

Europe's medium-term fiscal dilemma

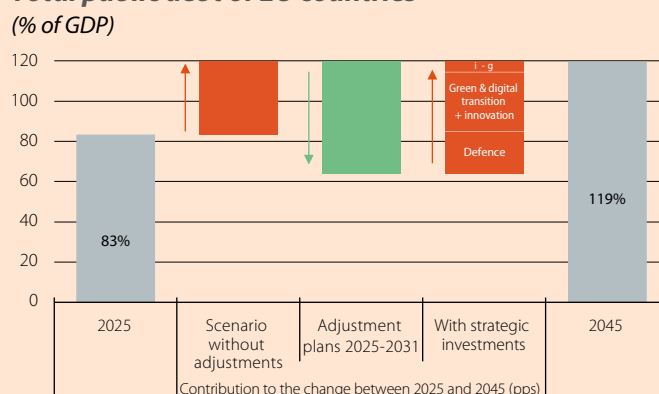
This year's return to fiscal rules – as safeguards of the sustainability of public debt – and the persistent shortfall in investment needed to address the EU's priorities in the current geopolitical context create a scenario marked by frictions that requires a coordinated fiscal strategy that far exceeds the horizon of national and EU political mandates, both in duration and ambition. Therefore, it is essential that the differences that exist, as well as some taboos that have characterised the EU's economic history on other occasions, are overcome.

Two opposing forces: fiscal consolidation vs. strategic autonomy

On the one hand, the state of Europe's public finances since the pandemic¹ and the effects of population ageing² will lead to a marked fiscal deterioration in the absence of compensatory measures, causing a growing number of countries to stray from the benchmark levels established in the Stability and Growth Pact. Based on the European Commission's forecasts for the various Member States, in a scenario without adjustments, the EU's aggregate public deficit could reach 5% of GDP in 10 years (3.2% in 2024) and the public debt ratio could approach 100% of GDP (81% in 2024).³ Under the new European fiscal governance framework, the main instrument for correcting such imbalances is the medium-term fiscal-structural plans, in which Member States set out a roadmap for ensuring the sustainability of their public debt.⁴ For those countries that need to make adjustments, the measures included in the plans entail an annual reduction in the primary structural deficit of 0.5-0.6 pps of GDP between 2025 and 2031 (some in four years and others over an extended period of seven years). As for the public debt of the EU as a whole, the difference compared to the scenario without any adjustments is very substantial – up to 25 pps lower within 10 years and 50 pps lower within 20 years (see first chart). The implementation of the medium-term plans is therefore crucial in order to ensure the sustainability of the public finances.

On the other hand, as has been highlighted in recent years by COVID-19, Russia's invasion of Ukraine and the unilateralism of the new Trump Administration, the EU has strategic dependencies in areas such as defence, innovation and the twin green and digital transition. Thus, the Draghi report published in 2024 set out additional investment needs in these areas amounting to some 800 billion euros per year,⁵ a figure which now, following the commitments to higher defence spending made by NATO members,⁶ has been updated by the ECB to 1.2 trillion (around 7% of 2024 GDP).⁷ Assuming that the public sector finances 25% of these additional investment needs over the next 10 years (100% in the case of defence due to its natural status as a monopsony), this spending boost could raise EU public debt to a level that would offset the reduction expected under the medium-term adjustment plans (see first chart).⁸ Therefore, in the search for a desired strategic autonomy in the current geopolitical context, we would find ourselves back at the starting blocks in terms of debt (un)sustainability, with additional risks of adverse feedback effects due to the pressure on Member States' financing costs.⁹

Total public debt of EU countries*



Notes: * Change between 2025 and 2045. 2025 forecast published in the European Commission's spring report. 'i - g' indicates the effect of the change in the spread between the interest rate (i) and nominal GDP growth (g), assuming that each 1-point increase in the public debt ratio results in a 4-bp increase in the cost of new financing, and a fiscal multiplier of 0.75 for changes in the primary structural balance. It is assumed that strategic investments will result in the existing gap being gradually closed by 2035.

Source: CaixaBank Research, based on data from the European Commission and the ECB.

1. See the Focus «[Debt limits: 2025 edition](#)» in this same *Monthly Report*.

2. See the Dossier «[Challenges and policies in the age of longevity](#)» in the MR09/2025.

3. Internal calculations based on the scenarios submitted by the European Commission to Member States prior to the preparation of the medium-term fiscal-structural plans in 2024-2025.

4. See the Focus «[The new EU economic governance framework](#)» in the MR01/2025.

5. See the Focus «[Draghi proposes a European industrial policy as a driving force to address the challenges of the coming decades](#)» in the MR10/2024.

6. See the Focus «[5% of GDP on defence: Why? What for? Is it feasible?](#)» in the MR09/2025.

7. ECB (2025), «Time to be strategic: how public money could power Europe's green, digital and defence transitions».

8. In the baseline scenario, we consider a gradual increase in defence spending to 3.5% of GDP by 2035 (5% for Poland and the Baltic Republics) and an increase in public investment on innovation and the dual green and digital transition of 1.5 pps over the same period.

9. E. Baldacci and M.S. Kumar (2010), «Fiscal Deficits, Public Debt, and Sovereign Bond Yield» estimates interest rate sensitivity in the range of 3 to 5 bps for each pp increase in the public debt ratio. Thus, *ceteris paribus*, the increase in public investment for strategic purposes could raise the cost of new financing by between 0.75 and 1.25 pps in 10 years and by between 1.5 and 2.5 pps in 20 years compared to the scenario with adjustments under the new fiscal rules.

Mitigation levers for the transition towards a new balance

In this scenario, a credible fiscal strategy should combine some short-term flexibility in order to close the investment gap – extending the escape clause for defence spending activated this year to other critical areas and increasing joint financing of EU public assets – with the imperative requirement to achieve greater efficiency in public spending and to build a solid foundation for greater potential growth. Such a strategy would allow the necessary medium-term fiscal consolidation process to be addressed, which more realistically could entail a higher end-point benchmark for the public debt ratio – closer to 90% of GDP than the current 60% – something that is in fact implicit in Germany's own stimulus plans.¹⁰

The aspiration to boost the EU's economic growth is inseparable from the fiscal debate. Faster economic activity growth will broaden the revenue base and allow public debt to be «absorbed» more quickly, while also containing the pressure on financing costs that a new medium-term fiscal anchor might entail (see second chart).¹¹ To this end, the aforementioned investments must be channelled through high-impact projects in terms of strategic autonomy and macroeconomic scope in the EU – with a growing prominence of European value added. Furthermore, as set out in the objectives of the Competitiveness Compass, in parallel progress must be made with the reform agenda, including regulatory simplification, deeper integration of the single market, new financing instruments within a capital markets union, and the revision of the competition and state aid framework in order to promote European projects with an EU-wide approach.¹² As Draghi himself pointed out on the anniversary of his report, the adoption and implementation of this ambitious agenda must be urgently accelerated in order to generate a virtuous circle with greater participation of private capital and lower demands on the public accounts.¹³

As for the role that joint financing can play in meeting strategic needs, the issuance of pooled debt has shown its potential in the face of large-scale shocks accompanied by stress in financial markets, thus facilitating the implementation and lowering the cost of short-term countercyclical policies, while also relieving pressure on public finances in the medium term.¹⁴ However, in «normal times» and in the absence of a complete federal structure, the use of joint financing (whether via markets or through the EU budget) seems less justifiable as a means to guarantee the EU's combined fiscal sustainability – after all, it is debt that Member States will have to repay. However, this approach is more justifiable due to the potential efficiency gains it could offer in areas where national public spending is fragmented, such as trans-European energy and transport networks, or minimum defence capabilities coordinated at the EU level. That said, the 530 billion euros proposed by the European Commission to finance strategic investments for the period 2028-2034 – including the new Competitiveness Fund and greater resources for the Connecting Europe facility – seems rather small in scale, since its incremental share compared to the previous budget is equivalent to just 4% of the total gap estimated by the ECB.¹⁵ An increase of 25% of these funds would finance up to 20% of the public investments in strategic areas in the coming years.¹⁶

Consolidation, but adapted to the new times

Greater potential economic growth, greater efficiency in public spending, a higher degree of co-financing in EU public assets and greater flexibility in the fiscal rules are key mitigation levers for the sustainability of Europe's public debt. However, it is likely that they will not be sufficient in the face of potential future shocks and a certain amount of additional consolidation will remain necessary in the medium term, although it would be much more limited in scale than the adjustment plans approved for the coming years (see second chart).¹⁷ This path will be easier to follow provided it is gradual yet persistent and integrated into a credible fiscal strategy that is coordinated among Member States.

10. J. Zettelmeyer (2025), «What does German debt brake reform mean for Europe?», and Z. Darvas, L. Welslau and J. Zettelmeyer (2025), «What Germany's medium-term fiscal plan means for Europe».

11. We estimate that, beyond the multiplier effect of strategic investments, a 0.5-pp increase in the average annual growth of nominal GDP over the next five years, and a 1-pp increase thereafter, could reduce the EU's public debt ratio by around 15 pps within 20 years.

12. See the Focus «[A shift in the EU's political priorities](#)» in the MR04/2025.

13. M. Draghi (2025), «High Level Conference – One year after the Draghi report: what has been achieved, what has changed».

14. P. Burriel, I. Kataryniuk and J.J. Pérez (2022), «Computing the EU's SURE interest savings using an extended debt sustainability assessment tool».

15. See the Focus «[The 2028-2034 EU budget: An impossible mission?](#)» in the MR09/2025.

16. If jointly financed, we estimate that the national debt ratio for all EU countries as a whole could be around 10-12 pps lower in 2045, compared with a slightly smaller increase in EU debt, resulting from the differential impact on the cost of financing.

17. According to our internal estimates, stabilising the public debt ratio from 2045 would require an increase in the primary structural balance equivalent to a reduction in EU debt of between 10 and 15 pps of GDP. For countries with levels in excess of 90% of GDP, it is assumed that they would converge on this level or, if higher, on the level that would be expected after the adjustments set out in the medium-term adjustment plans (excluding strategic investments).

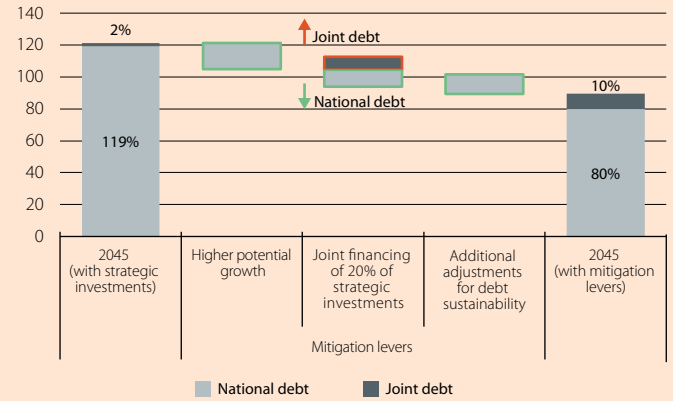
On the revenue side, the tax structure must promote economic growth and eliminate distortions in market efficiency, while also helping to mitigate – through an adequate level of collections and suitably progressive tranches – any social and territorial inequalities that may arise in the transition towards a European economy that is more autonomous and competitive at the global level. On the expenditure side, besides allocating the greater strategic investment to more productive areas, it would also be beneficial to continuously monitor the efficiency and impact of public policies, as well as evaluating the effects that the change in the composition of budgets will have on growth and income distribution.¹⁸

We see, therefore, that reconciling the sustainability of public debt with the drive for European strategic autonomy is a challenge of enormous complexity, marked by tensions between fiscal discipline, necessary investments and geopolitical demands. Each step that is taken on one of these fronts implies adjustments and risks on the other fronts, and this will require ambitious and flexible coordination between Member States, under the continued discipline of financial markets and with the additional complication of growing domestic political fragmentation. The magnitude and interdependence of the challenges addressed in this analysis highlight the difficulty of achieving a lasting balance. However, inaction or a lack of ambition could leave the EU lagging behind other global powers in terms of welfare and with a debt challenge far greater than the current one.

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Total EU public debt in 2045*

(% of GDP)



Notes: * Change versus a scenario with strategic investments. Total EU public debt includes Member States' national debt and joint EU debt. The balance of the joint debt expected for 2045 corresponds to the gradual repayment of the financing for NGEU. The scenario with higher potential growth assumes a gradual increase of 0.5 pps through to 2030 and of up to 1 pp from 2035. The gap between the increase in joint debt needed to finance 20% of strategic investments and the reduction in the national debt ratio is explained by the impact on financing costs. The additional adjustments for the sustainability of public debt are materialised in a gradual increase in the primary structural balance beginning in 2029, when the escape clause for defence spending (here extended to other strategic investments) ends. The effects consider the impact via fiscal multipliers and interest rates of the new financing.

Source: CaixaBank Research, based on data from the European Commission and the ECB.

18. IMF (2025), «Fiscal Monitor: Spending Smarter: How Efficient and Well-Allocated Public Spending Can Boost Economic Growth».