



FISCAL AFFAIRS

Discussion of “Sovereign Debt and Fiscal Integration in the European Union” (Darvas, Welslau, and Zettelmeyer (2025))

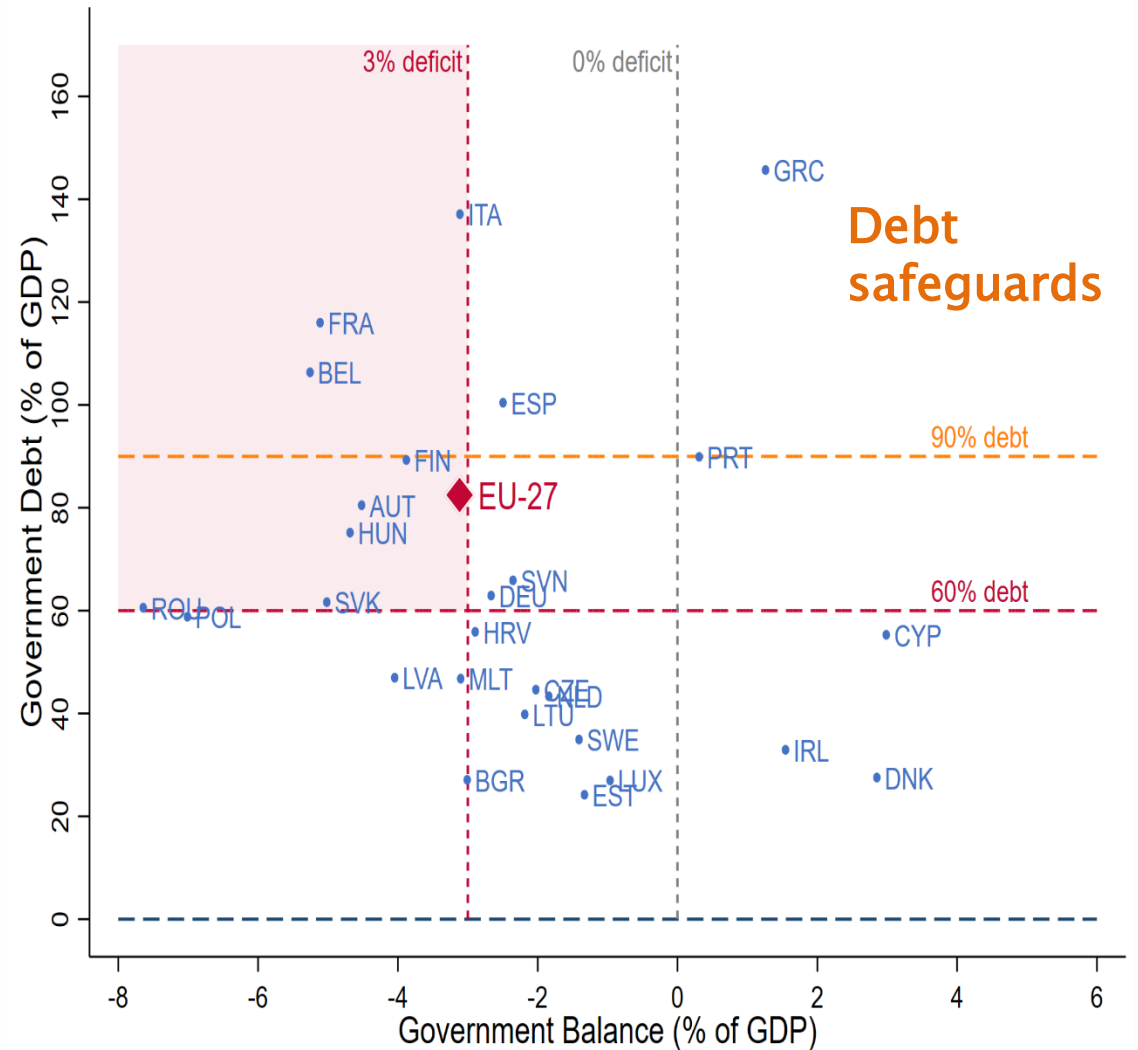
32nd Dubrovnik Economic Conference, May 31, 2026

ERA DABLA-NORRIS

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What the paper does and why it matters

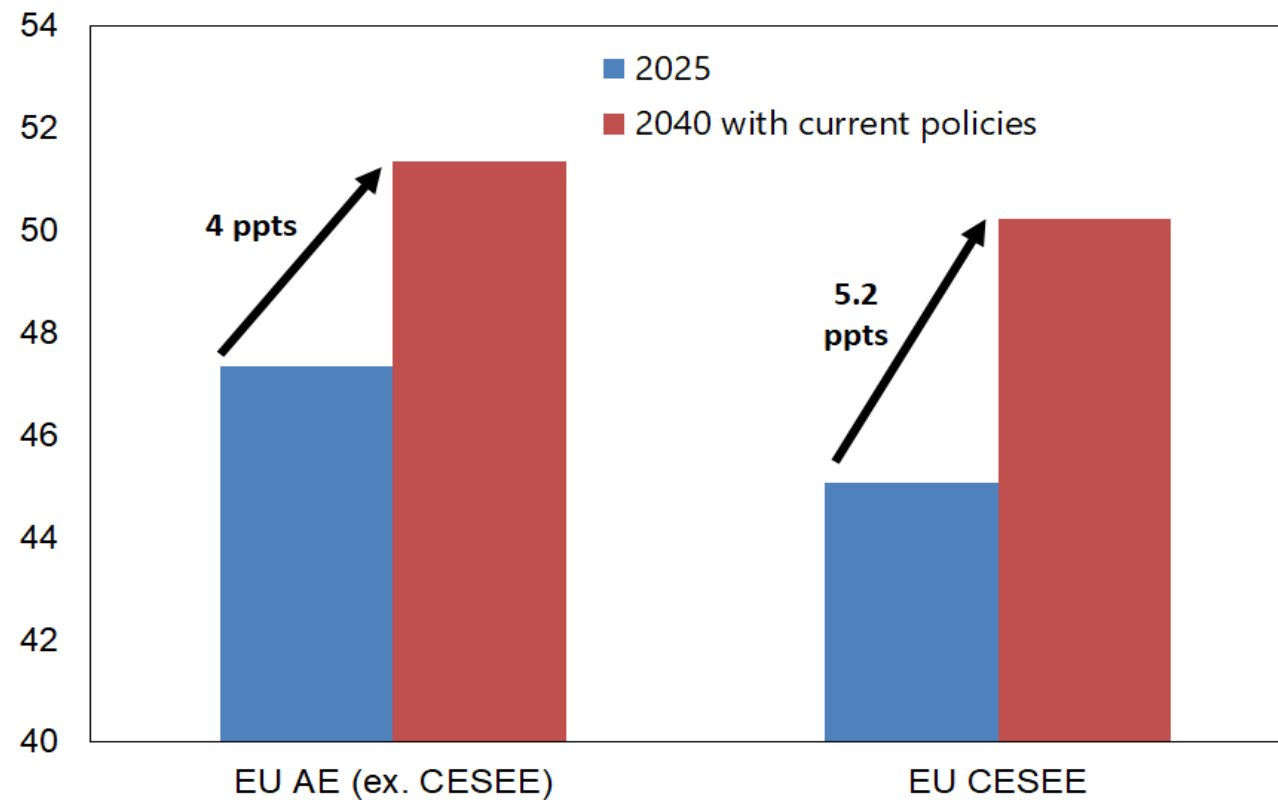
- Examines **whether the euro area's incomplete fiscal architecture** can manage sovereign debt risks in a high-debt, high-shock environment.?
- Combines **stochastic debt sustainability analysis with fiscal reaction functions** to assess whether policy responds sufficiently as debt rises.
- Finds debt often *appears* sustainable, but fiscal responses to rising debt have weakened, motivating further reform of EU fiscal rules.



Mounting spending from aging, defense, and energy

Public spending ratios

(Government expenditure in EU countries; percent of GDP)



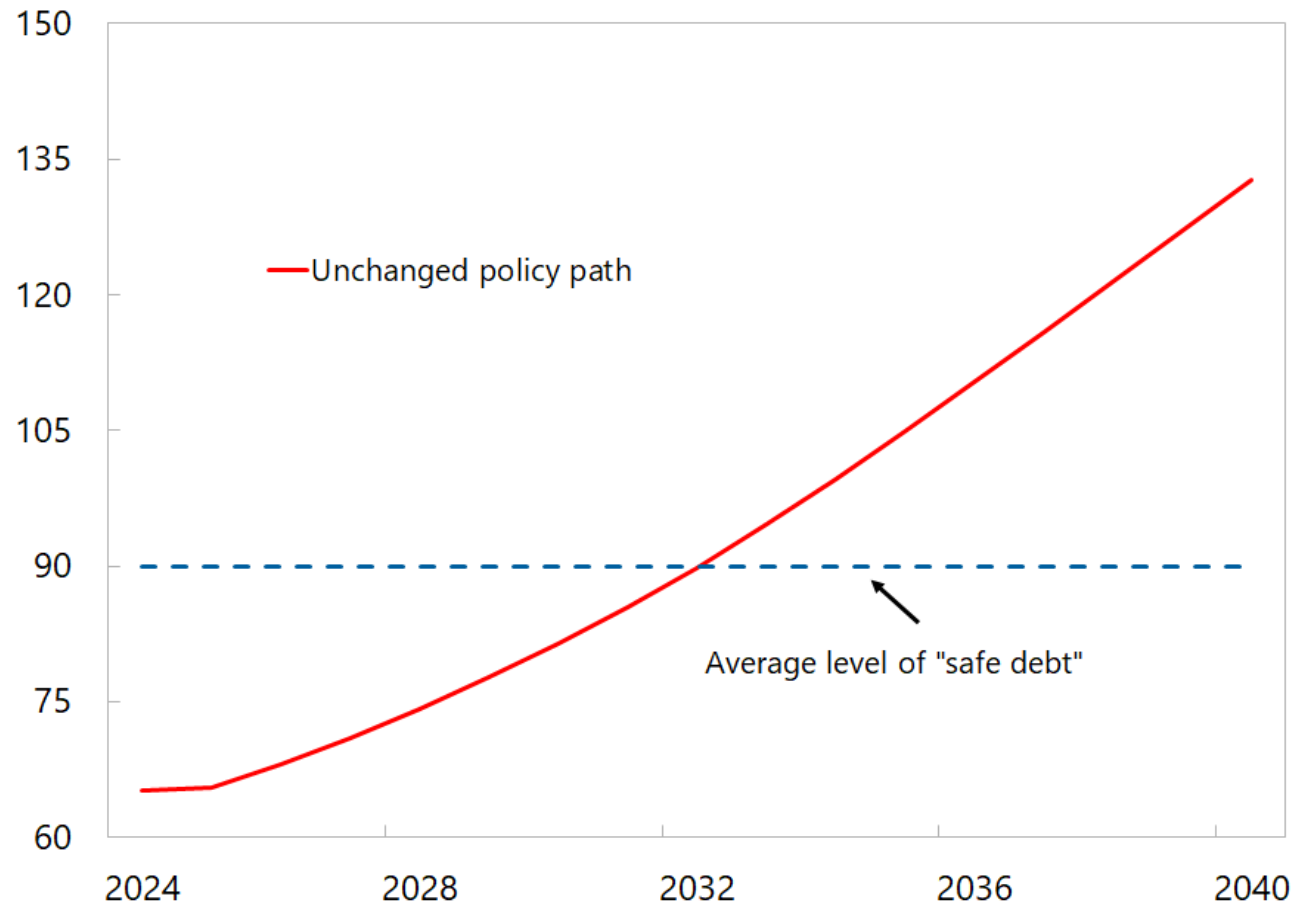
Source: Eble and others (2025) and "Europe's Fiscal Squeeze – Tackling Rising Spending Pressures" (IMF Departmental Paper, forthcoming July 2026).

Note: EU Advanced Economies (AEs) (ex. Central, Eastern and Southeastern (CESEE) countries) include Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Spain and Sweden. EU CESEE countries include the remaining EU countries. EU public goods, policies to catalyze private investment, and pension reforms.

Public debt could double by 2040 without policy action

General government debt

(Simple average of EU countries; percent of GDP)



Source: "Europe's Fiscal Squeeze – Tackling Rising Spending Pressures" (IMF Departmental Paper, forthcoming July 2026). measures, deeper integration of the sin Note: "Safe" debt is an estimate of the debt carrying capacity of each country, using the methodology proposed in the IMF October 2025 European Regional Economic Outlook, Note 1, averaged across countries. public goods, policies to catalyze private investment, and pension reforms.

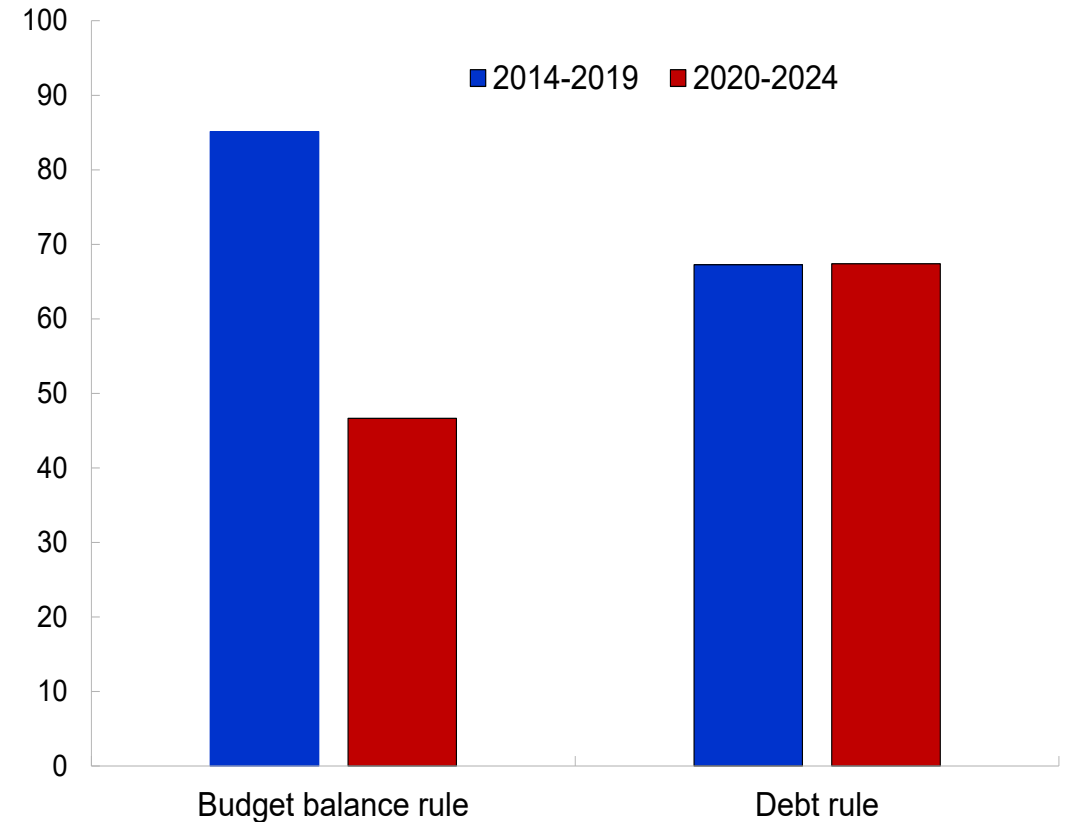
Key proposals to modernize EU fiscal architecture

- **Targeted “Investment” Clause:** Exempt certain **EU-priority public investments from deficit/debt limits** – *with offsets* to keep debt sustainable.
- **Higher, Risk-Based Debt Limit:** Increase EU **debt reference (~60→90% GDP)** and tailor debt reduction to country risk (low-risk = gradual; high-risk = stricter).
- **Expand EU Safe Assets: Scale up joint EU borrowing** (NextGenEU-like) to supply a large **euro safe asset** – strengthening market stability & crisis buffers.

Discussion (1): Making fiscal rules credible

- Greater flexibility in fiscal rules only works if **adjustment paths are realistic, enforceable, and transparent.**
- Over-optimistic growth and interest-rate assumptions remain a key risk to credibility in medium-term plans.
- Risk-based debt anchors are useful, but only if paired with **clear correction mechanisms when plans go off track.**

EU: Compliance with fiscal rules
(Percent of EU countries)

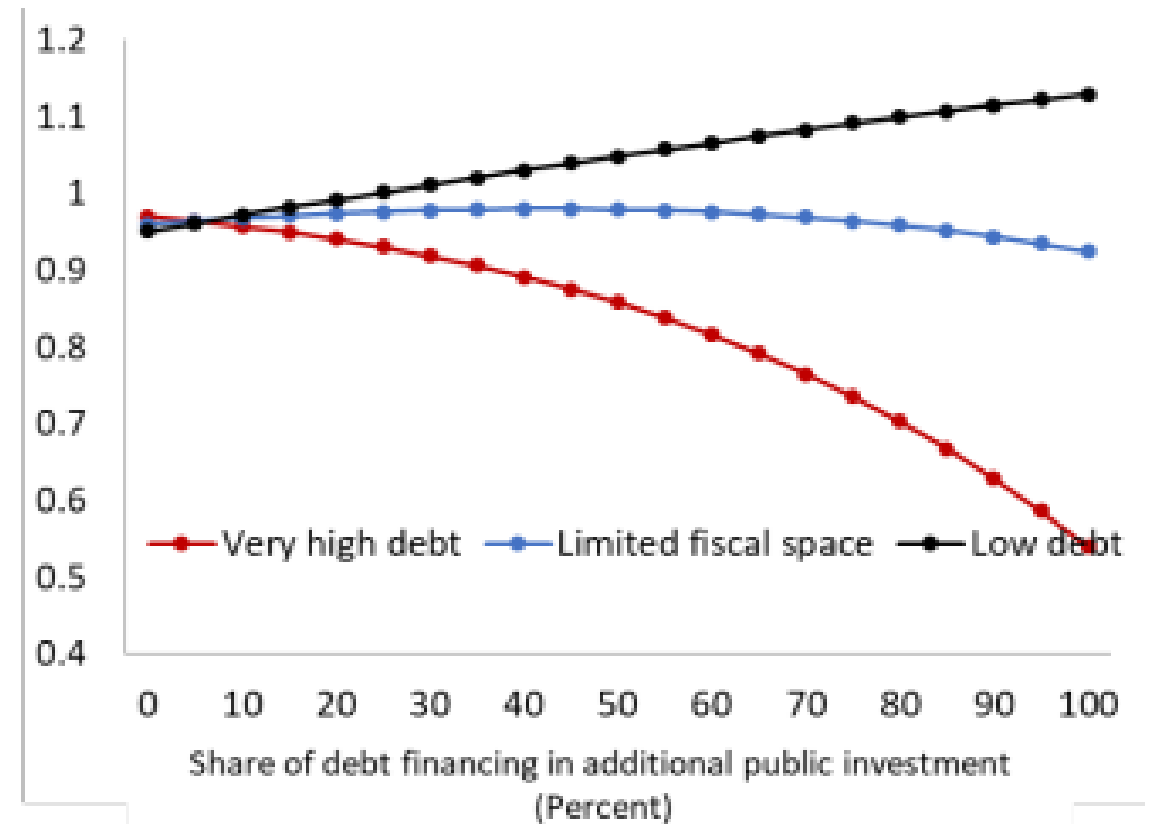


Note: Alonso et. al. (2025) and European Commission.

Discussion (2): Investment-friendly rules — with guardrails

- **Debt-financed investment does not reliably pay for itself**, especially at high debt levels and higher interest rates.
- Investment carve-outs **raises misclassification risks**, especially when investment definitions are broad.
- Credibility of investment flexibility hinges on **strong, independent fiscal councils** providing objective assessments of fiscal risks and assumptions.

Fiscal multipliers depend on financing costs
(Impact on output from 1 percent of GDP increase in public investment)



Source: M. J., Alonso-Albarran, V., Arroyo, C., Lam, M. W. R., Martinez, M. L., Nguyen, A. D. & Solovyeva, A. (2025). Fiscal Guardrails against High Debt and Looming Spending Pressures (No. 2025/004). International Monetary Fund.

Balancing integration and discipline – final thoughts

- More EU-level **safe assets** (joint bonds) would reduce fragmentation and allow for joint provision of European public goods.
- Common borrowing mainly improves **liquidity and efficiency**; it does **not resolve solvency risks**, so sound national fiscal positions remain essential.
- Success hinges on **credible enforcement, clear burden-sharing (“who pays”), and strong institutions**, so added flexibility does not weaken discipline.