Linking EU fiscal rules to climate targets

A proposal for a climate-linked extension of budgetary adjustment paths

institute for future-fit economies

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Summary

In order to incentivise the necessary green investments within the reformed EU economic governance framework, EU Member States could be granted more fiscal leeway through the lengthening of the budgetary adjustment path – subject to the achievement of climate goals. Under such a system, to obtain the 3-year extension of the adjustment period in the fiscal-structural plans, Member States would have to commit to achieve climate targets, as opposed to committing to specific investments. The achievement of the climate targets would be monitored ex-post. In case of non-compliance, a debt-based excessive deficit procedure (EDP) would be opened.

This approach offers several advantages, namely:

- No ex-ante definition of green investments is needed; governments do not have to submit comprehensive and binding investment plans – instead they need to agree to targets, e.g., greenhouse gas emission reduction paths.
- Governments are relieved from bureaucratic burden and have the flexibility to choose the most efficient investments, even if circumstances change (e.g.f if new technologies become available).
- The focus on results, as opposed to inputs and outputs, is designed to increase the effectiveness of green public investments in achieving climate targets.
- We focus here on climate targets, but the same approach can be used to achieve measurable and quantifiable social targets or biodiversity targets.

The fiscal leeway available to Member States is limited, and it is in the interests of everyone that public funds are used in a targeted and efficient manner. At the same time, increased fiscal leeway can be an important tool to help Member States invest in climate action. To fully exploit the fiscal leeway that Member States have at hand, national public finances could be restructured using a socio-ecological framework to reallocate public funds for sustainable and inclusive purposes. In addition, a revised climate-fit debt sustainability analysis could give governments room to undertake green investments. Prospectively, a targeted EU fund could be a useful complement beyond the reformed EU Economic Governance Framework if the disbursement of funds is made conditional on the subsequent achievement of climate targets.

1. Introduction

To minimise the devastating effects of global warming, we need a green turnaround. The European Commission (2021a) has calculated that **annual investments will have to increase by around €520 billion per year until 2030** to achieve the goals of the European Green Deal. For a scenario compatible with the 1.5°C of the Paris Agreement, the investment gap is projected to be significantly higher at €855 billion per year (Wildauer et al., 2020). Additional public funding is needed to unlock this level of investment and mobilise spin-off private capital. Moreover, accelerating the speed of investment now is cost-effective (European Commission, 2018), because of the long-term economic benefits of kick-starting the green transformation at once.

Yet, there is a **risk that EU Member States are not investing enough in decarbonising European economies and societies**. The current EU fiscal framework does not provide enough flexibility for Member states to adequately prepare for the green transition by increasing debt-financed green public investments (Pekanov & Schratzenstaller, 2023). Different estimations conclude that, even under the reformed rules, only 3–4 Member States will have sufficient fiscal leeway to meet their public green investment needs (Mang & Caddick, forthcoming; Van den Noord, 2023). Hence, the present reform of the EU fiscal rules provides an opportunity for improving the EU economic governance framework in a way that it secures important investments to tackle long-term challenges. However, the reform ideas do not account for climate-related investments separately (European Commission, 2022a), which puts into question, **whether Member States will have enough incentives and leeway to undertake these investments**.

It is a much-debated issue how the EU fiscal framework can be redesigned to create sufficient leeway and incentives for Member States to address long-term challenges while ensuring debt sustainability (e.g., Bénassy-Quéré, 2022, Darvas & Wolff, 2022). Existing proposals to promote green investments through exemption clauses or the allowance of targeted debt-financed investment currently do not have majority support - not least because there is no suited regulatory framework for defining green expenditures. The inclusion of an exemption clause for green investments in the Stability and Growth Pact (SGP), according to which these are only eligible after a thorough assessment, not only creates additional administrative burden, but could lead to a significant delay in implementation due to time-consuming assessment procedures (Pekanov & Schratzenstaller, 2023). Likewise, allowing deficit- or debt-financed green investments through a "green golden rule" fails to create incentives for governments to spend their money on green investments in the most efficient and effective way. In other words, existing proposals have so far mostly focused on the means rather than the results. As such, they do not necessarily lead to the desired outcomes.

The European Commission has proposed to replace the preventive arm of the Stability and Growth Pact with country-specific budgetary adjustment paths in medium-term fiscal-structural plans, and thus focus on controlling expenditure. EU leaders have agreed that the adjustment path can be extended to give Member States more time to reduce public debt if

they make reforms and investment aligned with EU's strategic priorities (ECOFIN, 2023). However, clear criteria are missing for defining eligible public investment for an extension of the budgetary adjustment path. **Overall, this opens up room for introducing a sustainability-link to the extended adjustment period.**

This paper addresses this gap and proposes to make the granting of the extension of the budgetary adjustment path conditional on the achievement of climate-specific targets. To this end, Member States should be given an extension if they commit to achieving the emissions reduction targets set out in the National Energy and Climate Plans (NECPs) which are currently being revised. Evaluation processes in the context of annual fiscal surveillance should verify the achievement of the targets. This proposal follows the logic of Sustainability-linked Fiscal Leeway (SLFL) (Hafele et al., 2023) and borrows from the prominent tactics of sustainability-linked bonds on financial markets[1].

Given the requirement for Member States to stay below the 3% deficit threshold and the need to bring debt-levels on a downward facing trend, the Commission's fiscal trajectory may not be sufficient to fully achieve climate targets. In order to fully exploit the fiscal leeway for achieving climate targets, we propose that Member States use a **socio-ecological framework** in bilateral negotiations with the Commission to help restructure national budgets so that, for example, fossil fuel subsidies can be withdrawn and used for green purposes. Likewise, a revised **climate-fit method to assess the sustainability of public debt** in the long-term should consider climate risks and thus increase fiscal leeway for green investments.

In doing so, this proposal bridges two political fronts: It addresses **the need for effective green investment[2] while ensuring budgetary control, debt sustainability, and minimal bureaucracy.** The targets are coherent with NECPs which ensures policy coherence but also circumvents the need to predefine eligible green investments upfront. Focusing on the achievement of climate-specific targets ensures effective outcomes, while giving Member States flexibility to opt for adequate and effective measures within a long-term framework. In addition, the additional bureaucratic burden is kept to a minimum. Member States operate within the fiscal trajectory that is set in accordance with the Commission, which ensures that public finances are kept to a sustainable level.

The remainder of this paper is structured as follows. Next, the current context of the reform debates is described, followed by the presentation of our proposal to apply the SLFL to the extension of the budgetary adjustment path. The paper concludes with a discussion how the proposal benefits current reform debates and an outlook of the future requirements to

[1] Sustainability-linked bonds are borrowing instruments where the premium paid by the issuer depends on whether they meet green performance indicators within a given timeframe (ICMA, 2020). There is a growing market for corporate sustainability-linked bonds, while Chile and Uruguay issued the first sovereign sustainability-linked bonds in 2022 (Lehmann & Martins, 2023).

[2] Throughout this paper, the term "investment" includes spending that might be needed to complement investment, e.g., investments in wind turbines might require to train workers to acquire the skills needed to install these.

enable Member States to adequately prepare for and react to challenges of the green transition.

2. The context of the EU economic governance reform

In the orientations for the reform of the European fiscal framework, the Commission plans to partly replace the set of existing fiscal rules (European Commission, 2022a). The general direction of this reform has been endorsed by the Council, while the details are still up to debate (ECOFIN, 2023). The underlying reform logic is to define an overarching objective: debt sustainability over the medium- and long-term, which serves as an anchor for fiscal policymaking. The proposed rules require Member States with a moderate or substantial public debt challenge to reach a "plausibly and continuously declining" debt level after an initial adjustment period of at least 4 years. Importantly, the pace of the debt reduction after the adjustment period is no longer specified with a numerical benchmark. The 1/20th rule, which set a mostly unrealistic pace in the old framework, no longer applies.

In order to assess the magnitude of the debt challenge and prescribe a trajectory of how to obtain a declining debt level over the medium term, the Commission proposes that its in-house Debt Sustainability Analysis (DSA) will play a larger role. At first, the DSA splits Member States into three broad categories - those with a low, medium, and high risk to debt sustainability. All Member States are required to submit medium-term fiscal-structural plans, which replace the existing Stability and Convergence Programmes (SCPs) in the European Semester process. For Member States in the medium- or high-risk bracket, the Commission will draft country-specific expenditure pathways based on the DSA. These expenditure ceilings should serve as the basis for the medium-term fiscal-structural plan but are open to bilateral negotiations between the Member State and the Commission.

According to the Commission proposal, the speed of debt reduction can vary and depends on certain circumstances. First, Member States with only a medium debt sustainability risk receive a 7-year adjustment period whereas Member states with high debt sustainability risks receive a 4-year adjustment period. Second, both medium and high-risk Member States can obtain an (additional) extension of 3 years when they commit to a set of eligible reforms and investments. According to the Council Conclusions, any reform or investment shall be eligible, if it enhances "growth-prospects or resilience, strengthens public finances and thereby their long-term sustainability, and addresses EU strategic priorities, including public investment challenges for the green and digital transition and the build-up of defence capabilities" (ECOFIN, 2023, p. 4). The Commission would then calculate a second prolonged expenditure path, accounting for such reforms, to present the "carrots" they would receive if they adhere to EU strategic goals. On the basis of this reference path, Member States negotiate in bilateral dialogues with the Commission on the final fiscal leeway they receive when committing to eligible reforms and investments.

However, the criteria for eligible reforms and investments are still vague. Investments that improve growth prospects and thus have a positive impact on debt sustainability are considered eligible for extension. However, investments that improve the resilience of

Member States equally have a positive and long-term impact on debt sustainability (Suttor-Sorel & Fiscal Matters, 2023) and are thus an important addition to the criteria. Either way, criteria are missing to ensure that environmentally-harmful activities will not be eligible and that green investments will instead be promoted. Since not every investment in the green transition has a growth case but may nevertheless contribute to environmental and debt sustainability, other incentives for green investments are required. Hence, clear criteria ensuring that green investments are eligible for extension as well as a mechanism enforcing these investments should be part of the economic governance framework.

3. Climate-linked extension of budgetary adjustment paths

To integrate such clear criteria for effective green investments into the economic governance framework, this paper applies the logic of SLFL (Hafele et al., 2023) to the granting of an extension of the budgetary adjustment paths. This approach aims to create incentives for effective and efficient climate investments by focusing on the achievement of climate targets instead of specific climate investments. While the underlying mechanism described in Hafele et al. (2023) refers to environmental targets in a broader sense, our proposal is centred around climate targets, due to better data availability and the existence of EU targets and processes around the reduction of climate emissions. Member states define their emission reduction targets in the NECPs, which the following proposal refers to[3].

Box 1: **The ongoing review of the National Energy and Climate Plans (NECPs)**

The Commission introduced the National Energy and Climate Plans (NECPs) in 2018. Each Member State was required to submit a plan outlining how it wants to address the targets of the energy union for the period 2021-2030. The plans touched on five dimensions: decarbonisation, energy efficiency, energy sufficiency, the internal energy market, and innovation. The Commission reviewed each NECP and made country-specific recommendations that Member States had to then incorporate into their plans.

In view of the significantly changed (geo-)political circumstances in the energy and climate sector, the plans are now due for revision. Member states must now submit their updated national plans by June 2023. They are expected to identify more ambitious climate action and demonstrate how to accelerate the transition to clean energy and energy security. The revision of the NECPs also requires the submission of a detailed financing plan to cover the investment needs for each of the five dimensions (CO2 emissions reduction, energy efficiency, security of energy supply, internal energy market and research, innovation and competitiveness) through the cost-effective use of public budgetary resources and the mobilisation of private investment.

[3] For a survey of different key performance indicators in the context of sovereign sustainability-linked bonds see Flugge et at. (2021). Next to climate indicators, indicators pertaining to natural capital, biodiversity or planetary boundaries could be used as well. In the EU context, however, the target setting is most developed in the climate and energy dimension through the NECPs.

The final plans are due in June 2024. It is likely that this period will coincide with the submission of the first fiscal-structural plans under the revised EU fiscal rules.

4. Applying SLFL to the extension of budgetary adjustment paths

In the context of the Commission's proposal, the SLFL approach would consist of an ex-ante granting of fiscal leeway by the European Commission and an ex-post evaluation mechanism which involves an independent supervisory body.

4.1 Ex-ante: Determining fiscal leeway for achieving climate goals

The proposal closely follows what the Commission is already contemplating. First, the Commission defines technical fiscal trajectories as explained in section 2. By committing to achieving the emissions reduction targets set out in the NECPs, Member States could then receive an extension of the adjustment period by 3 years. The Commission and the Member State would then bilaterally negotiate the exact amount of fiscal leeway granted under the multiannual expenditure ceilings.

The decision about how much fiscal leeway to grant for achieving the climate targets could be based on evidence about investment needs, or on the investment amounts specified in the NECPs[4]. To ensure that the negotiated expenditure ceilings give Member States sufficient leeway for climate investments, there are two essential requirements:

- **A socio-ecological framework to encourage reforming public finances**

  First, in bilateral negotiations, the Commission should encourage Member States to evaluate and implement other levers for increasing fiscal leeway. For example, withdrawing fossil fuel subsidies could free up funds for other sustainable and inclusive purposes. Similarly, socio-ecological tax reforms or measures against corruption can have analogous effects. A robust quality framework could help to determine, which reforms can restructure public finances in a way that is sustainable and promotes social, environmental, and resilience goals. For this, Member States could use the Do No Significant Harm (DNSH) principle and the European Pillar of Social Rights as guidance. Existing tools such as the Recovery Index for Transformative Change (RITC) could provide a holistic view when assessing policies that systematically promote a just transition and the protection of the natural environment (see Miller et al., 2021).

[4] In the latter case, the projected fiscal leeway would equal the amount of money needed for the investments listed in the NECPs. However, to maintain flexibility, Member States would not commit to these specific investments but only to the emissions targets.

- **Climate-fit Debt Sustainability Analysis (DSA)**

  Second, improvements that could be made with regards to the Commission's proposed DSA could increase fiscal leeway. The DSA methodology has been criticised for its bias against public investment (Heimberger, 2023). For instance, it focuses only on public liabilities and therefore disregards public asset creation. Moreover, its estimates of the fiscal multiplier (0.75) are fairly conservative and might be higher in the case of investments in the green transition. Tweaking these minor points could already free up more room for public investment.

  However, the arguably bigger lever for creating fiscal leeway that merits further discussion is that climate-related risks are widely absent from the concept of debt sustainability. Yet, climate change poses an acute threat to debt sustainability (Avgousti et al., 2023). Its consequences entail a variety of transition and physical risks that will put a strain on public budgets. The further the action is delayed, the more costly it could become. Moreover, long-term real interest rates are predicted to rise as a result of climate change (Bylund & Jonsson, 2020). The effect on borrowing costs can already be observed today. Since the Paris Agreement, many governments that are lagging behind on the green transition face higher yields on their long-term bonds than countries that pursue effective climate policies (Bingler, 2022).

  This suggests that public green investments and public debt sustainability are a false dichotomy. Investments into the green transition, especially renewable energies, may in fact enhance debt sustainability by averting climate risks and thus also lowering borrowing costs (Collender et al., 2022). Hence, the Commission should, for the sake of debt sustainability, strengthen the incentives for governments to make green investments. If a Member State commits to the NECPs' climate targets, the Commission could calculate a second expenditure pathway, as it does already in the case of the investment-induced extension, but under the assumption that climate investments will be undertaken that contribute to the achievement of climate targets. Likewise, it should also be recognised that resilience-building reforms and investments reduce fiscal risks and thus contribute to improving long-term debt sustainability (Suttor-Sorel & Fiscal Matters, 2023).

If the two presented levers for increasing fiscal leeway create agreement between the Member State and the Commission about the fiscal leeway in the adjustment period, the Commission would grant the Member State this exact fiscal leeway.

4.2. Ex-post: Review procedure and potential sanctions

An independent supervisory body should control the achievement of the targets that Member States have committed to. This reduces the discretion of the Commission, insulates the monitoring process from political capture and, in the case of national institutions, may increase Member States' ownership in the surveillance of the rules. For instance, independent fiscal institutions (IFIs), either on the EU level or on a national level, could

assess whether Member States have achieved the emissions reduction targets that they have committed to. Taking into account that the IFIs' capacities (e.g., staff capacities) strongly differ among Member States, this approach might require increasing the IFIs' capacities in some Member States.

Step 1: The independent supervisory body and the Commission could issue recommendations with early warnings if they see strong risks that climate targets will be missed.

Step 2: After the end of the extension period[5], the independent supervisory body monitors the target achievement as part of the yearly surveillance circle. If climate targets have been met, the review procedure ends. If climate targets have been missed, step 3 applies.

Step 3: The supervisory body should examine whether to trigger an escape clause if objective factors beyond the control of the government have caused the failure to meet the targets. An exceptional circumstances clause, as suggested in the Commission's orientation paper, would allow for temporary deviations from the climate-targets in case of exceptional circumstances outside the control of a given government. This can be triggered by individual countries and requires the consent of the Council. Similarly, the general escape clause can be activated with the consent of the Council when the euro area or the Union as a whole faces a severe economic downturn. If the failure to meet the climate targets is not covered by an escape clause, step 4 applies.

Step 4: The tools of the debt-based EDP could be used[6]. In case of non-compliance, the Council would adopt recommendations detailing the path how to achieve the targets within a given deadline. If the Member State does not take effective action, revised recommendations are formulated and a sanction procedure is triggered. Following the current EDP, sanctions could take the form of a 0.2% GDP fine that can be increased to up to 0.5%.

[5] To control regularly whether Member States actually use the granted fiscal leeway to achieve climate targets, the examination of the country's progress towards the targets could occur more regularly. However, since it might take some time for the implemented policies and investments to result in emissions reduction, the time intervals for this examination should not be too short.

[6] Additionally, non-compliance could imply that the Member State cannot request another 3-year extension period in the near future.

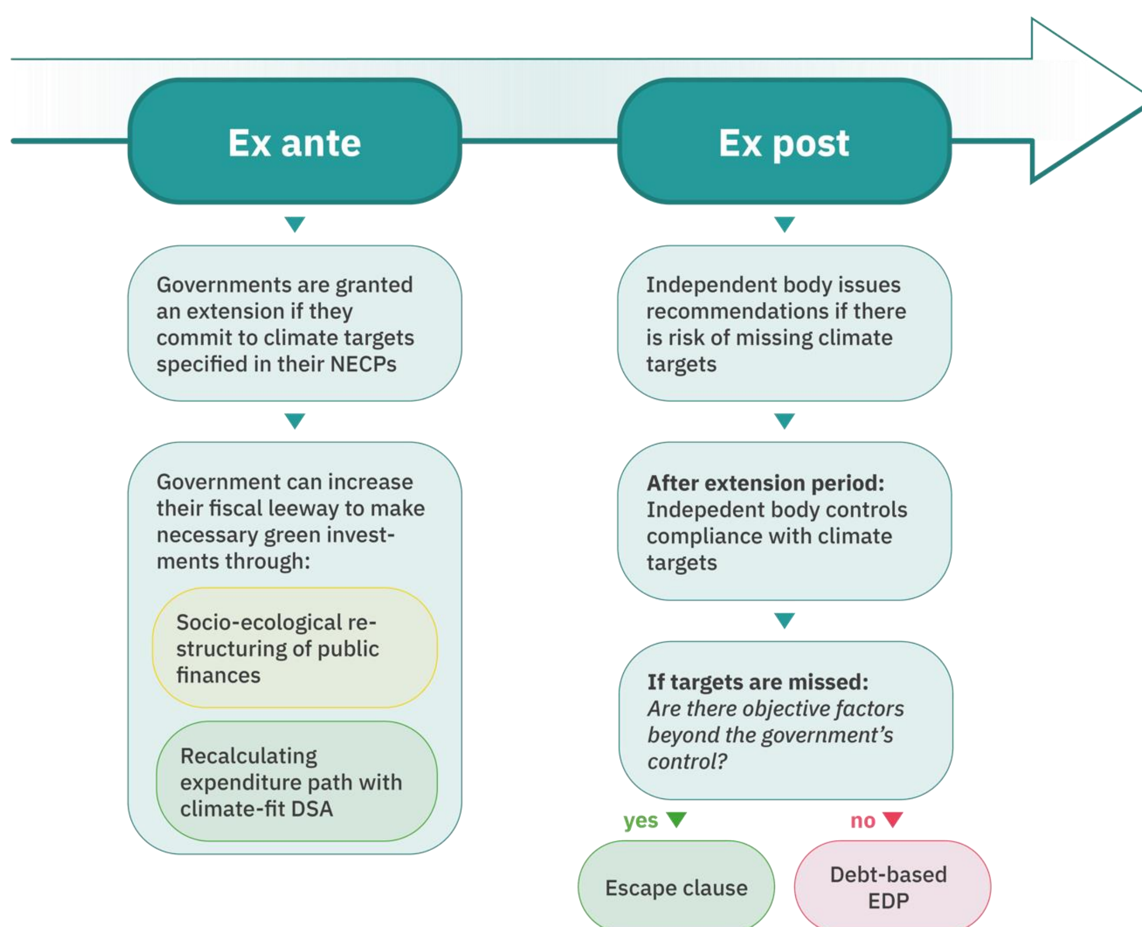

Figure 1: Overview of the proposed mechanism.

5. Discussion

Designing fiscal rules that aim to incentivise green investments comes with many challenges. We identified five key challenges in Hafele et al. (2023), which are summarised in Figure 1[7]. Making the extension of the adjustment period dependent on ex-post compliance with climate targets tackles all of these key challenges. First, the Commission proposal does not need to precisely define which investments are eligible. Instead, the eligibility is granted ex-post if investments lead to the achievement of climate targets. Second, the ex-post monitoring ensures the effectiveness of climate public investment. Third, it reduces the burden of bureaucracy in evaluating the medium-term fiscal structural plans, as no ex-ante assessment about the eligibility of climate investments is needed. Fourth, the ex-post review mechanism disciplines governments to spend their money on the green transition most efficiently and leaves them the flexibility to adapt to new, more efficient solutions. Lastly, the government debt incurred for financing the green transition is likely to be lower and more

[7] Since Hafele et al. (2023) refer to sustainability in a broader sense instead of focusing on climate targets and investments, figure 1 refers to green targets and investments in a broader sense as well.

sustainable, as the mitigation of climate risks reduces future strain on governments' budgets and is likely to stabilise borrowing costs.

	Definition	Effectiveness	Bureaucracy	Efficiency	Debt Sustainability
Challenges	• No suitable basis for an ex-ante classification of green investments	• There is a risk that green investments are not effective (e.g. emissions are not reduced because of rebound effects)	• Drafting, reviewing, and assessing investment plans requires large bureaucratic effort	• Incentives to use green investment most efficiently needed • Investment plans leave little flexibility to adapt to changes (e.g. technology)	• Both the costs of action and the costs of inaction with respect to the green transiton put pressure on public budgets
Sustainability-linked Fiscal Leeway	• Achievement of targets is controlled ex-post → Ex-ante definition of green investments not needed	• Additional fiscal space depends on the effectiveness of green investments in that they attain targets	• No investment plans needed	• Review mechanism disciplines governments to use funds efficiently • Long-term framework leaving room for adaption	• Effective and efficient green investments mitigate climate change and limit the increase in public expenditure

Figure 2: Presentation of the challenges for green public investments and how SLFL addresses them.

Possible extension of the approach to social and biodiversity objectives

In this paper, we focus on how the SLFL approach can be used to protect reforms and investments to achieve climate goals as part of the reform of EU fiscal rules. However, focusing solely on climate targets leaves important social issues directly related to them (Lorek et al., 2021), as well as biodiversity protection issues unaddressed. Further conceptual work is needed to integrate these goals, because in principle the SLFL approach can also be applied to quantifiable and measurable social, and biodiversity conservation and restoration goals. In the SLFL proposal this paper builds on, Hafele et al. (2023) describe the general principles for the selection of targets, that should be observed in a short time period, measurable and quantifiable with existing data, externally verifiable and coherent with national targets.

For example, regarding the social dimension, the headline targets of the European Pillar of Social Rights could be used (European Commission, 2021b). Similarly, a multitude of indicators exist as part of its related Social Scoreboard, which could be further operationalised into binding targets. Likewise, to protect biodiversity, the SFLF approach could be enhanced by the binding targets suggested by the Nature Restoration Law (European Commission, 2022b), as soon as they are adopted by the European Parliament and the Council.

To ensure that none of the promoted reforms and investments come at the expense of environmental objectives, the Do No Significant Harm (DNSH) principle could be applied to

the SLFL approach, similarly to its application in context of the National Recovery and Resilience Plans (NRRPs). This principle prescribes that the projects do not undermine any environmental goals, including a variety of dimensions other than climate, such as biodiversity and the use of water, air, and soil. A similar DNSH principle could be envisioned with respect to social dimensions.

A SLFL-central fiscal capacity can have a complementary effect on several layers

Our suggestion of restructuring national finances with the help of a socio-ecological framework and recalculating the expenditure ceilings on the basis of a climate-fit DSA should free up more fiscal leeway for green investments. However, if the Commission and Member States fail to create sufficient additional leeway through reforms and a revised climate-fit DSA, Member States might not have enough leeway at hand for expenditures needed to meet their climate targets. This risk concerns in particular highly-indebted countries, where the DSA prescribes very tight expenditure ceilings – even if amended with climate risks. Under the current proposal of the Commission, only few Northern and Western EU Member States would be granted sufficient leeway to reach their green investment needs. In fact, there is a positive correlation between the approval rate of green investments and GDP per capita, meaning that the DSA favours richer countries (Van den Noord, 2023). A climate-fit DSA would increase the fiscal leeway for green investments but is unlikely to remove this bias towards the wealthier core.

Not only for the attainment of climate targets but also for the sake of regional cohesion, the EU will need to provide additional funding to the peripheral countries that score worse on the DSA. This could be achieved via a central fiscal capacity, modelled after the Recovery and Resilience Fund (RRF). Many have suggested complimenting the EU fiscal rules with a central capacity (Allemand et al., 2023; ECCO, 2023; Heimberger & Lichtenberger, 2023), including authors affiliated with the IMF (Arnold et al., 2022) and with the ECB (Abraham et al., 2023). To minimise borrowing costs and ensure debt sustainability in the union, such a fund may require mutualised debt instruments, as was the case with NextGenEU.

We propose to model such a fund on the idea of SLFL. In contrast to the RRF, Member States would not have to submit investment plans but would commit to climate targets. The ex-post monitoring of climate targets and potential sanctions[8] would discipline Member States to deploy the EU funds appropriately. This would reduce bureaucracy, circumvent the challenge of defining eligible investments, and give Member States flexibility to implement the most efficient and effective investments.

6. Conclusion

The fiscal leeway available for additional climate investments through the extension of the budgetary adjustment path is limited, which is precisely why it is important that this leeway is maximised for most effective and efficient use. This paper details a proposal wherein the

[8] This could, for instance, include disbursing a lower amount of funds in following years.

achievement of climate targets is the decisive factor for granting Member States an extended budgetary adjustment path. This is in contrast to advance decisions on individual investment items as part of their fiscal-structural plans. This proposal for sustainability-linked extension of budgetary adjustment paths, overcomes, firstly, the definitional challenge; it does not require an explicit up-front definition of green investments. Secondly, it ensures the effectiveness of public investments in climate protection, as the focus of the evaluation is on the meeting of climate targets. Thirdly, it relieves governments of the bureaucratic burden because it does not require them to submit concrete investment plans, thereby enabling them to retain flexibility to choose the measures they consider most appropriate. Fourthly, the ex-post disciplining mechanism encourages governments to spend their green transition money as efficiently as possible, leaving them the flexibility to adapt to new, more efficient technical solutions. While this paper focusses on climate targets, the same approach can be used to link additional fiscal leeway to the achievement of social targets and broader environmental targets.

In order to increase the fiscal leeway for green expenditures, this paper also calls for a robust socio-ecological framework to help restructure national finances in bilateral negotiations between Member States and the Commission. Such a holistic framework for the consideration of national budgets would help to identify how budget items could be restructured so that current subsidies for fossil infrastructures, for example, are redirected towards sustainable and inclusive solutions. In addition, the paper argues that revising the debt sustainability analysis to take climate risks into account contributes to increasing fiscal leeway. A climate-fit DSA could create room for climate investments which have a positive long-term impact on debt sustainability.

Finally, a central fiscal capacity would be a useful complement to ensure that Member States have sufficient funds available for green transformation. Tying such an instrument to Sustainability-linked Fiscal Leeway principles ensures that such funds are used efficiently, effectively, and with minimal bureaucracy. As such, this paper has shown that linking additional fiscal leeway to the achievement of climate targets has the potential to ensure efficient and effective use of public funding beyond the context of EU economic governance reform.

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