

Hungary faces EU wrath as it triggers its rule-of-law mechanism

The European Commission has triggered its rule-of-law mechanism against Hungary which could see the country lose billions of euros in funding. The lengthy process comes after EU warnings that Hungary is violating its core values. Given that Hungary has much to lose, we predict a deal will be done



Hungary's Prime Minister, Viktor Orbán, is on a collision course with the European Union

The European Commission's decision to trigger its rule-of-law mechanism comes days after elections in Hungary where Prime Minister, Viktor Orbán, was re-elected for the fourth time. Hungary stands accused of violating the bloc's principles and there are claims that EU funds are being misused. It's the first time the European Commission has triggered such a process.

Don't expect swift decisions; it could take three to five months to reach the first really important milestone in the rule-of-law mechanism, which presents a window of opportunity for a possible compromise. The whole process starts with a formal letter sent by the European Commission to the Hungarian government. In the most pessimistic of cases, if all dialogue ceases, the EU Committee could submit a proposal to the Council of the European Union to withdraw the rights to transfer EU funds. The Council would then have to make a decision by a qualified majority within one month of receiving the proposal. In exceptional cases, this deadline may be extended by up

to two months, giving one last chance for a compromise.

It is important to note that according to the political resolution of the European Council, the mechanism can only start with the 2021-2027 budget cycle and it can affect the Recovery and Resilience Facility as well, but it won't affect any payments for the period between 2014 and 2020. But even without that, much is at stake. We've previously written far more on that [here](#).

In February, The European Court of Justice dismissed complaints from Hungary and Poland against the mechanism which ties EU funding to the rule of law. At the time, we said that 'given the current geopolitical situation in Eastern Europe, and an upcoming general election in Hungary on 3 April, the European Commission will not start a formal procedure anytime soon'.

At that time, we envisioned a narrow majority for Orbán's Fidesz-KDNP party. As it was, the ruling coalition won by a much wider margin in the general election with a two-thirds majority, winning 135 out of 199 seats, based on unofficial results.

In his victory speech, Prime Minister Orbán was less than complimentary about the EU, mentioning Brussels three times. He was also warmly praised by Russia's President, Vladimir Putin. We can merely speculate whether that has played a role in the European Commission's move to trigger the mechanism just days after his emphatic victory.

The importance of EU funds for the Hungarian budget is particularly significant due to the so-called pre-financing process. The Hungarian government has been pre-financing 100% of all EU projects from the budget, which creates a shortfall and debt accumulation. If the EU cuts the transfers, this means that Hungary would not only be unable to spend the money but it would have to recover the funds which were pre-financed.

As for the Recovery and Resilience Facility (RRF) Hungary has until the end of December to reach an agreement with EU institutions otherwise they may lose 70% of allocated grants, which is about €4.1bn for Hungary. This is because, according to the official regulation on the RRF, the EC makes 70% of the grants available for allocation until 31 December 2022. This deadline is associated with the initial objective of the Recovery Plan, which assumes accelerated EU payments from the new facility in order to support the recovery of EU economies after the Covid-19 pandemic.

Taking all that into consideration, notably that hard deadline and the expected fiscal adjustment needs in 2022-23, we think a compromise is likely in the second half of this year. In the short term, we may hear opposing comments and a lot of posturing, but we assume that rational arguments will prevail and the odds for a Hungarian compromise with the EU are more than 50%, in our view.

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