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The new EU fiscal framework: Implications for public spending on the green and digital transition

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The new EU fiscal framework: Implications for public spending on the green and digital transition

Philipp Heimberger



The new EU fiscal framework:

**Implications for public spending on the green
and digital transition**

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Abstract

This paper provides a critical assessment of the new EU fiscal framework, with a focus on its implications for public expenditure on the twin green and digital transition. According to the reformed rules, member states may commit to a package of investment and reform to extend the fiscal adjustment path from four years to a maximum of seven years, provided the European Commission agrees that the package meets predefined criteria, including the contribution to EU priorities (in particular, the European Green Deal and the EU digital strategy). However, the reformed framework does not provide any broad-based exemption for public investment in the twin transition, although the necessary large expansion in public assets is rather unlikely, given the requirement to reduce public liabilities relative to output over the medium term. This implies that, if member countries want to increase green and digital public spending, they will have to make room for it either by restraining other spending items (e.g. social protection, health or education) or by increasing taxes. A major fiscal consolidation will be required in a number of (big) euro area countries from 2025 onwards to comply with the reformed EU fiscal rules. However, the temporary exemption for additional defence spending will make the overall fiscal stance in EU countries more expansionary than it would otherwise have been. There is now a political focus in the EU on industrialisation through rearmament. The pressure to go for additional deficit-financed defence spending will, however, eventually raise the share of government interest payments in total tax revenue, and the political aversion to higher fiscal deficits must be expected to exert downward pressure on public spending on the green and digital transition. Against that background, this paper discusses three options for how to boost the fiscal space for the required additional public spending on the twin transition: implementing changes to key assumptions in the technical substructure of the new fiscal framework when it comes to assessing country-specific debt sustainability; expanding national co-financing of EU programmes; and introducing an EU investment fund for climate and digitalisation.

Keywords: Green transition, digital transition, EU fiscal rules, public investment, fiscal policy, austerity

JEL classification: H41, H54, H60

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1. INTRODUCTION

New EU fiscal rules came into force on 30 April 2024 (EU Regulation 2024). This represents the most comprehensive reform of the fiscal framework since policy makers tightened the rules in the aftermath of the financial crisis (e.g. Claeys et al., 2016; Heimberger et al., 2020). Although the targets of a fiscal deficit of 3% of GDP and a 60% public debt ratio have remained unaltered, there are important changes to the old framework. The new framework establishes key technical elements for the negotiation of multi-year fiscal consolidation plans between individual national EU governments and the European Commission, where fiscal adjustment is supposed to ensure that the public-debt-to-GDP ratio is on a plausibly downward trajectory (e.g. Darvas et al., 2024; Heimberger et al. 2024).

This paper introduces the key elements of the new EU fiscal rules (section 2) and discusses them critically, with a focus on the question of how much scope the framework provides for member countries to address the challenges of the green and digital transition (section 3). The existing literature shows that there is a need for additional public investment to meet the climate goals (Heimberger and Lichtenberger, 2024), as current policy actions are inadequate to set the EU on a trajectory compatible with limiting global warming to 2 °C (Batut et al., 2024). While there are incentives for national governments to include an investment and reform package in the context of a multi-year fiscal adjustment path, and while the European Commission has stated that it is ready to activate national escape clauses to exempt additional defence spending, the reformed framework falls well short of providing adequate fiscal space, since governments would typically have to achieve an expansion of public expenditure on the green and digital transition either by reining in other spending items or by raising taxes. Meeting the new EU fiscal rules will require major euro area member countries to move from their currently sizeable primary deficits to substantial primary surpluses in the medium term. While the temporary exemption for defence spending will make the overall fiscal stance more expansionary over the next years than it would otherwise have been, the higher interest payments to service the debt incurred on defence spending and the aversion to higher fiscal deficits will exert downward pressure on public spending on the twin transition (section 4). Section 5 discusses three main options to provide additional fiscal space to expand public expenditure on the twin transition: changes to certain key assumptions in the technical substructure of the new framework; expanded national co-financing of EU programmes; and the introduction of an EU investment fund.

2. KEY ELEMENTS OF THE NEW EU FISCAL RULES

The new EU fiscal rules are supposed to bring the fiscal deficits of EU countries to below 3% of GDP and their public-debt-to-GDP ratios to below 60% of GDP. This implies that the major deficit and debt targets have not changed from the previous framework. However, the old framework's annual budgetary targets, based on meeting a 'structural' (cyclically adjusted) deficit limit, are no longer relevant. Furthermore, the previous debt reduction rule, according to which the public debt ratio had to fall to 60% of GDP within 20 years, has been scrapped. The new framework shifts the focus from the annual development of public finances to a medium-term view. There is an enhanced role for bilateral technical discussions and negotiations between each national government and the European Commission on country-specific multi-annual fiscal consolidation paths.

One major change is that the new rules replace multiple operational targets from the old framework with a single indicator: net expenditure growth. Net expenditure is defined as total government spending net of discretionary revenue measures (e.g. tax hikes would provide more room for a growth in expenditure), interest payments, expenditure on EU programmes that fully matches EU funds, national expenditure on co-financing of EU programmes, cyclical elements of unemployment spending, and one-offs and other temporary measures.

Under the new framework, when public debt exceeds the 60% reference value, or when the fiscal deficit rises above the 3% reference value, the European Commission will put forward a so-called *reference trajectory*. This trajectory is supposed to ensure that by the end of a fiscal adjustment period of at least four years, the public debt ratio is on a *plausibly downward trajectory*. The reference trajectory can be understood as pre-plan guidance on how much fiscal adjustment each member country would have to implement over a multi-year adjustment period to keep the public debt ratio on a plausibly downward path in the 10 years following the fiscal adjustment. Adjustment requirements are translated into a net expenditure path. The European Commission will use a control account to track annual and cumulative upward and downward deviations from the plan in actual net expenditure growth. Temporary deviations from the net expenditure path will only be allowed in exceptional circumstances. If a member state deviates from the plan markedly (by either 0.3 percentage points of GDP annually or 0.6 percentage points of GDP cumulatively), the European Commission may open an excessive deficit procedure, whereby the government in question will need to take corrective measures within six months (EU Regulation 2024).

Multi-year budget plans covering at least four years are to be negotiated between the European Commission and national governments against the background of the reference trajectory, rooted in an analysis of the sustainability of a member country's public debt (Heimberger, 2023; Darvas et al., 2023; Heimberger et al., 2024). Hence, the country-specific nature of the fiscal adjustment requirements is an important change from the old framework. The new framework includes a general EU escape clause and national escape clauses that can be triggered in the event of some serious occurrence that justifies temporary non-compliance with the rules.

Importantly, member states can commit to a range of investment and reform, extending the fiscal adjustment path from four years to a maximum of seven years, provided the European Commission agrees that the package of investment and reform meets the following criteria. They must: be growth-enhancing; be consistent with debt sustainability; address common EU priorities (e.g. Green Deal,

digitalisation, security); account for country-specific recommendations in the European Semester; and keep the national investment level at least constant. Notably, the reformed framework does not provide any broad exemption for public investment at the national level, irrespective of co-financing of EU programmes.

To extend the fiscal adjustment period and reduce the need for annual adjustment, there are incentives for national governments to submit a package of investment and reform to the European Commission. The package should include government spending on common priorities regarding the twin transition. However, member countries have to make the case that the planned measures are growth-friendly and consistent with debt sustainability. For example, climate spending that may well be required to meet the country's climate goals but that does not boost growth will not be allowed as part of the package to extend the adjustment period. Since there are no broad-based exemptions, if a member country wants to increase green and digital spending, it will have to make room by restricting other spending items, in order to comply with the technical requirements to limit the growth of net expenditure. There are already examples of this. Italy revised its National Recovery and Resilience Plan in late 2023, 'reallocating 11.8 billion euro to RePower EU at the expense of other missions. Notably, "strengthening the supply of educational services: from kindergartens to universities" and "social infrastructure, families, communities and the third sector" have seen the largest cuts, with a budget reduction of 360 million and 2.85 billion euro, respectively' (Reljic and Zezza, 2025, p. 11).

The insistence by Germany, Austria and some other countries on stricter fiscal rules during the reform process has further led to the introduction of so-called 'safeguards' for minimum fiscal consolidation. A new 'deficit resilience safeguard' will be applied when the multi-year path is set: this will require a government to continue with fiscal consolidation – even after it has reached the 3% fiscal deficit target – until the 'structural' fiscal deficit falls below 1.5% of GDP. The 'debt sustainability safeguard' requires the government in a country with a public debt ratio above 90% of GDP to plan a reduction in the debt ratio of at least 1 percentage point of GDP per year over the course of the adjustment period; and 0.5 percentage points of GDP per year for a government that faces a public debt ratio of between 60% and 90%. These 'safeguards' will lead to harsher fiscal adjustment requirements for several member states in the future (e.g. Darvas et al., 2023).

3. FISCAL CONSOLIDATION REQUIREMENTS TO MEET THE NEW EU FISCAL RULES

The European Commission uses Debt Sustainability Analysis (DSA) for its assessment of whether the public debt ratio will decline even under adverse scenarios. The DSA shows how the public debt ratio will evolve in the future, given assumptions on GDP growth, interest rates, inflation and fiscal policy (e.g. Van Dijk et al., 2022; Heimberger, 2023; Heimberger et al., 2024; Erce, 2025).

As described above, the new EU fiscal rules set net expenditure paths. However, net expenditure is derived from an interim variable: the structural primary fiscal balance (i.e. the cyclically adjusted fiscal balance net of interest payments). Since it is not very intuitive to present the adjustment requirements in terms of restrictions on the growth rate of net expenditure, we will follow previous contributions (Darvas et al., 2024; Heimberger et al., 2024; Heimberger 2025) and provide a discussion of how much the structural primary balance of an individual country will have to improve annually as a percentage of GDP

for it to meet the requirements of the new framework. We will focus on the 11 member states that joined the euro area (EA) in 1999,¹ plus Greece, which joined two years later, in 2001. We will refer to this group as the EA12.

Figure 1 presents the fiscal adjustment requirements to meet the new EU fiscal framework for the EA12 countries, based on the reference trajectories submitted to the individual governments by the European Commission in June 2024 (Darvas et al., 2024). The DSA-based criteria of fiscal consolidation are binding for eight of the EA12 countries. This means that the safeguards were typically not a significant constraint in the first round of application of the new EU fiscal rules, because the DSA-based criterion was stricter for the vast majority of EU member states (Darvas et al., 2024). However, the safeguards must be expected to lead to harsher fiscal adjustment requirements in future rounds of application of the new EU fiscal rules, in particular for member countries with high public debt levels.

Over the four-year period from 2025 to 2028, the average annual fiscal consolidation requirement in the EA12 is slightly below 0.5% of GDP per year. For a seven-year adjustment – for which governments must submit an acceptable investment and reform package – the average annual adjustment requirement in the EA12 is halved, to 0.25% of GDP. However, the fiscal consolidation effort varies significantly from country to country. In the four-year (seven-year) adjustment case, the average annual adjustment for Finland amounts to 1.2% of GDP (0.6%); Italy: 1.1% (0.6%); France and Spain: 0.9% (0.5%); Belgium: 0.7% (0.4%); Austria: 0.5% (0.3%); Netherlands: 0.1% (0.04%); Germany: 0.1% (0.02%); Portugal: 0.1% (0.01%); Greece: 0.03% (0.05%); Ireland and Luxembourg: 0% (0%). France, Italy, Spain and Belgium represent about half of overall EA12 GDP. The addition of Finland and Austria (where the governments are also set to implement substantial fiscal consolidation) brings the GDP share of euro area countries conducting contractionary fiscal policies to well over 50%.

Heimberger (2025) shows that countries such as Italy and France are set to implement fiscal consolidation that is historically large – comparable to the time of the euro crisis.² Against this background, the outlook for the coming years will be one of austerity: Europe will witness a multi-year period of simultaneous fiscal cutbacks in many EA12 member countries that represent a major share of the overall euro area economy.

However, in the first quarter of 2025, developments surrounding the war in Ukraine and the Trump administration's strategy of withdrawing financial support have put large-scale defence spending high up on the European political agenda. The European Commission (2025a) has proposed activating national escape clauses for defence spending. That said, there would be a flexibilisation limit, as the maximum exemption for additional defence spending would be 1.5% of GDP. Furthermore, the exemption under the national escape clause would only be for four years, although the political commitment to raise military expenditure extends much further into the future. Hence, there would be pressure to finance additional defence spending through national budgets in the medium term by raising taxes and/or by cutting back on social spending. The European Council (2025) welcomed the proposal to use national escape clauses as an immediate measure, but asked the European Commission to explore further options beyond using the flexibility of the new fiscal rules. The legislation could be changed to exempt

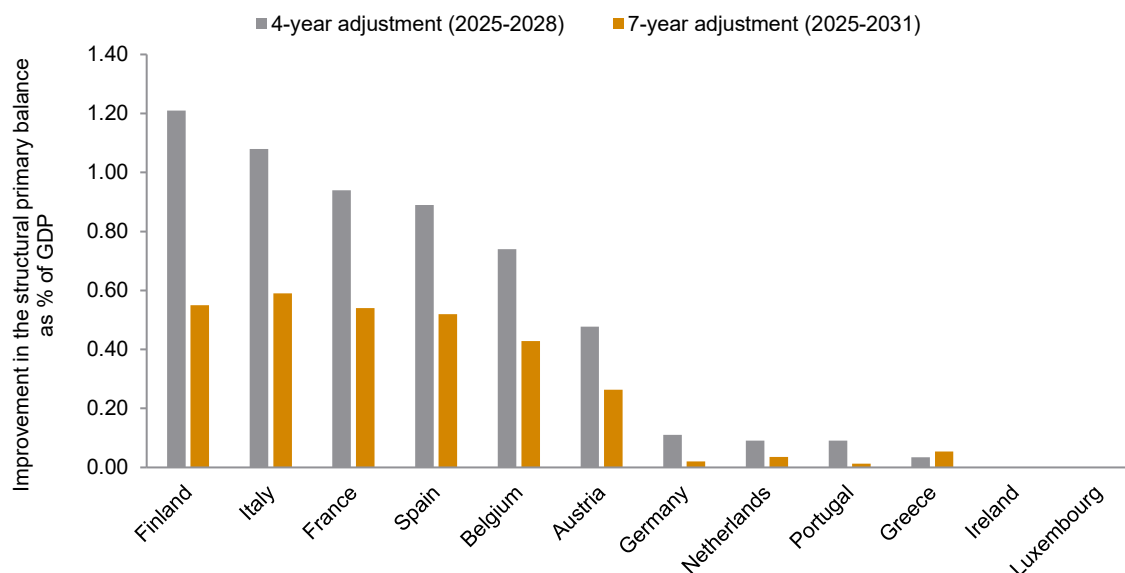
¹ This group includes: Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal and Spain.

² Paetz and Watzka (2024) also highlight the fact that some of the required fiscal adjustments in EA12 countries are substantial in the historical perspective.

additional defence spending by introducing a targeted and temporary exemption from the fiscal rules for defence spending. The Commission's plan to use the flexibility built into the EU's fiscal rules may not provide long-term certainty about the resources available for defence spending (Guttenberg and Redeker, 2025).

In any case, having additional military spending exempted from the current EU fiscal rules would lead to a deterioration in the fiscal balance, at least in the short term; although the overall impact on the economy and public finances would depend on how much additional military spending increased economic output (Ilzetzki, 2025). Importantly, defence spending at present is mostly current spending on military personnel and equipment; meanwhile many studies on defence spending focus on R&D spending. R&D expenditure delivers considerably stronger overall positive economic effects than military expenditure on personnel and equipment. However, R&D is only a small fraction of military expenditure. Zezza and Guarascio (2024) provide evidence for Italy that digital and green public spending comes with a high fiscal multiplier of, on average, just below two. This indicates that, if governments were to focus on positive and long-lasting investment on the twin transition, the additional spending could contribute substantially to an increase in economic activity and tax revenue, whereas an increase in current military expenditure on personnel and equipment would not raise economic activity in the longer run.

Figure 1 / Technical trajectories submitted in June 2024: fiscal consolidation requirements to meet reformed EU fiscal rules (annual improvement in the structural primary balance as % of GDP)



Source: Darvas et al. (2024).

The deadline for individual national governments to submit their fiscal-structural plans based on the European Commission's reference trajectories was October 2024. With the exception of a small number of EU member states where elections were scheduled for shortly before or shortly after the deadline,³ the national governments submitted multi-annual fiscal policy plans, and the European Commission (2024a) published its assessment at the end of November 2024. For only 5 of the 21 medium-term plans that the European Commission had assessed by the end of 2024 did it recommend an extension of the fiscal adjustment period from four to seven years, based on the packages of investment and reform submitted (Finland, France, Italy, Romania and Spain). All the other countries assessed were to enter a four-year adjustment period.⁴

Examples of investment and reform accepted as part of the packages submitted in a bid to extend the adjustment horizon included: reform of unemployment allowance, national health, social assistance and social security (Finland); reform of unemployment insurance, acceleration of renewable energy production, spending reviews, simplification of the business environment (France); reforms in the area of civil justice, tax administration, business environment, public administration and investment in childcare (Italy); reform of the pension system, the minimum wage, public-sector remuneration, taxation of micro-enterprises and tax administration (Romania); investment in the digital transformation of education, promotion of renewable energy generation, reform of taxation and education (Spain). While this list does include some elements that are relevant to the green and digital transition, it is apparent that many other items do not address – either directly or indirectly – the priorities of the twin transition.

4. A CRITICAL ASSESSMENT OF THE NEW EU FISCAL RULES

The new EU fiscal rules will be less restrictive than would have been the case had the old framework been reactivated. The abolished public debt reduction rule, requiring governments to bring down the public debt ratio to 60% of GDP within 20 years, would have been harsher, in particular for member countries with a high public debt level (e.g. Eichengreen and Panizza, 2016; Balboni 2024). After the rise in public deficits and public debt due to the pandemic, the old framework would have been so harsh as to be virtually unenforceable.

The key idea of the new framework remains that governments have to demonstrate that they have sufficient fiscal discipline to bring public debt ratios down over the medium term. However, if the negative growth effects of fiscal consolidation turn out to be greater than anticipated by the European Commission's DSA framework, public debt ratios will also turn out to be higher than expected (Heimberger et al., 2024).

³ For countries that did not meet the October 2024 deadline, a new reference trajectory (based on updated macroeconomic and fiscal projections) is to be used. For example, Austria had elections in late September 2024 and did not meet the October deadline for submitting a multi-year fiscal plan, since the plan needed to be submitted by the new government. As a consequence, the European Commission submitted an updated reference trajectory in December 2024, which took the deterioration in fiscal and macroeconomic forecasts into account and led to considerably stricter adjustment requirements.

⁴ Notably, many EU member countries did not apply for an extension of the adjustment period from four to seven years, especially those where the adjustment requirements are comparatively low.

The focus on multi-annual fiscal consolidation strategies comes with significant political risk, as existing research highlights that adjustments typically lead to a decline in government approval and a corresponding rise in political instability (e.g. Jacques and Haffert, 2021), while they tend to increase electoral abstention and boost the electoral outcome of populist parties, especially in economically vulnerable regions (Gabriel et al., 2023; Baccini and Sattler, 2024).

There is a political push for additional deficit-financed defence spending. However, this must be expected to lead to a rising share of government interest payments in total tax revenue. Furthermore, one has to expect political aversion to increased government spending other than on defence, because that would lead to even higher fiscal deficits. Taken together, these developments will exert downward pressure on national public spending on the twin green and digital transition. If fiscal adjustments to spending other than on defence end up burdening the economy – or, in the case of cuts to social spending, if they hit larger parts of the population – voters may react with dismay, while some bond investors could also show concern if there are signs of political instability (Born et al., 2020). More volatile financial markets may increase the pressure on the European Central Bank to backstop government bond markets, which would likely be politically contentious.

As the EU fiscal framework focuses on the medium-term reduction in public liabilities relative to output, it becomes unlikely that public assets can be increased during the twin transition. The new EU fiscal framework does not take account of the build-up of public assets through public (infrastructure) investment. Ball et al. (2021), in an article published on the International Monetary Fund's website, argue that countries with stronger government net worth – calculated as total public assets minus liabilities – enjoy greater economic stability and stronger macroeconomic development. From this perspective, public assets are also key to ensuring sustainable public finances in the long run. However, considerations of government net worth are not part of the new EU fiscal framework, as the focus is on public liabilities. The green transition, in particular, requires the capital stock to be replaced and extended over the coming decades (e.g. Shayegh et al., 2023; ECB, 2025). The EU fiscal rules' focus on a reduction in public liabilities will constrain the expansion of public assets.

The reformed EU fiscal framework is inadequate when it comes to promoting public investment in climate and energy. It provides incentives for governments to submit investment and reform plans to the European Commission. If the Commission accepts the package of measures, it does not grant a broad-based exemption for the financing of these investments; instead, it only extends the fiscal adjustment horizon to up to seven years, which typically does not change the overall fiscal consolidation requirements substantially, but reduces the need for annual adjustment (Darvas et al., 2024). The level of public investment at least has to be kept constant. However, to meet the net expenditure rule, governments have to make room for an increase in national spending on public investment in the green and digital transition by restraining other spending items, for example social protection, health or education. Governments could also raise taxes, although this may prove unpopular, in particular if the tax hikes were to affect large sections of the population. Furthermore, the current geopolitical context is characterised by pressures to increase military spending.

Keeping the level of public investment constant will not be enough to meet the ambitious climate targets over the next decade(s). Furthermore, an analysis by Boivin and Darvas (2025) of the multi-year budget plans submitted by EU member states to the European Commission shows that the nationally financed public investment rate is projected to be cut in more than a third of countries. Hence, the Commission's

conclusion that EU countries will maintain or increase investment over the plan horizon is exaggerated. The EU target of becoming climate neutral by 2050, and thus achieving net-zero greenhouse gas emissions, will require significant additional investment, e.g. in transport and energy infrastructure and more energy-efficient housing (Abraham et al., 2023; Stöllinger, 2023; Pisani-Ferry, 2021; Wildauer et al., 2020). Much of the additional investment will have to be launched by the public sector to attract further private investment, pointing to a need to increase public investment by at least 1% of EU GDP per year (Heimberger and Lichtenberger, 2023). The first round of plans submitted to the European Commission does not meet the requirements for additional public investment.

The rise in defence spending, in combination with fiscal consolidation pressure on other spending items from 2025 onwards, will make it impossible for national governments to sufficiently boost public investment in the twin transition – although this is necessary if climate and digitalisation targets are to be met. Existing research shows that public investment can be reduced or postponed more easily than other government spending components, especially when the pressure to cut back on government spending increases (Jacques, 2021). National EU governments' fiscal plans to meet the new EU fiscal rules from 2025 onwards show that harsher fiscal consolidation measures correlate with deeper public investment cuts (Boivin and Darvas, 2025).

5. OPTIONS FOR PROVIDING ADDITIONAL SPACE FOR HIGHER PUBLIC SPENDING ON THE GREEN AND DIGITAL TRANSITION

In what follows, I discuss three options to increase the fiscal space available for public spending on the twin transition in the context of the new EU fiscal rules: changes to the European Commission's DSA framework; national co-financing of EU programmes; and an EU investment fund for climate and digitalisation.

Changes to the European Commission's DSA framework. While debt sustainability is the key element of the new regulatory framework, studies on the European Commission's DSA show that fiscal consolidation requirements can be significantly altered by making minor changes to a few DSA assumptions (Heimberger et al., 2024). Hence, changes to the DSA assumptions could reduce the DSA-based fiscal adjustment requirements. This may include allowing for a different treatment of ageing costs in some countries (Paetz and Watzka, 2024).

However, the most sensible change may involve the treatment of investments and reforms within the DSA framework. As explained above, the new fiscal rules aim to incentivise governments to submit investment and reform plans in order to extend the adjustment period. However, the European Commission's DSA framework currently does not consider the potential for positive economic growth effects stemming from investment and reform. One way forward could be to implement changes to the DSA framework, so that the effects of increased investment and new reforms are explicitly taken into consideration. For example, one could use public investment multipliers from the existing empirical literature (e.g. Fournier, 2016; Suresh et al., 2024) to allow for higher potential growth rates in the medium term. In similar fashion, one could assess the effects of structural reform (e.g. Campos et al., 2025) on growth and public debt ratios. Higher growth rates in the DSA would lead to more favourable simulations of how the public debt ratio will develop over time, thereby reducing DSA-based fiscal adjustment requirements.

Changing the DSA methodology would be possible without further legislative reform, as the legislative texts do not regulate the DSA assumptions. The application of the DSA was left to the discretion of the European Commission, which decided to use its existing DSA framework (European Commission, 2024b) for the first round of reference trajectories. A DSA working group is supposed to review the underlying methodology. One limitation is that the new EU fiscal rules also include safeguards that stipulate minimum adjustment requirements, in particular for countries with high structural fiscal deficits and high public debt ratios. The reduction of the DSA-based consolidation requirements may make a safeguard binding. Furthermore, there is a minimum fiscal consolidation requirement of 0.5% of GDP per year for EU member states in an EU excessive deficit procedure. Currently, 8 of the 27 EU member states are in an excessive deficit procedure. Hence, the minimum adjustment requirements in the preventive and corrective arm of the fiscal regulation framework place limits on how much additional fiscal space can be gained by implementing sensible changes to the DSA framework. Furthermore, the room for manoeuvre that may arise from changes to the DSA framework is not earmarked for spending on the twin transition. Nevertheless, taking account of the positive growth effects of investment and reform in the context of the European Commission's DSA would support the European Commission's goal of incentivising national governments to submit investment and reform plans by making potential growth policy dependent. And modifications to the technical substructure of the EU fiscal rules that do not require changes to the legal text come with the potential of extra fiscal space when the DSA-based adjustment requirements are binding.

National co-financing of EU programmes. When assessing whether individual member states comply with their fiscal plans submitted under the new framework, the European Commission will exclude national spending on the co-financing of EU funded programmes from government expenditure. In the short term, this will not have a major impact, since most national co-financing relates to spending on EU regional funds. In the longer run, however, it will provide incentives to channel extra money through the EU budget, and may increase the scope for steering national fiscal spending into EU policy priorities in order to increase co-financing expenditure.

Using national co-financing under EU programmes does not count toward net expenditure in assessing compliance with the new EU fiscal rules. In future, an expanded use of national co-financing may enable governments to meet the fiscal targets more easily and to align them more closely with EU policy goals, including green and digital transition efforts. By leveraging EU funds, national governments could enhance their ability to achieve national objectives, while also contributing to the EU's broader strategic priorities. However, the potential for co-financing will depend on what EU programmes are available in the future and how much national co-financing they require or allow. Hence, the next Multiannual Financial Framework (MFF, 2028-2034) will be crucial. If the EU were to step up its co-funding for Important Projects of Common European Interest (IPCEIs), national governments would have more fiscal space and motivation to earmark resources for these projects, despite the tight budget (Di Carlo et al., 2024).

The European Commission has proposed making the MFF significantly more flexible: instead of fixed programmes, there should be a more general budget pot that addresses broadly defined EU objectives (European Commission, 2025b). The governments of individual member states could then set their own priorities in light of the EU objectives. Consequently, EU funds could be leveraged much more easily than before, and they could also be combined more easily and effectively with the exemption of national co-financing from EU fiscal rules.

Heimberger and Schratzenstaller (2024) argue that expenditure under the MFF should be reallocated to finance additional public climate investment. This would include enhancing the climate-friendliness of cohesion and agricultural policy and increasing the current target of 30% of EU spending related to climate targets. Furthermore, Heimberger and Schratzenstaller (2024) suggest that, while the MFF is currently primarily financed by the national contributions of EU members, the introduction of new sustainability-oriented own resources could provide additional financing for climate investment and support the EU's strategic goals. Revenue from EU emissions trading and the carbon-border adjustment mechanism are suitable as green own resources. Further potential sources of funding for the next MFF include taxes on shipping traffic, international air traffic and cryptocurrencies.

EU investment fund. As explained above, the necessary investment in the green and digital transition is difficult to finance with national funds alone, if the new EU fiscal rules are to be adhered to. One option that would enable a substantial increase in public investment would be the introduction of a permanent investment fund for climate and digitalisation at the EU level (Heimberger and Lichtenberger, 2023; Heimberger and Lichtenberger, 2024).

The key aspects of such a new EU investment fund could be based on the experience gained with the Recovery and Resilience Facility (RRF). The RRF was adopted during the COVID-19 crisis to support the economic recovery of EU member states from that crisis, in tandem with the implementation of investments and reforms to better achieve climate and digital goals. The RRF is not large enough to address the investment demands adequately, especially since the grants will only flow until 2026. Cornago and Springford (2021) argue that achieving the EU climate target by 2030 would require an expansion of public investment in the order of 10 times the green investment share of the RRF.

Following the example of the RRF, the European Commission would issue bonds on behalf of the EU to raise the investment funds on financial markets for the new EU investment fund to promote the green and digital transition. While member states would not be individually liable for the EU bonds issued, there is still the question of how to service the debt in the context of the overall EU budget. In this regard, member states could either agree on additional EU own resources in order to generate a revenue stream from which the EU bonds could be serviced, or they could allow for the build-up of an EU debt stock (Heimberger and Lichtenberger, 2023).

Investments financed by such a permanent EU investment fund could focus on genuinely European public goods projects in the field of energy and transport system transformation, as well as digital infrastructure, to create EU added value (Beetsma and Buti, 2024). For example, Creel et al. (2020) propose investment in a European high-speed rail system that could reduce CO₂ emissions in the transport sector over the long term. In addition, in the area of energy and decarbonisation, they recommend the introduction of an integrated electricity grid for the transmission of 100% renewable energy and support for complementary battery and green hydrogen projects. When it comes to digital infrastructure, genuine EU projects could focus on significant cross-border benefits for multiple member states that align with the EU-wide digital strategy and foster EU integration in the digital space, including a high-speed, ultra-broadband network connecting all EU regions, an EU-wide 5G network, EU cloud infrastructure, cross-border digital identification systems, European digital health infrastructure, and an EU high-speed data transport network.

6. CONCLUSIONS

The design of the new EU fiscal rules demonstrates that policy makers have learnt little from past mistakes, when lack of fiscal policy coordination among member states exacerbated the euro crisis in the period 2011-2013 (Heimberger, 2017). Large fiscal consolidation will be required in a number of (big) euro area countries from 2025 onwards, in order to comply with the reformed fiscal rules. However, the move towards not counting a (sharp) rise in military spending in the EU fiscal rules over the next four years will make fiscal policy in the EU member states overall more expansionary than it would otherwise have been. However, it is to be expected that the rise in military expenditure, in combination with fiscal consolidation pressure on other spending components, will lead to key policy goals related to the targeting of climate change and digital challenges being missed.

The new EU fiscal rules will increase the pressure for fiscal consolidation. To make room for additional defence spending in the medium term, governments will have to raise taxes and/or cut other spending on social protection, education and health. In light of the new EU fiscal rules, the options to expand the fiscal space for additional public expenditure on the twin green and digital transition at the national level include: an expansion of the national co-financing of EU programmes, which is not counted when assessing compliance with net expenditure restrictions in the reformed fiscal rules; and changes to key assumptions in the technical substructure of the new rules that will lead to an overall reduction in fiscal adjustment requirements. A permanent EU investment fund for climate and digitalisation could provide funding at the European level, thereby focusing on genuinely European projects that deliver EU value added – e.g. investment in an integrated electricity grid, high-speed trains across the EU, an EU-wide 5G network or an EU cloud infrastructure. In any case, to meet their ambitious policy goals policy makers must find new long-term financing solutions for the twin green and digital transition.

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