Chapter 2
The EU response to Covid-19: breaking old taboos?

Cinzia Alcidi and Francesco Corti

Introduction[1]

This time is different. Though we've heard that many times, this adagio applies particularly well when trying to understand the context of the EU response to the Covid-19 pandemic, especially in comparison with the financial crisis of 2009-10. The reason is threefold.

First, the nature of the economic shock differs from any experienced in the past (Gros 2020). The Covid-19 crisis was caused by a pandemic (public health shock) which hit all countries in the same way, and not by an internal build-up of imbalances, reckless creditors or reckless debtors. The demand and supply shocks that unfolded in the aftermath of the measures implemented to contain the pandemic led GDP to contract much more than in the previous recession and hit EU countries in a very unequal way (Dauderstädt, this volume).

Second, the EU institutional framework differs from that of 2009, allowing the EU to rely on different policy tools. One prominent example is the response of the European Central Bank which, immediately after the outbreak of Covid-19, was in a position to start purchasing potentially unlimited amounts of sovereign bonds. Nevertheless, the incompleteness of the EMU architecture again showed its weaknesses. As put by Bénassy-Quéré and Weder di Mauro (2020), on the fiscal side the 'European roof is not only leaking, it is missing altogether for the kind of shock that is unfolding'. The Eurozone still lacked a mechanism for automatic fiscal stabilisation and a common fiscal capacity to face asymmetric shocks. In addition, the buffers and firewalls put in place after the global financial crisis and the euro crisis were designed to fight a different sort of crisis, originating in the financial sector or in a country's sovereign debt.

Third, the ideational framework is different. The chorus of scholars reacting to the outbreak of the pandemic in March 2020 was unanimous in calling on national governments to act fast and do whatever it takes to 'keep the lights on' until the recession was over (Baldwin and Weder Di Mauro 2020). This was reflected in national policymakers' unanimity on the recipe to tackle the pandemic. Across countries, this revolved around four pillars: provide liquidity, support income and employment, protect the financial system and speed up economic recovery. A surprising consensus

1. The authors would like to thank Willem Pieter De Groen, Daniel Gros and Inna Oliinyk for their valuable support in the data collection and indispensable exchanges on the interpretation of the EU response to the pandemic crisis compared to the previous EU response to the Great Recession.

emerged among academic observers and policymakers on how the European Union (EU) could help protect lives, firms, workers, the Single Market, banks, national budgets and sovereign debt. More controversial – as expected – were the discussions on the funding options which included so-called Coronabonds, credit lines from the European Stability Mechanism (ESM), EU borrowing backed by contributions to the EU budget, and monetary policy.

A year and a half after the outbreak of the pandemic, with the economy recovering and the vaccination campaign speeding up in Europe, the time is ripe to take stock of the EU economic and social response to Covid-19, asking whether it represents a step towards greater solidarity in the EU. Solidarity – from the Latin *in solidum* – means the formal commitment to pay back a debt. It thus implies shared responsibility and risk pooling. In this chapter, we understand solidarity at EU level in both meanings: as risk-sharing to achieve common goals but also as mutual support among the members of the Union.

This chapter takes stock of the EU initiatives adopted to tackle the Covid-19 pandemic, distinguishing between three phases. During the first, which we call 'applying the lessons learnt', the EU quickly and smoothly put in place several initiatives aimed at easing national fiscal policies – mainly drawing on the experience of the 2009 financial crisis. The second phase, dubbed 'acting as a second-line defence', refers to the set of EU initiatives put in place by both using the available instruments and exploiting the existing legal provisions to create new instruments to financially support Member States in their efforts to immediately stabilise their economies. The third phase, named 'preparing the post-pandemic recovery' focuses on the NextGenerationEU package, its redistributive effects and its investment-led growth strategy.

The chapter is organised as follows. Section 1 is devoted to analysing the EU response to the Covid-19, while Section 2 looks briefly at the EU response to the Great Recession and the ensuing policy debate on EMU reforms. Section 3 draws conclusions on the nature of the current pandemic, discussing why we should consider it a step towards more solidarity in the EU.

1. The EU response to the pandemic crisis

The size of the national fiscal measures taken in response to the Covid-19 outbreak is unprecedented (European Fiscal Board 2020). In total, EU Member States adopted almost 1,300 fiscal measures worth about €3.5 trillion to mitigate the negative impacts of the Covid-19 crisis in the period from March to December 2020. These included discretionary expenditure and revenue measures, financial instruments, guarantees and tax payment measures.[2] While national governments have been at the forefront of the economic response to the pandemic crisis, they have not walked alone. European-level action has been significant, revolving around three pillars: (a) monetary and banking policies; (b) state aid and fiscal rules; and (c) budgetary and financial support measures

2. See footnotes 9 to 13 for more details on these measures.

(i.e. funding). This policy mix did not come all at once. We distinguish three phases in the EU response to Covid-19 which we term 'applying the lessons learnt' (Section 1.1), 'acting as a second-line defence' (1.2) and 'preparing the post-pandemic recovery' (1.3).

1.1 Applying the lessons learnt (first phase)

At the onset of the Covid-19 pandemic, priority was given to injecting liquidity into financial markets to prevent financial instability, provide income support to temporarily laid-off workers, support businesses (tax relief, credit lines) and strengthen the healthcare sector.

The European Central Bank was the first to intervene. Its action revolved around four main axes: (a) maintaining key interest rates unchanged;[3] (b) safeguarding liquidity conditions in the banking system through a series of favourably priced long-term refinancing operations and protecting the continued flow of credit to the real economy through a fundamental recalibration of the targeted longer-term refinancing operations (by providing a liquidity backstop);[4] (c) collateral policy to mitigate the tightening of financial conditions across the Eurozone;[5] and (d) asset purchase programmes aimed at supporting favourable financing conditions for the private and public sectors. With respect to the fourth point, on 18 March 2020 the ECB introduced the new temporary Pandemic Emergency Purchase Programme (PEPP) of €750 billion, subsequently increased to €1,350 billion on 4 June 2020 and to €1,850 billion on 10 December of the same year. Securities bought under the PEPP come on top of the net purchases under the Asset Purchase Programme (APP). Since November 2019, the average monthly pace of APP purchases was €20 billion. In March 2020 this was extended until the end of the year to purchases related to the extra temporary package of €120 billion.

Two days after the launch of the PEPP, the European Commission intervened with two Communications directed at easing the way for national policies, rather than designing an EU-level response. Presented on 19 March 2020, the aim of the first one, the 'Temporary Framework for State aid measures to support the economy in the current Covid-19 outbreak', was to enable Member States to use the full flexibility foreseen under state aid rules to support their economies in the context of the Covid-19 outbreak. Five types of interventions were initially allowed under the new temporary framework.

(i) Direct grants, selective tax advantages and repayable advances (up to €800,000 to a company to address its urgent liquidity needs).
(ii) State guarantees on loans taken out by companies from banks.
(iii) Subsidised public loans to companies with favourable interest rates, aimed at

3. Main refinancing operations: 0.00%; Marginal lending facility: 0.25%; Deposit facility: -0.50%.
4. Two measures need to be mentioned: (a) the reduced interest rate for TLTRO (Targeted Longer-Term Refinancing Operations) III outstanding operations from June 2020 to June 2021; and (b) the introduction of a new series of non-targeted Pandemic Emergency Longer-term Refinancing Operations (PELRO).
5. Measures in this area include the temporary increase in the Eurosystem's risk tolerance in order to support credit to the economy; easing the conditions for the use of credit claims as collateral (guaranteed loans to SMEs and the self-employed), the waiver to accept Greek sovereign debt instruments as collateral in Eurosystem credit operations and the general reduction of collateral valuation haircuts by a fixed factor of 20%.

helping businesses covering immediate working capital and investment needs.
(iv) Safeguards for banks that channel state aid to the real economy.[6]
(v) Short-term export credit insurance.

In the following months, three amending Communications[7] were adopted by the Commission. The first amended the initial Communication on the temporary State Aid framework with the aim of further facilitating Member State intervention in support of Covid-19 relevant research and development, the construction and upgrade of testing facilities for Covid-19 relevant products, and the production of products needed to respond to the outbreak. In addition, targeted support in the form of deferrals of payments of taxes and social security contributions and wage subsidies for employees was made possible. The second was aimed at supporting non-financial companies otherwise viable before the Covid-19 outbreak and which had experienced losses decreasing their equity and thus reducing their ability to borrow on the markets. In such cases, recapitalisation aid was allowed. Announced in June 2020, the third allowed Member States to provide public support to micro and small companies, under specific conditions, even if they were already in financial difficulty on 31 December 2019.

On 20 March 2020, the Commission published a second important Communication on the activation of the 'General Escape Clause' of the Stability and Growth Pact (SGP).[8] This allows a coordinated and orderly temporary deviation from the normal SGP requirements for all Member States in a situation of generalised crisis caused by a severe economic downturn of the Eurozone or the EU as a whole. The Commission's objective was to provide Member States with the flexibility needed to take all necessary measures for supporting health and civil protection systems and to protect the economies, including through further discretionary stimuli and coordinated action. The activation of the General Escape Clause allowed Member States to temporarily depart from the adjustment path towards the medium-term budgetary objective.

Fiscal measures adopted by Member States under the temporary state aid framework in 2020 amounted to €2.3 trillion. In absolute terms, Germany ranked first (€1,121.2 billion, 34% of GDP), followed by Italy (€415.3 billion, 25% of GDP), France (€399 billion, 17%) and Spain (€122.7 billion, 9%). As Figure 1 shows, the lion's share of the state aid measures consists of guarantees[9] (82% of total support measures). The remaining share is divided between discretionary expenditure[10] (6%), financial

6. Some Member States plan to build on banks' existing lending capacities and use them as a channel for support to businesses – in particular to small and medium-sized companies. The Framework made clear that such aid is considered as direct aid to the banks' customers, not to the banks themselves, and gives guidance on how to ensure minimal distortion of competition between banks.

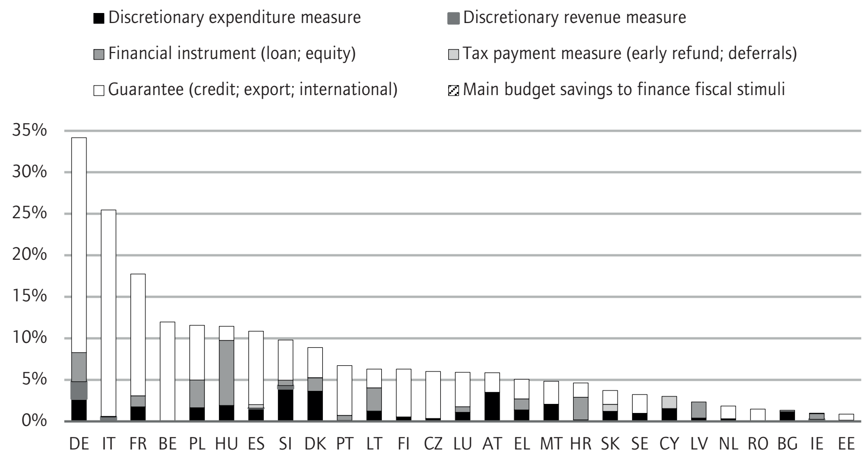
7. C(2020) 2215 final; C(2020) 3156 final; 2020/C 218/03.

8. Based on Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Regulation (EC) 1467/97.

9. Guarantees aim to support the liquidity positions of companies through a promise from the government to repay the guaranteed debt in case of default. These measures have an indirect budgetary impact, as the guarantees are not supposed to be used. The guarantees come under three detailed classifications: i) national credit guarantees, ii) national equity guarantees, and iii) international guarantees (e.g. SURE).

10. The general objective of discretionary expenditure measures is to increase aggregate demand by increasing public spending. These measures have a direct budgetary impact, increasing government spending. They include, for instance, measures to support employment (i.e. furlough schemes), the incomes of enterprises and households, and the healthcare sector.

Figure 1 **Fiscal measures adopted under the temporary state aid framework (% GDP)**



Source: CEPS Authors' elaboration based on European Commission (2021a).

instruments[11] (8%) and discretionary revenue measures (3%).[12] The large share of guarantees might lead to a misleading interpretation of the relative budgetary effort of Member States. Guarantees indeed only have a budgetary impact when a debtor is unable to repay a loan.[13] A better indication is provided by discretionary expenditure and revenue measures, both of which have an immediate budgetary impact. Based on this metric, Austria ranks first, with discretionary measures exceeding 5% of GDP, followed by Germany, Slovenia and Denmark. All these countries had larger margins for fiscal intervention.

The activation of the General Escape Clause allowed Member States to intervene regardless of their room for fiscal manoeuvre under the SGP rules and in relation to their debt levels. This turned out to be particularly important for highly indebted countries. As a matter of fact, it was those countries with the highest pre-Covid debt burden which experienced the largest increase in the debt-to-GDP ratio. In Greece, Italy and Spain, this ratio rose by more than 20 percentage points, driven by large fiscal deficits and, above all, major GDP contractions. Under the normal SGP framework, such increases would not have been possible. In 2020, the Eurozone average ratio increased by 15 percentage points, going up to 100%.

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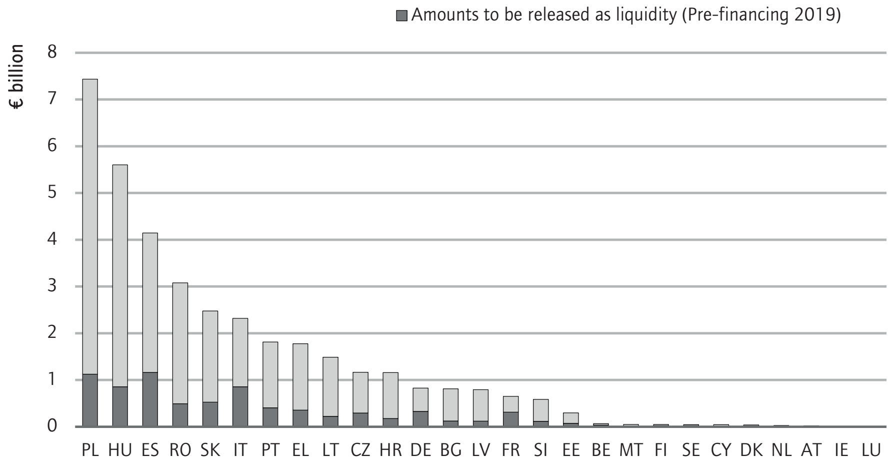
11. Financial instruments aim to support the liquidity position of enterprises through loans or equity injections. These measures primarily have an indirect budgetary impact as the loans and equity injections should ultimately be repaid and the interest covered. Financial instruments include loans and equity injections.

12. The general objective of discretionary revenue measures is to increase aggregate demand by lowering or suspending taxes. These measures have a direct budgetary impact, lowering government revenues. These include tax rate cuts and tax payment relief.

13. The difference between budgeted amounts and those implemented is particularly large for credits and guarantee schemes. It is therefore important to distinguish between the total amounts 'budgeted' or 'planned', the amounts actually guaranteed and the amount of credits or guarantees called by potential beneficiaries. The latter indicates the actual take-up of the guarantees' schemes and gives us an idea of the use made of guarantee schemes so far.

Figure 2 **Resource distribution under CRII (€ billion)**



Source: Authors' elaboration, based on European Commission (2020).

1.2 Acting as a second-line defence (second phase)

While temporary changes to the EU fiscal framework and state aid regulations provided a backstop for immediate Member State relief efforts, the lack of an EU fiscal capacity significantly constrained the margins for manoeuvre of the EU shock absorption response. Not benefiting from a shock absorption capacity, the EU budget lacks the flexibility to promptly redistribute resources to Member States in need. Even so, the EU was able to use existing resources and instruments to put in place *ad hoc* measures to support Member States in tackling the immediate effects of the pandemic.

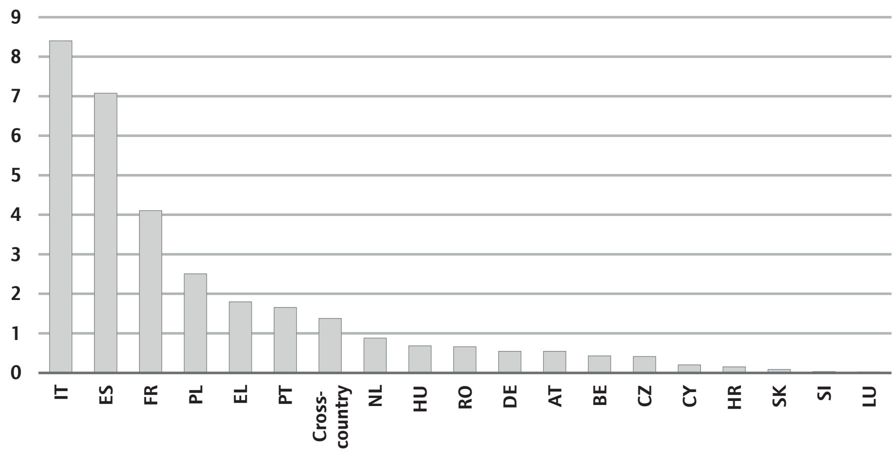
The first set of measures included two packages,[14] the Coronavirus Response Investment Initiative (CRII)[15] and the CRII Plus.[16] These aimed to use the (modest) flexibility in the EU budget to support Member States health systems and firms facing liquidity constraints. Overall CRII and CRII Plus had the potential to mobilise €37.3 billion of European public investment (Figure 2): an upfront cash injection capacity of around €7.9 billion (including €0.2 billion for the UK) coming from the unspent pre-financing of EU cohesion funds that Member States would normally repay to the EU budget by the end of June 2020, and €29.4 billion (including €0.3 billion for the UK) of co-financing from the EU budget.

14. Two further measures were adopted. First, the European Emergency Support Instrument with a total budget of 2.7 €billion, which was used to secure the production of vaccines in the EU and sufficient supplies for its Member States through Advance Purchase Agreements with vaccine producers. Second, in March 2020, the Commission changed the regulation of the European Solidarity Fund with the aim of broadening its scope to include major health emergencies.

15. Adopted on 13 March 2020.

16. Adopted on 2 April 2020.

Figure 3 **Amounts of EIB Covid-19 projects (€ billion)**



Source: Authors' elaboration, based on EIB data. https://bit.ly/3yxClwW

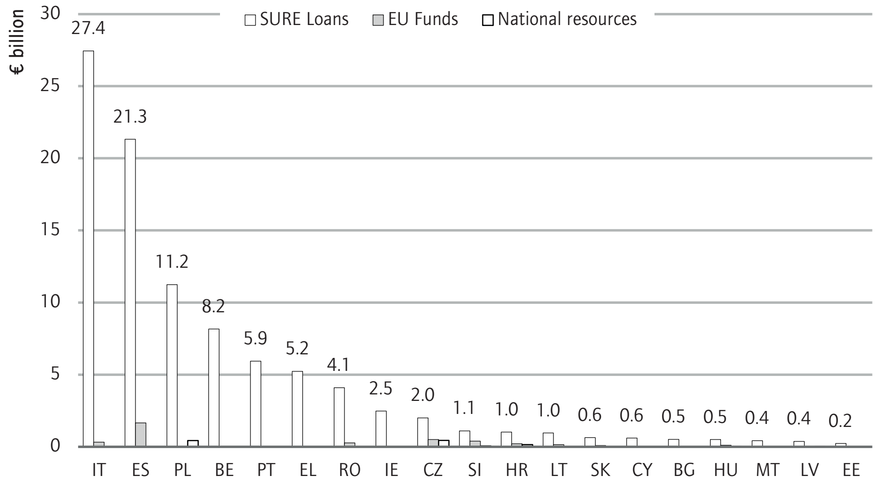
As of 30 June 2021, more than one year after the outbreak of the pandemic, only around 61% of the earmarked CRII and CRII Plus financial support has been used by Member States: €7.6 billion for health-related actions, €11.2 billion for actions directed to businesses and €4.1 billion for direct support for people, including workers and vulnerable groups.[17]

The reason for this slow take-up is intrinsic to the nature of the financial support, requiring Member States to ask for an amendment of their national or regional operational programmes, in line with the procedures governing the EU Structural and Investment Funds. With respect to the possibility to ask for a 100% EU financing of structural funds, the Member States set to benefit most from the flexibility are Hungary, Croatia, Portugal and Slovakia. To sum up, even though the flexibility of the structural funds allowed some Member States to benefit from liquidity support, the CRII and CRII Plus contributed – at most – to a sectoral reallocation of structural funds but not to a reallocation across Member States.

The second set of measures built on the experience of the Juncker Plan.[18] Together with the European Investment Bank, the Commission presented in April 2020 a plan consisting of:

17. Data is retrieved from the European Commission CRII Dashboard. https://bit.ly/3F0RpFJ
18. The Juncker Plan, i.e. the European Fund for Strategic Investments (EFSI), was the infrastructure investment programme first announced by European Commission President Jean-Claude Juncker in November 2014 with the aim of unlocking public and private investments in the 'real economy' to the tune of at least €315 billion over a three-year fiscal period (January 2015–December 2017). In December 2017, the Council extended the EFSI until December 2020, targeting half a trillion euros of additional investments.

Figure 4 **SURE loans, EU funds and national financing to support STW schemes and similar measures (€billion)**



Source: CEPS calculations based on Council implementing decisions. https://bit.ly/3dSO80L

i) €1 billion dedicated guarantee schemes under the COSME Loan Guarantee Facility, and €2.2 billion, under the InnovFin SME Guarantee, for banks and other lenders to provide liquidity to SMEs and mid-caps;
ii) €5 billion dedicated liquidity lines to banks from the EU Programme Loan Response to Covid19 crisis for SME&MIDCAPS with the aim of ensuring additional working capital support for SMEs and mid-caps of up to €10 billion; and
iii) €2 billion dedicated asset-backed securities (ABS) purchasing programmes from the EU Programme Loan ABS Response to Covid19 crisis for SME&MIDCAPS to allow banks to transfer risk on portfolios of SME loans.

In addition, the Commission and the European Investment Bank (EIB) announced a €5 billion pipeline – under the InnovFin Infectious Disease Finance Facility – for projects in the health sector.

Finally, on 23 April 2020 the European Council agreed on the creation of a new instrument, the €25 billion European Guarantee Fund (EGF), enabling the EIB to issue special guarantees to incentivise banks and other lenders to provide liquidity to European SMEs and small mid-cap companies hit by the economic impact of the coronavirus pandemic.

To sum up, the EIB intervention put in place almost €40 billion guarantees aimed at mobilising up to €233 billion in investments across the EU. About €14 billion comes from already existing programmes redirected to support Covid-19-related projects, while €25 billion is new.

Table 1 **Key statistics of the SURE borrowing transactions**

Transaction	Tranche	Size of the bond (€)	Yield	Total investor demand (€)	Beneficiaries
20.10.2020	20 years	7 billion	0.131%	88 billion	IT, ES, PL
	10 years	10 billion	–0.238%	145 billion	
10.11.2020	5 years	8 billion	–0.509%	105 billion	CY, EL, ES, HR, IT, LT, LV, MT, SI
	30 years	6 billion	0.317%	70 billion	
24.11.2020	15 years	8.5 billion	–0.102%	114 billion	BE, HU, PT, RO, SK
26.01.2021	7 years	10 billion	–0.497%	83 billion	BE, CY, EL, ES, HU, IT, LV, PL, SI
	30 years	4 billion	0.134%	49 billion	
09.03.2021	15 years	9 billion	0.228%	86 billion	CZ, ES, HR, IT, LT, MT, SK
23.03.2021	5 years	8 billion	–0.488%	54.5 billion	BE, CZ, ES, IE, IT, PL
	25 years	5 billion	0.476%	55 billion	
18.05.2021	8 years	8.137 billion	0.019%	59.3 billion	BE, BG, CY, EE, EL, ES, IT, LT, LV, MT, PT,
	25 years	6 billion	0.757%	43.5 billion	

Source: Data compiled by CEPS based on Commission technical note.

As of 30 April 2021, 162 projects have been presented: 17 are under appraisal at the time of writing (€2.2 billion), 90 have been signed (€18.5 billion) and 53 have been approved (ca. €12 billion). Italy is the country so far benefiting the most from the EIB intervention, followed by Spain, France and Poland (see Figure 3).

Finally, on 2 April 2020 the Commission proposed the establishment of a European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) to provide temporary financial assistance to Member States to address severe increases in public expenditure for the preservation of employment.[19] Funds can be used for creating or extending short-time work schemes and similar national measures taken in response to Covid, including for self-employed persons. The SURE Regulation empowers the Commission to borrow on financial markets by issuing EU bonds, worth up to €100 billion. The loans extended to Member States are underpinned by a system of voluntary guarantees from Member States, and amounting to at least €25 billion.

SURE became formally available on 22 September 2020, after all the Member States had provided their guarantees. In the meantime, 16 Member States[20] had submitted their requests for loan support, and the Commission formally presented the Council implementing decisions in August for a total of €87.3 billion in financial support, which was granted. Three additional countries requested and obtained access to SURE

19. For an extensive discussion on SURE, see Corti and Alcidi (2021) and European Commission (2021c).
20. BE, BG, CY, CZ, EL, ES, HR, IT, LT, LV, MT, PL, PT, RO, SI, SK.

loans for €3.3 billion.[21] Furthermore, in March 2021, the Commission proposed to the Council to grant an additional €3.7 billion in financial assistance to six Member States, which already received the loan support.[22] Approval of the implementing decisions increased the total SURE loan granted to €94.3 billion. 5% of financial assistance has been allocated to health-related measures, with the remainder going to employment protection measures. Italy has received the largest share of the loans, followed by Spain, Poland and Belgium (see Figure 4). For those Member States requesting the support, the total amount requested covered almost all the current and planned expenditure.

From the perspective of highly indebted countries, for which raising additional debt may be an issue, the SURE loans are financially attractive. As an example, the 10-year SURE bonds are placed at the negative interest rate of -0.24%, the 20-year ones at 0.13%. Comparable Italian long-term government bonds (*Buoni Poliennali del Tesoro* – BTPs) pay 0.72% and 1.25% respectively. Assuming that interest rates remain unchanged for the entire period of the loan and that the bonds issued by the Commission remain equally distributed (60% at ten years, 40% at twenty years), the accumulated savings in terms of lower interest rates for Italy would amount to approximately €4.36 billion. A further attractive element is the very long maturity of the issuances, on average 16.25 years, a level difficult for small countries to achieve. This explains why SURE loans are attractive not only for countries with high public debt (such as Italy, Spain and Belgium), but also for those with a small local debt market which, despite their low debt-to-GDP ratio, have requested SURE support (e.g. Bulgaria, Estonia).

In terms of interest savings, according to the European Commission (2021c) report[23] based on data for the first four issuances of SURE, up to the disbursement on 2 February 2021, Member States are estimated to have saved a total of around €5.8 billion in interest payments thanks to the EU's more favourable borrowing conditions.

The last measure came from the ESM. On 15 May 2020, a new ESM credit line, the Pandemic Crisis Support, became operational. Based on its Enhanced Conditions Credit Line (ECCL), it is available to all Eurozone countries and worth up to 2% of a borrower's 2019 GDP (i.e. €240 billion, should all 19 Eurozone countries draw from the credit line). It reflects current challenges, on the basis of preliminary assessments by the European institutions (Commission and ECB together with the ESM). The only requirement to access the credit line will be that Eurozone Member States requesting support commit to use this credit line to support domestic financing of direct and indirect healthcare, cure and prevention-related costs due to the Covid-19 crisis. The credit line will be available until the end of 2022. Despite the low conditionality, no request has yet been submitted. This may partly reflect perceptions among Eurozone Member States that the ESM is a lender of last resort whose loans are subject to strict conditionality, or the stigma often associated with ESM loans.[24]

21. Hungary (€504 million, formally granted on 23 October 2020), Ireland (€2.5 billion formally granted on 4 December 2020) and Estonia (€230 million formally granted on 24 March 2021).
22. These countries are Belgium, Cyprus, Greece, Latvia, Lithuania and Malta.
23. The report ran its estimations based on only the first four transactions.
24. As a consequence of this, discussions started on the future of the ESM and the proposal for an incorporation of the ESM into a revamped EU legal order. For a discussion, see Guttenberg (2020).

1.3 Preparing the post-pandemic recovery (third phase)

While a broad consensus has developed – since the beginning of the Covid-19 pandemic – on the need for the EU to intervene to support Member States in their post-pandemic recovery, a lively debate has arisen on how to design the EU financial response. The academic debate revolved around four main issues (Bénassy-Quéré and Weder di Mauro 2020).

The first issue was about whether and which strings should be attached to a potential European recovery plan. The concern regarded the risk of moral hazards possibly stemming from a misuse of such assistance.

The second issue related to the use of loans as opposed to grants. This touches upon both the legal constraints that allow the EU to provide only back-to-back loans to a Member State in case of 'natural disasters or exceptional occurrences beyond [its] control' (Art. 122 TFEU), and the risk of further increasing indebtedness when providing loans to an already indebted country (Gros 2020).

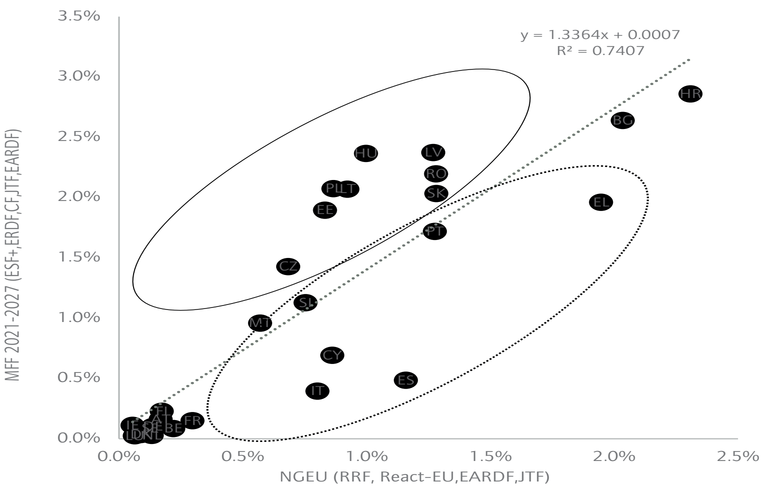
The third issue regarded the vehicle through which to finance the EU response: European versus joint and/or several liabilities. In the first case, the Commission is enabled to borrow on behalf of the EU by issuing new bonds guaranteed by future higher contributions to the EU budget. In the second case, the new European debt is backed either by new own resources, as a joint and several guarantee (Eurobonds or Coronabonds), or by limited (capped) guarantees from the Member States (i.e. several, but not joint guarantees).

Finally, the fourth issue concerned EU own resources and how to generate tax revenue to finance the recovery. Various proposals have been advanced, ranging from a new carbon tax, via a digital tax, to the common corporate consolidated tax. As yet, no consensus has been achieved.

Some of these proposals fuelled a lively political debate, especially in the first months of the crisis when the old dividing line between core and periphery within the Eurozone appeared to reopen. On the one hand, governments in fiscally sound countries were initially reluctant to concede on their red lines concerning transfers and common debt. On the other hand, weaker, southern Eurozone member countries, which considered the ESM to be inadequate and politically toxic, were concerned that their limited fiscal capacity would not allow them to support their economies and felt that the opposition to common debt issuance was not justified in the context of the life-threatening crisis.

However, on 23 April 2020 the European Council agreed in principle on a 'Roadmap to Recovery' and on establishing a new fund 'of a sufficient magnitude, targeted towards the sectors and geographical parts of Europe most affected, and dedicated to dealing with this unprecedented crisis' (European Council 2020). The European Commission was asked to develop a proposal on how to use this recovery fund. In the meantime, France and Germany published a proposal on 18 May for a €500 billion fund to help EU

Figure 5 **Annualised MFF 2021-27 and NGEU grants (% of 2020 GDP)**



Source: Authors' elaboration, based on European Commission. We assume that the NGEU funds will be distributed over a period of six years (2021-2026) while the MFF over seven years (2021-2027).

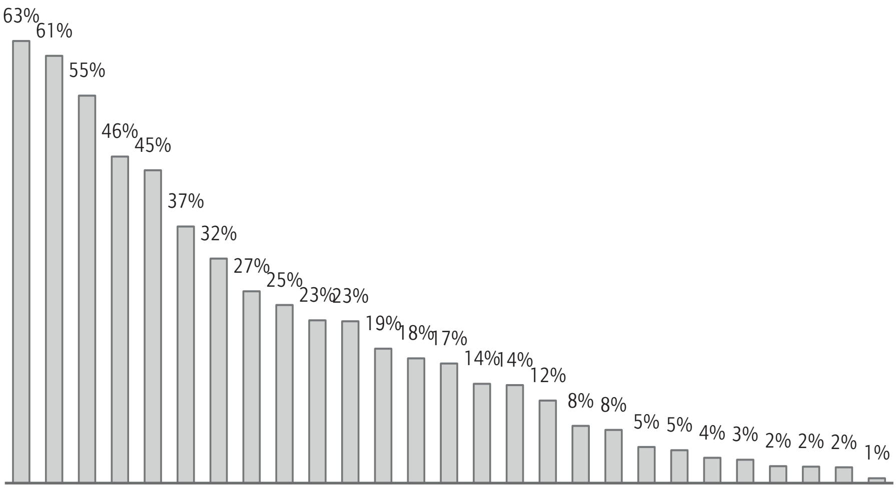
Member States finance the recovery effort, with funding ensured through the issuance of common EU bonds. On 27 May 2020 the Commission presented its proposal for the next Multiannual Financial Framework (MFF) 2021-2027. In conjunction with this, it launched its NextGenerationEU initiative with the aim of supporting and coordinating EU economic recovery in the years to come.[25]

The agreement of the European Council concerning NextGenerationEU of July 2020 has been welcomed by many commentators as something of a 'Hamiltonian moment' for the EU. For the first time, the EU will raise money by temporarily lifting the maximum amount that the EU can request from Member States to cover its financial obligations to 2.0% of Gross National Income for the EU. The associated European debt, which has a long-term maturity, will be guaranteed by the next MFFs and will have to be repaid (including interest) by means of increases in the revenues of these same MFFs, but also through the introduction of new own resources and, for the component relating to the loans, by the payment of financial charges and reimbursement made by the beneficiary countries.

The NGEU package contains various measures to support Member State efforts in tackling the pandemic, to further strengthen already existing programmes and to support countries' recovery.[26] However, the key novelty of the NextGenerationEU (NGEU) instrument is certainly the Recovery and Resilience Facility (RRF), endowed with resources of €672.5 billion, equivalent to almost 90% of the entire NGEU initiative

25. For an extensive discussion of the political debate underpinning NGEU, see De la Porte and Jensen (2021).
26. See Table A1 in the Annex for an overview of the funding allocated by NGEU to these funds.

Figure 6 **Annualised RRF allocation (grants): ratio to general governments' gross fixed capital formation (average 2016-19)**



Source: Authors' calculations, based on European Commission and AMECO. We assume the RRF grants will be distributed over a six-year period (2021-2026).

(Corti and Nunez-Ferrer 2021). The RRF provides large-scale financial support to reforms and investments undertaken by Member States, with the aim of mitigating the economic and social impact of the coronavirus pandemic and of making EU economies more sustainable, resilient and better prepared for the challenges posed by the green and digital transitions. The scope of the RRF is thus broad, as its core objective is to support Member States in addressing the challenges identified in the European Semester in areas such as competitiveness, productivity, environmental sustainability, education and skills, health, employment, and economic, social and territorial cohesion.

Contrary to what one may have expected, the criteria for distributing the RRF grant components are not based on the depth of the economic (GDP contraction) and social shock (unemployment increase). Allocation is mainly based on the pre-crisis structural conditions of Member States (i.e. population, the 2019 per capita GDP, and 2015-2019 average unemployment rate compared to the EU average) and privileges countries with a lower GDP, higher unemployment rate and larger population.[27] Because of this, the RRF has a strong re-distributive component favouring southern and Central and Eastern Europe economies. These are the same countries that are also expected to request NGEU loan support, not only grants, as was already the case under SURE.

27. With the Council agreement of July 2020, this allocation key was maintained for the first instalment of the RRF grants, equal to 70% of the total (to be committed by end of 2022), while for the remaining 30% which is to be committed by the end of 2023, the 2015-2019 unemployment criterion is replaced, in equal proportion, by the loss in real GDP observed over 2020 and by the cumulative loss in real GDP observed over the period 2020-2021 and will be calculated by 30 June 2022.

The second most important NGEU component is React-EU, accounting for around 6.3% of the total NGEU envelope. React-EU will involve investments to support job maintenance, including short-time work schemes and support for the self-employed, as well as investments in operations contributing to preparing the transition to a green and digital economy. Contrary to the RRF allocation key, React-EU funds will be largely distributed in accordance with Member States' GDP contraction and only marginally to reflect increases in unemployment. This notwithstanding, React-EU again maintains a strong redistributive component in favour of Southern and Central and Eastern Europe Member States.

Looking solely at the grant component, total NGEU support to individual Southern and Central and Eastern Europe Member States could reach as much as 2.5% of domestic GDP each year over the period 2021-26 (see Annex I). One should remember that NGEU resources will top up the traditional EU transfers from the next MFF 2021-27. This means that countries that are the biggest beneficiaries of Structural and Investment funds, and thus set to receive significant support from the Just Transition Fund and the European Agricultural Fund for Rural Development, will also receive large additional funds under the NGEU.

All in all, Southern and Central and Eastern Europe Member States will have to absorb between 2% and 5% of GDP from the NGEU and the MFF funds every year until end of 2026. Interestingly, MFF funds will continue to be directed mostly to Central and Eastern Europe Member States, whereas the NGEU will prioritise southern countries (see Figure 5).

The level of resources is considerable by any metric (Alcidi et al. 2020). However, the amounts are even more considerable when one considers the final purpose of the RRF grants and loans, i.e. financing additional public investments. Figure 6 below shows the annualised RRF grants as a percentage of annual public investments, considering as a reference the average (2016-2019) general governments' gross fixed capital formation. What emerges is that, under the assumption of a 100% absorption rate[28] and full additionality, annual public investments for Bulgaria, Portugal and Croatia can be expected to increase over the next six years by circa 60%. For eight other countries, investment would increase by 20% to 46%.

2. Understanding policy learning

As illustrated above, in the face of the spread of the Covid-19 pandemic, European policymakers were able to draw on the lessons learned from the previous crisis. In the following, we briefly recollect the main steps that unfolded after the outbreak of the

28. As argued in Alcidi et al. (2020), how quickly a country absorbs EU funds usually depends on its capacity to identify and implement projects in line with the national operational programme agreed with the Commission. Based on previous experience, absorption rates are very high – close to 95% of the allocated funds –, but delays are the rule rather than the exception. Most of the time, funds are fully absorbed only three years after the end of the programming period. A quick look at the Multiannual Financial Framework 2014-2020 shows that Southern and Central and Eastern Europe countries have the lowest absorption rates, in some cases using just one third of the total funds allocated.

Great Recession in 2008, looking at the institutional and ideational change that has occurred over the past decade. Our aim here is to better understand to what extent the European response to Covid-19 represents a step forward towards a more solidaristic approach.

2.1 The EU response to the financial crisis (2009-2014)

In the course of late 2009 and early 2010, when Greece became the focal point of financial markets' attention because of its very large budget deficit and high public debt, the EU institutions were not equipped to come up with a common and coordinated response to the deepening Great Recession. EMU economic governance was based on five key principles: a centralised monetary system, a no-bailout clause, sound public finance rules, no sovereign default and price stability. The ECB was prohibited from buying sovereign bonds in the primary market. No common automatic stabilisation mechanism was in place to cushion the effects of asymmetric shocks. It was assumed that fiscal rules would prevent fiscal shocks and that labour market flexibility would serve as shock absorber. A sovereign debt crisis was not contemplated in the monetary union construct (Gros 2019) and no banking supervision was foreseen at European level. Hence, the EMU had no rescue mechanisms for banks or states.

With the onset of the financial crisis, the weaknesses of the EMU structure and governance came to the fore. The EU response to the crisis was slow and hampered. The European institutions interpreted the crisis as a consequence of insufficient budgetary surveillance, lack of attention to macro-economic imbalances, mis-targeted surveillance of competitiveness, and insufficient alertness to the stability of the entire currency area and deficient enforcement, as the credibility of the sanctions in the Eurozone had already been undermined before (European Commission 2009). As such, the first measures adopted by the European institutions had the primary objective to detect and correct macroeconomic imbalances (notably, through the Six-pack, Two-pack and EuroPlus Pact[29]) and to better coordinate domestic economic and fiscal policies (through the European Semester). In 2012, the Single Supervisory Mechanism was established for supervising banks throughout the Eurozone. This was the first pillar of the Banking Union.

A few days after the Greek bailout, the European Financial Stability Facility (EFSF) was created as a temporary crisis resolution mechanism. In 2012, it was converted into a permanent mechanism, the European Stability Mechanism. Between 2010 and 2012, five Eurozone countries in financial distress requested emergency assistance. In all cases, with some degree of difference, the financial assistance was accompanied by strict conditions. In the case of Greece this was perceived as a punishment rather than a manifestation of EU solidarity. In addition to the toxic political aspect, one possible explanation for this is that the Greek bail-out programme was essentially agreed to

29. At the same time, in 2012, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, also known as Fiscal Compact, was signed as an intergovernmental treaty by all EU Member States, except the Czech Republic and the United Kingdom.

protect the monetary union against instability arising from one Member State, rather than helping that Member State in difficulty. From this perspective, the solidarity element was only a by-product, not the driver of the support.

In addition, before the crisis erupted, the ECB supported the mantra that 'lower deficits are good'. In the first years of the crisis, with Jean-Claude Trichet at the helm, the ECB raised interest rates twice, in 2008 and 2011, in a macroeconomic situation that was more deflationary than inflationary. Furthermore, the ECB promoted the necessity of structural adjustment and, based on the principle of internal devaluation, advocated labour market flexibility to increase the adjustment capacity of Eurozone Member States.

The ECB turnaround in the approach to protect the EMU integrity happened in 2012. President Mario Draghi's 'whatever it takes' vow to save the euro[30] and the subsequent announcement of the Outright Monetary Transactions (OMT) programme were followed by an immediate decline of sovereign bond spreads, restoring stability throughout the monetary union.

Overall, the Eurozone crisis uncovered the fundamental weaknesses of the Economic and Monetary Union design. The first reaction to the Greek sovereign debt crisis can be seen as a textbook application of the Optimum Currency Area (OCA) theory[31] recipe: in the absence of a central fiscal capacity, the response to an asymmetric fiscal shock requires internal devaluation and fiscal consolidation. More in general, the Stability and Growth Pact, and its revisions, limited the room of national governments for more expansionary fiscal policies. Even though significant efforts were made to set up new institutional mechanisms, from the new fiscal framework, via the Banking Union, to the safety net for sovereign debt (ESM), the EU reaction was slow, while the EMU architecture remained incomplete and largely reflected the ideational framework informing the design itself of the EMU.

2.2 The debate on the reform of the EMU (2015-2019)

On the eve of the 2014 European election, the sluggish economic recovery, mounting dissatisfaction with the European Union and the steady rise of Eurosceptic parties across Europe put the European project in political jeopardy. Many scholars started questioning the austerity recipe adopted to put countries on a sustainable growth path. Net public investment (which accounts for capital depreciation) collapsed after the crisis, especially in Southern Europe, with a consequent decay in the public capital stock. Italy is a case in point, with net investment there consistently negative since 2012 (it was around 0.5% of GDP in the previous decade). A similar path can be observed in Spain, Greece and Portugal. Consolidation measures resulted in larger than expected economic slumps in the Eurozone periphery, leading to a deep recession which worried

30. For the full speech, see Draghi, M. (2012) Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London, 26 July. https://bit.ly/3m6T2Kx
31. R.A. Mundell, 'A Theory of Optimum Currency Areas', American Economic Review, November 1961.

markets instead of reassuring them. In Greece, the first country to enter the economic adjustment programmes, the cost of such a long and deep recession had persistent financial, economic, social and political consequences.

Against this background, in 2015 the ECB launched its first asset purchase programme (APP), addressing the risks of a prolonged period of low inflation. The APP extended the ECB's existing programmes of private-sector asset purchases to include purchases of sovereign bonds. Since its launch it has significantly and persistently reduced sovereign yields on long-term bonds.

At the same time, from 2015 onwards, the Semester was marked by a progressive shift of the Commission's approach towards a more flexible interpretation and implementation of the EU fiscal rules that justified temporary deviations from the Medium-Term Budgetary Objectives (MTOs) or the path towards them.

In 2016 the Commission issued a Communication *Towards a Positive Fiscal Stance for the Eurozone*,[32] setting out the case for a more expansionary fiscal policy to support aggregate demand. Finally, in the 2018 Semester cycle, the Commission introduced a further element, the so-called 'margin of discretion' (EFB 2019: 17, 20), according to which the Commission can reduce a country's required fiscal adjustment when economic recovery is fragile.

The progressive erosion of the fiscal discipline paradigm was further driven by an equally important path-shifting macroeconomic reorientation. In February 2015, the Five Presidents' Report included the idea of automatic fiscal stabilisers at EU level, to be activated in the case of large macroeconomic shocks (European Commission 2015). Two years later in the Commission Reflection Paper on the Deepening of the Economic and Monetary Union (European Commission 2017), three options for a macroeconomic stabilisation function for the Eurozone were floated, including a European Unemployment Reinsurance Scheme. While this idea gained partial support in the European Parliament and later in the ECB, the process was far from being linear and has not yet been politically codified outside Brussels. Similarly, at the onset of the pandemic, the Banking Union was incomplete, notably lacking a common European Deposit Insurance Scheme (EDIS), while the EMU still has no common fiscal capacity.

To sum up, the EU entered the pandemic crisis in an institutional and ideational context substantially different from that of the financial crisis. On the institutional side, the EU was better prepared and disposed of manifold tools to – at least partially – face a crisis. On the ideation side, the austerity paradigm was eroding. Two months before the outbreak of the pandemic, the Commission issued a Communication[33] in which it listed the limits of current EMU economic governance, including the lack of a common fiscal capacity, the lack of fully-fledged counter-cyclical policies, little attention paid to public investments (low use of the flexibility clause), strong attention paid to annual fiscal adjustment and compliance assessment at the expense of long-term budgetary

32. COM(2016) 727 final.
33. COM(2020) 55 final.

planning. In addition, the Communication highlighted the insufficient differentiation between Member States' different fiscal positions and sustainability risks (the one-size-fits-all approach), the Macroeconomic Imbalance Procedure's (MIP) focus on current account deficits but not on current account surpluses, and the overall weak interaction between the EMU macroeconomic surveillance mechanism and emerging economic (e.g. climate change and environmental pressure) and social challenges.

3. Towards a more solidaristic EU?

The EU response to the financial crisis can be dubbed 'contain and prevent'. Most measures were aimed at containing at all costs the risk that idiosyncratic shocks arising in individual Member States would spill over to other countries, putting the whole monetary union construction at risk. Other measures were aimed at designing institutional reforms and tools that could prevent a similar-natured crisis. The preservation of the integrity of the monetary union was the overarching and underlying objective of most measures, not leaving much room for solidarity. On the contrary, it gave rise to many internal divisions, discord and social discontent. As public expenditure accounts for large parts of national budgets, fiscal consolidation unavoidably translated into lower public investment and welfare retrenchment.

While four (plus Spain) Eurozone countries were bailed out and received hundreds of billions of euros in financial assistance from the other Eurozone partners, no solidarity was seen. The conditionality attached to the assistance did not leave space for ownership of the changes adopted or for a proper dialogue with local institutions. Furthermore, the political discourse around the assistance was somewhat built on a judgemental and 'punitive' sentiment, distorting narratives, poisoning relations among Member States and undermining trust in EU institutions.

By contrast, since the onset of the Covid crisis, despite some political tensions and initial opposition from a group of Member States (the so-called Frugal Four), solidarity appeared a key underlying feature of the EU response. This may signal an important lesson learnt. But the difference goes beyond this. Annus horribilis 2020 ushered in the unthinkable. The European welfare state resurfaced as the newly praised hero to tackle the consequences of the pandemic. Covid-19 has strengthened the political salience of public health, social security, poverty relief, work-life balance, lifelong learning and macroeconomic stabilisation as collective goods. This was also reflected in the swift EU intervention to support Member States' fiscal efforts in preserving employment, strengthening their healthcare systems and cushioning the social consequences of the crisis.

How to make sense of this decisive watershed?

As argued at the beginning of this chapter, the pandemic nature of the crisis made the debate about a common EU response easier. Covid-19 constituted an immediate existential threat to health in nearly every country, spurring a collective assessment of values and aspirations. The lack of reckless creditors or reckless debtors allowed

EU policymakers to pursue an alternative policy agenda, without precedent in terms of speed, size and time horizon. Yet – as discussed by Hemerijck and Corti (2021) – the existential nature of the crisis alone cannot explain the EU response. While the experiential legacy of the Great Recession left EU institutions better equipped to face a second crisis (though of a different nature), the European Commission and the ECB in particular had learned from past errors.

All in all, the combination of existential crisis and experiential learning led EU policymakers, with the Commission and the ECB at the helm and with strong support from the European Parliament, to adopt a more solidaristic approach to respond to the Covid-19 crisis. Four main innovations can be identified.

The ECB was the first to innovate by lending at a rate below the deposit rate and to announce the new Pandemic Emergency Purchases Programme (PEPP), a flexible instrument compared to the usual ECB capital keys approach.

The second innovation was the resort to so-called 'social bonds' to finance projects and initiatives which aim to achieve greater social benefits. A case in point is SURE, a programme explicitly allowing EU borrowing to support public expenditure on short-time work schemes and similar measures to preserve employment.

The third innovation regarded the temporary suspension of the Stability and Growth Pact rules through the activation of the General Escape Clause, at a very early stage of the crisis. This allowed Member States to do 'whatever it takes' to tackle the impact of the pandemic.

Fourthly and more importantly, the EU Covid response broke a major taboo: the issuance of common EU debt. EU borrowing is being used to provide loans to support Member States' expenditure for short-time work schemes (under SURE) and will finance loans and grants under the long-term recovery strategy (RRF).

That said, while the EU response to the pandemic has certainly evidenced a shift from ex-post to ex-ante solidarity (Gros et al. 2021), this has not (yet) been accompanied by progressive steps to strengthen the institutional framework of the Eurozone. This remains formally unchanged. While the Eurozone still lacks its own fiscal capacity, the crisis set a precedent in terms of common fiscal effort in times of exceptional needs. Put differently, while Eurozone governance has not changed, its politics – at least in Brussels and Frankfurt – have been transformed. For this transformation to be completed, political codification outside Brussels and Frankfurt is needed. However, this requires political consensus to be gained in national capitals. In this respect, strategic consensus between Brussels and Frankfurt cannot seal a paradigm change for the EU as a whole. Member State governments have to come round half-way.

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Annex

Table A1 **NGEU and MFF 2021-2027 allocation per Member State**

	NextGenerationEU					MFF 2021–2027					
	RRF (€bn)	React-EU (€bn)	EARDF (€bn)	JTF (€bn)	NGEU grant % GDP annua-lised	ESF Plus (€bn)	ERDF (€bn)	CF (€bn)	JTF (€bn)	JTF (€bn)	Δin%
Belgium	5.6	0.2	0.0	0.1	0.2%	1.0	1.0		0.1	0.5	0.1%
Bulgaria	5.8	0.7	0.2	0.7	2.0%	2.3	5.1	1.5	0.5	1.8	2.6%
Czechia	6.5	1.2	0.2	0.9	0.7%	2.4	9.3	7.4	0.6	1.7	1.4%
Denmark	1.4	0.2	0.1	0.0	0.1%	0.1	0.1		0.0	0.5	0.0%
Germany	23.6	1.8	0.7	1.3	0.1%	5.8	9.7		1.0	7.0	0.1%
Estonia	0.9	0.2	0.1	0.2	0.8%	0.4	1.5	1.0	0.1	0.6	1.9%
Ireland	0.9	0.1	0.2	0.0	0.1%	0.5	0.4		0.0	2.0	0.1%
Greece	16.5	2.1	0.3	0.4	1.9%	5.2	10.2	3.5	0.3	3.6	2.0%
Spain	64.2	12.7	0.7	0.5	1.2%	9.9	20.9		0.3	6.9	0.5%
France	36.3	2.9	0.8	0.5	0.3%	5.9	8.0		0.4	9.4	0.1%
Croatia	5.8	0.7	0.2	0.1	2.3%	1.8	4.7	1.4	0.1	1.9	2.9%
Italy	63.7	14.4	0.8	0.5	0.8%	12.9	23.6		0.4	8.7	0.4%
Cyprus	0.9	0.1	0.0	0.1	0.9%	0.2	0.4	0.2	0.0	0.2	0.7%
Latvia	1.8	0.3	0.1	0.1	1.3%	0.6	2.2	1.2	0.1	0.8	2.4%
Lithuania	2.1	0.3	0.1	0.1	0.9%	1.0	3.1	1.6	0.1	1.3	2.1%
Luxem-bourg	0.1	0.1	0.0	0.0	0.1%	0.0	0.0		0.0	0.1	0.0%
Hungary	6.6	1.1	0.3	0.1	1.0%	4.9	11.8	3.0	0.1	2.7	2.4%
Malta	0.3	0.1	0.0	0.0	0.6%	0.1	0.4	0.2	0.0	0.1	1.0%
Nether-lands	5.6	0.4	0.0	0.3	0.1%	0.4	0.4		0.2	0.5	0.0%
Austria	3.2	0.2	0.3	0.1	0.2%	0.3	0.5		0.1	3.3	0.2%
Poland	22.2	2.1	0.9	2.0	0.9%	13.2	42.0	10.8	1.5	8.5	2.1%
Portugal	12.9	2.2	0.3	0.1	1.3%	6.7	10.2	3.9	0.1	3.5	1.7%
Romania	13.2	1.8	0.6	1.1	1.3%	7.3	15.1	4.1	0.8	6.2	2.2%
Slovania	1.6	0.3	0.1	0.1	0.8%	0.6	1.4	0.8	0.1	0.7	1.1%
Slovakia	5.9	0.8	0.2	0.2	1.3%	2.1	7.2	1.9	0.2	1.7	2.0%
Finland	1.9	0.1	0.2	0.2	0.2%	0.5	0.8		0.2	2.3	0.2%
Sweden	3.1	0.3	0.1	0.1	0.1%	0.6	0.8		0.1	1.4	0.1%
Total	312.5	47.5	7.5	10.0		86.8	190.7	42.4	7.5	77.6	

Note: NGEU includes also €5 billion for Horizon Europe, €1.9 billion for RescEU and €5.6 billion for InvestEU.