is a newcomer to the club, and thus far, the first years with the common currency have brought difficulties in every country that introduced the common currency.¹¹²

Finally, certain constitutional issues concerning the introduction of the Euro and its use are worth mentioning. In the case of Hungary, drafters of the Fundamental Law decided to grant constitutional status to the Forint, which means that whenever the government in power decided to introduce the Euro, it would need a 2/3 majority in the Parliament. While some argue that this solution may guarantee that the decision to introduce the Euro has to be taken with strong democratic legitimacy, others argue that it may create a situation in which Hungary will not be able to adopt the Euro despite fulfilling the Maastricht criteria and the actual government having the political will to do so.¹¹³ The other issue concerns Slovakia. The Parliament of Slovakia has systematically enshrined the right to pay in cash at the constitutional

110 Štrkolec, 2024b.

111 Festić and Bohinc, 2024.

112 *Flash Eurobarometer 512. The euro area Report* [Online]. Available at: <https://europa.eu/eurobarometer/surveys/detail/2663> (Accessed: 25 February 2024).

113 Marinkás, 2024b.

level. The regulation entered into force in July 2023. This move by the Slovak legislature has raised questions as to whether such a regulation might interfere with the EU's exclusive competence in the field of monetary policy and how the dilemma would be resolved if the proposed digital Euro, which is in a rather initial phase for the time being, replaces the 'physical Euro'.¹¹⁴

Another aim of the monetary policy chapters was to examine how the Banking Union was created and how member states within and outside it complied with its institutions. The Eurozone crisis made it clear that the previous banking supervision and resolution framework, which was based on cooperation, failed during the crisis because domestic authorities were prone to look the other way when it came to their 'national champions'. The first reactions of the Eurozone to tackle its effects date back to 2011. What happened in the next years was extraordinary and unthinkable even a few years earlier. As some characterised this era: 'supranationalism had gained momentum'. European legislators created the European Banking Union based on Art. 114 of the TFEU. Under the European Commission's proposal, the banking union should have been based on four pillars: the Single Rulebook, the Single Supervisory Mechanism, the Single Resolution Mechanism and the European Deposit Insurance Scheme. Until this day (25 January 2024), only the first three pillars were realised, and the EDIS was still in the making stage.¹¹⁵

In its April 2023 report on the Single Supervisory Mechanism, the European Commission concluded that the mechanism has developed into a well-functioning organisation capable of rapidly adapting to emerging supervisory challenges like the economic crisis induced by COVID-19. Other opinions support the idea that SSM positively impacts the banking system, even if some positive effects – such as enhanced profitability – are unintentional. The picture of the Single Resolution Mechanism is somewhat mixed: two novel judgments of the CJEU, introduced in the EU chapter, show that many years after the launch of the Single Resolution Mechanism, there are unclear issues, including who should be notified when a resolution starts, the competences of the participating institutions, and the legal nature of the resolution scheme.¹¹⁶

Those member states' central banks, which entered the Eurozone – namely Croatia, Slovakia and Slovenia –, participate in the functioning of the Banking Union based on the applicable rules. EU Member States whose currency is not the Euro may participate in the Single Supervisory Mechanism upon request by the so-called close cooperation between the ECB and their National Competent Authorities. The Croatian Central Bank entered close cooperation with the ECB in July 2020, after requesting it twice in 2018 and 2019 respectively.¹¹⁷ A key difference between being a full-fledged Eurozone member and the close cooperation is that ECB legal acts,

¹¹⁴ Štrkolec, 2024b.

¹¹⁵ Marinkás, 2024a.

¹¹⁶ Marinkás, 2024a.

¹¹⁷ Žunić Kovačević, 2024b.

including decisions on banks, do not have direct effect in the Member State. In return they do not have full representation within the Single Supervisory Mechanism, thus their influence is limited on supervisory decisions. Furthermore, they also cannot use the liquidity funds of the European Stabilization Mechanism provided for in the financing mechanisms of Pillar II. These factors surely played a role in the decisions of the Czech, Hungarian, Polish, and Romanian decision-makers concerning establishing such cooperation. As the Czech Central Bank claims, accessing the Eurozone or developing close cooperation would mean its hands would be tied, hindering an effective reaction to the so-called asymmetric shocks. It is worth mentioning that, as elaborated in the chapter on Czech monetary policy, the chosen crisis management tools of the Czech Central Bank resemble those of the ECB.¹¹⁸ In Poland, it remains complicated to determine the time horizon for adopting a common currency; thus, the decision to establish close cooperation is also complicated.¹¹⁹ Romania's prudential regulation is aligned with the requirements of the Basel Core Principle, because a large part of the Romanian banking system is owned by banks from the Eurozone.¹²⁰ In contrast, Poland witnessed the so-called repolonization of the banks, enhancing the state's role in the bank sector.¹²¹ However, these countries did not establish close cooperation. In January 2023, the ECB signed a Memorandum of Understanding with the National Competent Authorities of these countries to ease effective supervisory cooperation and information sharing arrangements between the ECB and the National Competent Authorities to supervise institutions and their cross-border establishments. Denmark and Sweden also signed the memorandum. Serbia, as a non-member state, cannot establish close cooperation; however, the Serbian Central Bank and the ECB have conducted numerous cooperation projects in the last 20 years and signed a Memorandum of Understanding in 2018 with the purpose of formalising cooperation and information-sharing mechanisms between the ECB and the NBS related to their supervisory roles.¹²² Slovenia's Eurozone membership was not preceded by close cooperation, as this mechanism was established only with the Banking Union.¹²³

Members of the Council of the Croatian Central Bank, presided over by the governor and comprising a deputy governor and six vice-governors, are elected by the Croatian Parliament based on the proposal of parliamentary committees defined by law. The nominees must fulfil strict criteria that guarantee their independence.¹²⁴ The supreme governing body of the Czech Central Bank is the Bank Board, which consists of the governor, two Deputy Governors, and four other Bank Board members. The president of the Czech Republic appoints all Bank Board members for

118 Tomášková and Radvan, 2024b.

119 Mikos-Sitek, 2024c.

120 Bíró, 2024.

121 Mikos-Sitek, 2024c.

122 Popović, 2024d.

123 Festić and Bohinc, 2024.

124 Žunić Kovačević, 2024b.

a maximum of two six-year terms.¹²⁵ The Fundamental Law of Hungary states that the President of the Republic should appoint the Governor and Deputy Governors of the Hungarian Central Bank for six years. The Hungarian Central Bank's governor is the Monetary Council's Chairman. Other members of the Monetary Council are elected by the Parliament.¹²⁶ The President of the Polish Central Bank is appointed by the Lower House of the Polish Parliament (Sejm) of the Republic of Poland at the request of the President of the Republic of Poland for a six-year term of office. The term is renewable once. The Monetary Policy Council consists of the Chairman of the Council, who is the Governor of the NBP, and 9 members appointed in equal numbers by the President of the Republic of Poland, Sejm of the Republic of Poland, and the Senate of the Republic of Poland.¹²⁷ The Central Bank of Romania is governed by the Board of Directors. The chairman of the Board is the Governor of the Central Bank of Romania. The Parliament elects board members based on the recommendations of certain parliamentary committees, as defined by law.¹²⁸ The Central Bank of Serbia performs its tasks through three main bodies: the Executive Board, the Governor and the Council of the Governor. The Governor is appointed by the Parliament upon the proposal of the President of the Republic of Serbia, for a six-year renewable term of office. The Executive Board consists of the Governor and Vice-Governors of the Central Bank of Serbia. The Council of the Governor consists of five members, including the president, appointed by the Parliament on the proposal of the parliamentary committee in charge of finance.¹²⁹ The term of office of the Board of Slovak Central Bank members is six years, commencing on the effective date of their appointment. There are no term limits for Bank Board members; however, no one may serve as a Governor or Deputy Governor for more than two terms. The Governor and Deputy Governors are appointed and may be dismissed by the President of the Slovak Republic at the government's proposal and are subject to the approval of the Slovak Parliament. The other three members of the Bank Board are appointed and may be dismissed by the Slovak Government at the proposal of the central bank Governor.¹³⁰ The decision-making bodies of the Central Bank of Slovenia are the Governor and the Governing Board of Banka Slovenije. The Governing Board comprises five members: the governor and four vice-governors. The members are elected by the Parliament for a period of six years at the proposal of the President of the Republic of Slovenia, and may be re-appointed.¹³¹ As a conclusion it can be stated that in five of the eight countries, the Parliament has the final word in appointing the Board Members, and only three countries' regulations entrust the head of the state with appointing the members. However, the Hungarian

125 Tomášková and Radvan, 2024b.

126 Marinkás, 2024b.

127 Mikos-Sitek, 2024c.

128 Bíró, 2024.

129 Popović, 2024d.

130 Štrkolec, 2024b.

131 Festić and Bohinc, 2024.

and Polish regulations do not belong categorically to either one, as in the case of Hungary the Governor and the Deputy Governors are appointed by the Head of State, and the parliament elects other members. Polish regulation also divides the right of appointment between executive and legislative powers, which one may deem as a desirable solution, creating a balance between the branches of power when appointing members of such an important institution.¹³²

As a common tendency during the first years of the Eurozone crisis, most developed countries' central banks soon achieved an interest rate level of near zero and sometimes even a negative interest rate. However, this traditional tool proved insufficient during the crisis; therefore, the central banks of developed countries started to apply quantitative easing. The ECB, as the initiator of the purchase programmes and the CJEU, as the supervisor of their legality, were not in an easy situation: they could have chosen either the functional 'amendment' of the Founding Treaties, or taking the risk of the Eurozone's possible fall. Subsequently, they selected the first option. While the ECB is often balanced on the borders of its competence, the CJEU has always displayed an 'amicable attitude' towards the institutional framework of the ECB's crisis management. The national constitutional courts did the same until the German Constitutional Court gave a strong signal in the so-called PSPP case, in which certain elements of the purchase program were declared to go beyond monetary policy. However, the German Constitutional Court 'retreated' after the loud political outcry, thus, the Federal Central Bank of Germany did not have to leave the PSPP-programme.¹³³

The central banks of Slovakia and Slovenia, members of the Eurozone since 2009 and 2007, respectively, had to adopt ECB crisis management. Unlike other central banks in countries outside the Eurozone, Czech and Polish banks did not go significantly beyond the standard monetary policy. The Czech Central Bank relied mainly on decreasing the base rate to a near-zero level of 0.05% and, to a certain extent, on foreign exchange intervention. According to the Czech Central Bank, the application of this tool prevented deflation and helped the country overcome its crises.¹³⁴ After the 2008 financial crisis, the Central Bank of Poland identified possible liquidity disturbances in the banking sector as the main threat to the stability of the national financial system. Attention was also drawn to the possible decline in trust in the interbank market.¹³⁵ In contrast, the Hungarian Central Bank played an active role in tackling the consequences of the Eurozone Crisis by facilitating the self-financing of the country and eliminating the high level of household debt, which created a serious risk. Of course, traditional monetary policy also played a role: the Hungarian Central Bank reduced the base rate from 7.0% to 0.9% and

132 Conclusion made by the editor.

133 Marinkás, 2024a.

134 Tomášková and Radvan, 2024b.

135 Mikos-Sitek, 2024c.

maintained it at that level between 2012 and 2019.¹³⁶ Romania became the first European Union country to cut interest rates in response to the Eurozone crisis with the November 2011 decision of the Romanian Central Bank.¹³⁷ In the wake of the crisis, Serbia was one of the most euroised economies in Europe, with a 72% loan euroisation. This created a risk similar to what the Hungarian Central Bank had to face, and the Central Bank of Serbia replied similarly: since 2011, dinarization has been highlighted as one of its objectives in its monetary policy program. In 2012, the NBS and the Government of the Republic of Serbia signed the Memorandum on the Strategy of Dinarisation of the Serbian Financial System and re-affirmed their commitments in 2018.¹³⁸

In response to the negative economic effects of the COVID-19 pandemic, the ECB launched the Pandemic Emergency Purchase Program with an initial envelope amounting to EUR 750 billion, reaching EUR 1,850 billion by the end of the program. The Governing Council of the ECB decided on 16 December 2021 to discontinue the programme by the end of March 2022. The ECB left the base-rate near zero. The negative economic effects of the Russo-Ukrainian War required a rather different approach, however: the challenges of the new crisis characterised by high inflation rates, contrary to the disinflation trends of Eurozone and the COVID-19 crisis, required a return to the ‘good-old’ restrictive monetary policy with high interest rates and abandoning the refinancing role. In July 2022, the ECB increased its fixed interest rate to 0.5% for the first time in six years. Subsequently, the ECB increased the interest rates almost monthly. By June 2023, the rate reached 4%, the highest since the start of the global financial crisis in 2007. The ECB’s other tool for fighting inflation is the phasing out net purchase programs.¹³⁹

In tackling the negative effects of the COVID-19 crisis and the Russo-Ukrainian War, the central banks of Slovakia and Slovenia applied the ECB’s monetary policy and its measures. The Croatian Central Bank, still not a Eurozone member state’s central bank then, fully followed the ECB’s policy, most probably with a view towards the nearby Eurozone accession.¹⁴⁰ Central banks of countries outside the Eurozone handled the crises related to COVID-19 and the Russo-Ukrainian war similarly due to economic necessities. The Czech Central Bank began a ‘return to normalcy’ in 2021, similar to its Hungarian counterpart, and increased its base rate. The currently applicable base rate is 6.75%. This tendency to raise base rates strengthened in 2022 at other central banks as well, after the economic effects of the Russo-Ukrainian war started to spill in.¹⁴¹ The Hungarian base rate hit a record of 13% and has only recently decreased. The Hungarian Central Bank also decided to moderate its refinancing role, which was excessive compared to the Czech

¹³⁶ Marinkás, 2024b.

¹³⁷ Bíró, 2024.

¹³⁸ Popović, 2024d.

¹³⁹ Marinkás, 2024a.

¹⁴⁰ Žunić Kovačević, 2024b.

¹⁴¹ Tomášková and Radvan, 2024b.

and Polish banks, and gradually phased out certain programs.¹⁴² Poland's base rate reached its lowest (0.10 %) in May 2020. The current applicable base rate is 5.75%.¹⁴³ Like other countries, the Romanian Central Bank handled the COVID-19 crisis by decreasing the base rate and dispensing with refinancing the markets. Romania's interest rate reached its lowest level in 2021 (1.25 %). The Romanian Central Bank, together with the government, banks, and creditors, contributed to the measure to defer payment of loans to firms and households for up to nine months under a government guarantee scheme and also used tools that could be deemed as quantitative easing. New challenges of the Russo-Ukrainian war were handled by the Romanian Central Bank, with a rise in the base rate up to 7%.¹⁴⁴ In Serbia, the base rate reached its lowest value of 1.50% in the spring of 2020, when the economic effects of COVID-19 peaked. Another monetary policy measure the Serbian Central Bank applied was to provide dinar and foreign currency liquidity to the banking sector during a state of emergency by applying swap auctions and repo operations. These programs were terminated in October 2021. In January 2024, the base rate was 6.5%.¹⁴⁵

In summary, despite the diverging paths chosen by the selected Central European countries, namely the attitude towards the common currency and monetary sovereignty, several similarities could be observed in handling crises and also in their regulations on central banks. Even though some central banks displayed a rather restricted response to the Eurozone crisis, most central banks outside the Eurozone applied similar tools to handle the crises induced by the Eurozone and COVID-19, including extremely low interest rates and the extensive use of refinancing programs, while abandoning these tools when they needed to mitigate the effects of the Russo-Ukrainian war. In other words, the monetary policies of the analysed countries, as an important part of economic governance, showed similarities.

142 Marinkás, 2024b.

143 Mikos-Sitek, 2024c.

144 Bíró, 2024.

145 Popović, 2024d.

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