Policy Brief

The Hungary Files:
Untangling the political and economic knots

8 December 2022

#RuleOfLaw
#Hungary
#RecoveryInstrument

Thu Nguyen, Policy Fellow

The battle over the rule of law in Hungary is coming to a head. Two separate but related rule of law procedures are currently on the Council's agenda, with 7.5 billion Euros in cohesion funds and 5.8 billion Euros in grants from the EU recovery instrument on the line for Hungary. Both procedures are currently stuck in a political limbo as member states, faced once again with Hungarian vetoes, cannot agree on a common course of action. In this policy brief, Thu Nguyen untangles the two files and argues that the EU is in a strong negotiating position: The Hungarian government can, in the current economic climate, very ill-afford to lose the funds.

Introduction[1]

The battle over the rule of law in Hungary is coming to a head. Two separate but related dossiers landed on the EU Council's agenda on Tuesday, 6 December: firstly, whether to suspend 7.5 billion Euros in funds under the EU's cohesion policy under the new rule of law conditionality mechanism; and secondly, whether to approve the Hungarian national recovery and resilience plan (NRRP), on which 5.8 billion Euros in grants from the new Recovery and Resilience Facility (RRF) hinge.

Untangling the two procedures is crucial: even though they are negotiated and decided in parallel by the same institutions, they concern different funds, and their decision-making procedures and consequences are very different. While the Council's approval of the Commission proposal in one dossier (conditionality mechanism) would mean the freezing of regular EU funds under cohesion policy, the approval of the Commission proposal in the other dossier (RRF) would constitute a first step towards unlocking money from the EU pandemic recovery instrument. Overall, Hungary benefits from 22.5 billion Euros under the EU cohesion policy from 2021 to 2027. These funds are part of the regular EU multiannual financial framework and intended to foster growth and employment in structurally weak regions of

[1] This text was published in parallel on Verfassungsblog as: The Hungary Files: Untangling the political and economic knots. VerfBlog, 2022/12/08.

the EU. In addition, Hungary can receive 5.8 billion Euros in grants and 9.6 billion Euros in loans from the RRF to alleviate the economic fallout of the Covid-19 pandemic, in return for a number of reforms and investments that it negotiates with the Commission.

Both files are currently stuck in a political limbo as the member states cannot agree on a common course of action, complicated by the fact that Orbán is holding his veto over Brussel's head on a 18 billion Euros aid package for Ukraine and a global corporate tax, both of which require unanimity in the Council. At the same time, these are substantial amounts for Hungary. Faced with a declining economy, the Hungarian government can ill-afford to lose these funds. The entire package is now blocked in Council and to be put back on the table in the next two weeks. Now the question is: Who will move first, Orbán or the other member states?

File one: Suspending €7.5 billion in cohesion funds

On 30 November, the European Commission proposed to suspend 65 percent of operational programmes under the cohesion policy against Hungary under the rule of law conditionality mechanism. The procedure was triggered – for the first time ever – on 27 April. On 19 October, the Commission made a proposal for a suspension of 7.5 billion Euros in cohesion funds. The Hungarian government then had until 19 November to implement several reforms to rectify the breaches of rule of law identified by the Commission, which were subsequently found insufficient by the Commission.

Now the ball is supposed to be in the Council's court: In order for the funds to be suspended, a qualified majority in Council must agree – i.e. at least 15 member states that represent 65 percent of the EU population. The Council is not bound by the Commission proposal in its decision but may amend the amount of funds to be suspended. Theoretically, this means that the final amount is still subject to change. In practice, this is rather unlikely as it would mean that the member states would not only have to agree on whether to suspend funds but also on an exact amount – a decision that they almost certainly will not be able to agree on, let alone before 19 December. Unless Orbán triggers the emergency brake and escalates the procedure to the European Council, which would prolong the procedure by up to three months, that is the cut-off date, after which the procedure will expire, with or without suspension.

Instead, the Czech Council presidency has now played the ball back to the Commission and asked it to come up with a revised proposal. A group of member states in the Council, led by France and Germany and including Italy, wants the Commission to adjust the proposed suspension in light of the measures already taken in Hungary. Referring to the requirement of proportionality under the regulation, their argument is that even if the reforms were not sufficient to abrogate the proposal for sanctions, the Commission should have lowered the proposed amount to reflect the (little) progress already achieved. They are opposed by a different group of countries, including Benelux and Northern states, who would support the Commission's proposal on the table. In contrast to the article 7TEU procedure, which requires unanimity between the member states to suspend voting rights in the Council for breaches of EU values, the financial penalties under the conditionality mechanism cannot be blocked by single member states. But Germany, France, Italy and, for example, Poland together would have sufficient voting weight to do so.

File two: Approving the €5.8 billion recovery and resilience plan

On the same day on which the Commission proposed the suspension of the funds under the conditionality mechanism, it also proposed the approval of the Hungarian national recovery and resilience plan (NRRP). Approval of the NRRP is the pre-condition for pay-out

of the 5.8 billion Euros in grants and 9.6 billion Euros in loans from the pandemic recovery instrument. The final decision on the approval has, again, to be taken by the Council with a qualified majority but some member states have already made their intention clear that they will only vote for its approval if Hungary withdraws its veto on the Ukraine funding dossier.

Crucially, approval of the NRRP would not mean that grants would automatically flow to Hungary. The Hungarian government must first implement the milestones and rule of law reforms set out in the plan before the Commission will release the first tranche. In particular, the Commission has identified a set of 27 milestones – which it has dubbed the "super milestones" – which will need to be implemented before any money will be paid out. This, in turn, means that we will only see next year whether funds from the RRF will, in fact, flow to Hungary once the Commission has made its assessment of whether Hungary has sufficiently implemented the 27 rule of law milestones.

At the same time, the Commission's current plan to integrate the new REPowerEU plan, which is aimed at reducing EU dependency on Russian fossil fuels, into the RRF has raised the stakes for Hungary. If Hungary wants to use existing RRF money to diversify its energy infrastructure away from gas and benefit from some of the additional funds that the Commission wants to make available under REPowerEU money, it will first need approval of its NRRP as well as implement the super milestones. NRRP approval is, thus, not just about cash flows to recover from the pandemic any longer but also required if it wants to use EU money to wean off Russian energy exports.

A substantial loss in a downturn economy

Against this backdrop, the question is not only whether funds will be blocked but also how substantial the amounts on the line are for Hungary. I have made the argument last year with regard to Poland that the EU's leverage is greater the more painful the penalties are to the member state's budget. The same goes for Hungary. Moreover, the current economic crisis means that Orbán can afford to extort the EU even less.

The proposed amounts to be frozen under both procedures are substantial. Firstly, the cohesion programmes under the current multiannual financial framework run from 2021-2027. This means that Hungary risks losing out on 7.5 billion Euros until the end of 2027, which amounts to about 1.5 billion Euros per year. This is approximately 0.98 percent of Hungary's GDP in 2021. The RRF, in turn, runs over a slightly shorter period, from 2022-2026. This means that, broken down annually, Hungary risks losing 1.45 billion Euros per year between 2023 and 2026. This amounts to approximately 0.94 percent of its GDP in 2021.

This means that the overall sum, which Hungary might see frozen, is almost 2 percent of its GDP last year. Compared to other possible sanctions under EU law, this is a hefty fine. For example, under the current the EU's fiscal framework, member states that do not comply with European fiscal rules can ultimately be subjected to a fine. For Eurozone member states, to which more stringent rules apply than to non-Eurozone member states, the rules require the Commission to recommend a fine of 0.2 percent of GDP on the member state, should it fail to take corrective action to correct its excessive deficit. The proposed sums to be frozen against Hungary at the moment is altogether, per year, almost ten times higher in relation to its GDP. But also compared to other fines for rule of law breaches, this is substantial. In October 2021, Poland was ordered to pay 1 million Euros per each day that it did not comply with an interim order of the ECJ regarding its disciplinary chamber. This was the highest fine ever enacted in infringement proceedings. Yet, over the course of one year, the annual sum of 365 million Euros overall only amounts to 0.064 percent of Poland's 2021

GDP. Hungary faces to lose about 31 times as much in relation to its GDP.

This is a lot of money. And losing out on it would hurt Hungary even more in the current economic climate.

Interest rates on 10-years Hungarian government bonds have almost doubled from 4.5 percent in the beginning of January to 8.36 percent in the beginning of December. Compensation blocked EU funds through additional borrowing on financial markets thus has become a lot more expensive for the Hungarian government. This weighs especially heavily as the Hungarian economy is in dire need of impulses. After difficult years during the pandemic, GDP growth is again projected to fall from 5.5 percent in 2022 to only 0.1 percent in 2023. Inflation, fueled by Orbán's price cap on certain foods and fuel (the latter now scrapped), was soaring at 22.5 percent in November – to compare, in the Eurozone inflation was at 10 percent in the same month. The Hungarian government deficit is estimated to exceed 3 percent - which is the limit defined under EU fiscal rules – for the next three years by the Commission. And in contrast to Eurozone member states, Hungary also has the problem with its national currency. The Forint, is historically weak against the Euro, meaning that Hungarian imports have become all the more expensive.

All of this means that the money coming from Brussels – in Euros – is sorely needed.

Throwing punches where it hurts

This has two effects. On the one hand, the economic state of his country puts additional pressure on Orbán to comply with the rule of law reforms to access EU funds. Economically, the EU has a strong leverage vis-à-vis the Hungarian government. On the other hand, it member states in the Council are very reluctant to go through with the sanctions, seemingly out of fear of the possible political and economic consequences. Not only is there the question of whether a too high fine might be struck down in Court later, or whether such a fine would lead to a precedence that might hurt their own interests in the future if they themselves become subject of a rule of law conditionality procedure. But there is also the question of how serious Orbán is about his veto. If nothing else, this episode, once again, demonstrates the increasing problem of unanimity in the EU, whereby every other month Brussels gets stuck in game of chicken over a single national veto – even those decisions that could be decided with qualified majority.

Either way, the ball is in the Council's court, and whether the rule of law conditionality mechanism becomes an effective instrument not only in this case but also in future procedures now hinges on the member states' readiness to act upon it. If the Council now sends the message that it is afraid to throw punches as soon as they start hurting this would undermine not only the instrument but the EU's credibility as a community based on values as a whole. So if member states are serious about the rule of law, perhaps it is time to do exactly that: throw the punches where they hurt.

Gefördert durch:

Alexanderstraße 3
D – 10117 Berlin
Tel.: +49 (0)30 259219-107

Online: delorscentre.eu
E-Mail: info@delorscentre.eu
Twitter: @delorsberlin