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THE EU-HUNGARY DEAL ON UKRAINE AID, EU FUNDS & GLOBAL TAXATION

Implications for international investors

14 December 2022

EXECUTIVE SUMMARY

In a much-anticipated agreement with crucial implications for Hungary, Ukraine and the rest of the European bloc, the Czech Presidency of the Council of the European Union has secured a compromise deal to unblock post-pandemic EU recovery funding for Hungary, joint EU aid to Ukraine and the bloc's adoption of the OECD-proposed global corporate minimum tax.

On 12th December, EU member states approved Hungary's National Recovery and Resilience Plan (NRRP), unlocking €5.8 billion in EU recovery funding under the bloc's post-pandemic economic recovery program. In turn, the Hungarian government vowed to undertake a series of judicial reforms needed to disburse the funds, dropped its months-long opposition to joint EU financial aid to Ukraine and approved the 15% global corporate minimum tax within the EU, albeit in exchange for a national exemption.

While the EU also moved to temporarily suspend €6.3 billion in cohesion funds to Hungary, the bloc's approval of Hungary's NRRP is extremely significant, given the country's expected economic downturn, as well as energy and cost-of-living crises. At the same time, ongoing access to these funds is subject to the successful implementation of judicial reforms demanded by the EU, as well as to the continuous review of the European Commission.

Below, we provide further insight into the Czech-brokered "mega deal" and its implications for international businesses.

This memo will cover:

- the EU-Hungary compromise deal on EU funds, Ukraine and global taxation,
- key takeaways from joint EU aid to Ukraine and the incoming global corporate minimum tax,
- scenarios for Hungary as Budapest aims to implement reforms in exchange for crucial funds,
- an introduction into Hungary's National Recovery and Resilience Plan (NRRP),
- a short-term political and economic outlook on Hungary.

A LONG-AWAITED COMPROMISE

Following weeks of uncertainty, the Council of the European Union – the intergovernmental decision-making body of the European bloc – has reached a much-anticipated agreement on four key EU issues, including cohesion and post-pandemic recovery funding for Hungary, joint EU support to Ukraine and global taxation.

On 12th December, EU member state ambassadors to the Council approved Hungary's National Recovery and Resilience Plan (NRRP), a national funds management plan needed to unlock €5.8 billion in post-pandemic EU recovery funding under the bloc's Recovery and Resilience Facility (RRF). Simultaneously, the Council of the EU also agreed to lower a previously proposed EU cohesion funding cut to Hungary from €7.5 billion to €6.3 billion.

Hungary's RRF funds have been blocked by the European Commission – the bloc's top executive body – since last May over concerns of funds mismanagement, rule-of-law breaches and systemic corruption concerns. Led by Prime Minister Viktor Orbán, the Hungarian government earlier this year vowed to implement a series of transparency reforms to unlock the recovery funds.

On 30th November, however, the Commission found that the reforms undertaken in recent months were insufficient, proposing a €7.5 billion cohesion funding freeze to the Council under the bloc's new rule-of-law conditionality mechanism unless Hungary implements an extended series of new anti-graft and rule-of-law measures, which the government in Budapest has now agreed to. While the Council also agreed to the conditional funding cut, its amount was reduced to €6.3 billion.

In turn, Hungary lifted its unofficial veto on joint EU financial aid to Ukraine, allowing the European bloc to start transferring the first tranche of a proposed €18 billion aid package. Furthermore, Hungary also gave up its months-long opposition to EU approval to the OECD-proposed global corporate minimum tax, in exchange for a unique exemption for Budapest that will allow the Hungarian government to keep its corporate tax rate unchanged.

IMPLICATIONS FOR MULTINATIONAL INVESTORS

On the political level, the EU-Hungary deal is widely seen as a typical Brussels compromise, allowing all sides to claim victory after a politically tense period. In recent weeks, the Hungarian government has faced widespread criticism for de facto vetoing joint EU aid to Ukraine[1], arguing that it wants to avoid joint EU debt in favour of bilateral financial aid to Kyiv, which the Ukrainian government rejected, most likely wary of potential political conditions attached to the financial support. Some EU member states even saw the move as a blackmail attempt.

While the four issues agreed on in the Council were officially unconnected, the Czech Presidency of the Council of the EU, following Hungary's controversial opposition to joint EU support, insisted on voting on these issues as a package deal and successfully unlocked the deadlock between Budapest and the rest of the European bloc. Below, we outline the main implications of the Council agreements for international businesses.

[1] Hungary was also scrutinized for allegedly stalling the approval of Finland's and Sweden's NATO applications until the country's NRRP is approved. Hungary rejected these claims, however Budapest's greenlight to the two Scandinavian countries was postponed and is now expected for 20th February.

The €18 billion assistance package to Ukraine marks a significant step in the EU's role in Ukraine's reconstruction. With borrowing guarantees provided by EU member states and the bloc's budget, the aim of the package is to provide short-term financial relief, finance Ukraine's immediate needs in the public sector and support the rehabilitation of the country's critical infrastructure after a series of targeted Russian bombings. The package will also lend initial support towards post-war reconstruction and ultimately support Ukraine on its path towards European integration.

With financing to begin on 1st January, the EU – in partnership with international partners – is expected to place an even higher emphasis on supporting Ukraine's reconstruction, together with international partners, potentially opening up opportunities for international companies to participate in rebuilding the country. The EU deal comes as the G7, comprising the world's largest economically advanced economies and democracies, also vowed to support Ukraine's "repair, recovery and reconstruction" in coordination with international organizations. The G7 will establish a "multi-agency Donor Coordination Platform" with a secretariat to coordinate existing mechanisms of ongoing short- and long-term support, as well as to coordinate further international funding.

On global taxation, the agreement means that the OECD-proposed corporate minimum tax of 15% will become EU law. With both Hungary and previous critic Poland having now dropped their opposition, the EU agreed to implement the minimum taxation component of the OECD'S reform of international taxation. Under the component, also known as the Pillar 2 directive, multinational companies, domestic company groups and corporations with a combined annual turnover of at least €750 million will be taxed at a minimum rate of 15%. The decision foresees that the above directive has to be transposed into the national law of EU member states by the end of 2023.

Following its initial agreement to the OECD's international tax reform last year, Hungary made a U-turn on supporting the 15% global minimum corporate tax rate earlier this year, arguing that the Hungarian economy would lose competitiveness in an economically crucial period. Similar to the Polish government, which also dropped its veto when Warsaw's NRRP was approved by Brussels in June, the Orbán Government also lifted its veto, but only after securing an unique exemption for Hungary. Under the deal, Hungary's local business tax will also be calculated as part of its corporate tax, allowing Budapest to maintain its corporate tax rate at 9%, among the lowest in the world.

SCENARIOS FOR HUNGARY

Even with the agreements reached on 12th December, the scope of EU funding to Hungary, which Budapest and Brussels have been negotiating for more than 18 months, remains uncertain and subject to the implementation of a wide range of anti-corruption and rule-of-law reforms.

Having secured the Council's approval of its revised NRRP, the Hungarian government managed to avoid a significant loss of EU payouts as NRRPs must be approved by the end of 2022. Without a deal, Hungary would have lost out on an estimated 70% of the funds dedicated to Budapest. Furthermore, the agreements reached in Brussels foresee a conditional cut to Hungary's cohesion funds that is 30% lower than that originally proposed by the Commission.

Altogether, the agreement brings some relief for Hungary on the international markets. However, neither the recovery nor the blocked cohesion funds can be accessed unless Hungary implements 27 "super milestones" to improve the independence of its judiciary, strengthen the rule of law and tackle systemic corruption.

Our baseline scenario assumes that Hungary will implement all the judicial reforms agreed on with the EU institutions to unlock all cohesion and recovery funds going forward. This seems essential given the Hungarian economy is heading into technical recession, besides facing an energy and cost-of-living crisis. Hungarian central bank governor György Matolcsy recently claimed that the country's economy is on the brink of a major crisis.

In the event of the successful implementation of necessary reforms, Hungary could see its frozen cohesion funds unlocked by the Council as early as next April or March. For this to happen, the remaining package of judicial reforms will have to approved by the Hungarian National Assembly by the end of March next year, with the government vowing to implement all reforms necessary.

It is also possible, however, that re-emerging disagreements between Brussels and Budapest will result in the continued freezing of crucial EU funds. If the Commission determines the Hungarian government has not met any of the "super milestones" of the agreed reform agenda, both cohesion and recovery funds can be withheld. However, the soonest Hungary could face losing the penalized €6.3 billion is the end of 2024, with an additional €14.3 billion in cohesion funds remaining unblocked. While another funds row is not in the interests of the country's ruling Fidesz party, particularly in view of the near-crisis situation of the Hungarian economy, the Hungarian government has a history of long-running disputes around democracy and the rule of law with EU institutions.

Furthermore, the European Parliament, one of the strongest critics of the Hungarian PM, and instrumental in convincing the Commission to propose a €6.3 billion (initially €7.5 billion) suspension from Hungary's cohesion funds, might also put pressure on the Commission to "get tougher" with Hungary and continue with the funds' suspension. In this regard, an additional risk is potential future disagreement between Hungary and the rest of the European bloc on topics related to Russia, which might further complicate Hungary's long-awaited access to EU funds.

HUNGARY'S NATIONAL RECOVERY AND RESILIENCE PLAN (NRRP)

Key Figures from Hungary's Revised & Approved NRRP		
Policy Component	**Framework Amount (EUR)**	**Framework Share (%)**
Demographics & Education	621 million	11
Skilled & Competitive Labour	692 million	12
Rural & Regional Development	225 million	4
Water Management	146 million	2
Sustainable Transport	1414 million	24
Green Transition	1246 million	22
Circular Economic Transition	109 million	2
Healthcare	1306 million	22
Public Administration	66 million	1
Total	5.825 billion	100
Contribution to EU Climate Targets		48.1
Contribution to EU Digital Targets		29.8

LOOKING AHEAD: HUNGARY IN 2023

The much-anticipated "mega deal" between Budapest and Brussels comes as Hungary is braced for an economic downturn and likely heading into recession early next year, even as the government in Budapest hopes to avoid that. Largely to counter the impacts of Russia's war against Ukraine, the past six months have seen a series of (often controversial) anti-crisis measures, ranging from windfall taxes imposed on companies across multiple industries (most recently on oil companies), prolonged and/or scrapped price caps on essential food items, household energy and fuel, austerities hitting the SME sector, as well as an emerging cost-of-living and energy crisis, with inflation in Hungary now the highest in the EU.

However, the conditional EU greenlight to Hungary's recovery plan comes as a reassurance, with considerable opportunities for companies, particularly those involved in the green, circular economic and the digital transition. Unlike a number of EU member states, the Orbán Government has not yet applied for €billions of preferential EU loans under the RRF but has left this option open for the next six months, which might prove necessary as the economic situation worsens.

Although Hungary is among the economically most impacted countries by Russia's war against Ukraine, the Hungarian government maintains a generally milder position on Moscow in comparison with the EU mainstream, providing for a vast number of political disagreements with the rest of the European bloc. The government in Budapest argues that the EU's sanctions policy against Russia over Ukraine is detrimental to the Hungarian and European economies and wants them entirely or at least partially scrapped – a position unlikely to gain EU majority support, particularly in view of the bloc's 9th sanctions package. At the same time, Hungary will maintain opposition to further energy sanctions against Moscow and potentially seek exemptions from certain restrictive measures.

While the ruling Fidesz-KDNP alliance is poised to lose popular support due to the current cost-of-living crisis, Hungarian PM Viktor Orbán and Fidesz's supermajority in the Hungarian parliament will likely remain unchallenged. Hungary's opposition remains too fragmented, both ideologically and structurally, and far too unpopular to mount any meaningful challenge against the Fidesz Government.

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If you would like to schedule a discussion of this paper, please contact:
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