



# *The European Commission's DSA in the Economic Governance Framework: how do we get to a reference trajectory?*

Finnish Parliament working group on fiscal policy

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# Key principles of the new EU fiscal framework

- **Debt sustainability at the core of the framework:** anchors fiscal policy in a medium-term perspective, commitment to a net expenditure path that ensures that debt converges to or remains at prudent levels (+ respects common numerical safeguards)
- **Risk-based differentiation** between countries receiving a **reference trajectory** (debt > 60% of GDP or deficit > 3% of GDP) and countries eligible for **technical information**. **Country-specific fiscal requirements** reflect different macro-fiscal situations but within a **common DSA-based framework**
- **More national ownership:** bringing together national fiscal policy, investment and reform commitments in a single national medium-term fiscal-structural plan prepared by the Member State
- **Possibility to extend the adjustment period** from 4 to 7 years, with a more gradual adjustment, if commitment to **structural reforms and investment** strengthening debt sustainability and promoting sustainable and inclusive growth
- **Built-in memory:** the framework relies on a sequence of multiannual plans, where end point of one plan is starting point of next plan

# Why a medium-term DSA-based approach?

- Given current debt levels and future fiscal headwinds, need to anchor fiscal policy in a **credible medium-term perspective**: high debt will not be brought to 'safe levels' in one or two years, future fiscal pressures and uncertainty (e.g., Blanchard et al., 2021; IMF, 2022).
- The DSA, as a medium-term public debt projection framework, is a **well-established and state-of-the-art tool** that puts key fundamental / economic concept at its core.
- The DSA integrates the latest available information to set **country-specific requirements** within a common framework relying on **common assumptions and methodologies**:
  - Commission short-term macro forecast
  - Medium-term (T+10) GDP growth projections based on the EU commonly agreed methodology with the EPC Potential Output Working Group
  - Ageing cost projections based on the latest Ageing Report (jointly prepared with the EPC Ageing Working Group)
  - Interest rates and inflation reflect financial markets' expectations and agreed convergence values

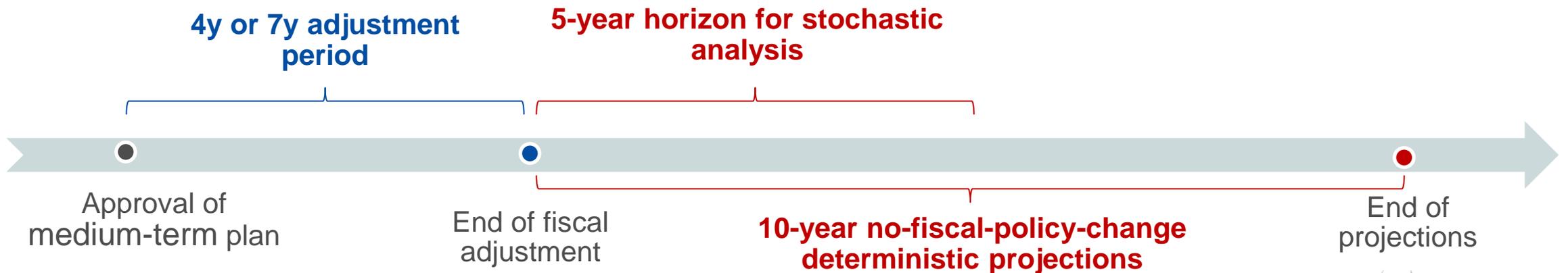
# Is the DSA too complex?

- A certain degree of complexity is needed to **rightly capture risks**: e.g. the snapshot level of debt alone is a poor predictor of debt sustainability risks (IMF, 2021; ECB, 2017)
- Yet, **high degree of transparency**:
  - Annual publications of the **Debt Sustainability Monitor** with extensive explanations on the assumptions and the methodologies (DSM 2023 for a detailed account for first plans)
  - Most of the analysis can be **replicated** in Excel spreadsheets
  - **Dedicated EFC-A (DSA) working group** discusses possible methodological improvements for future plans

# Reference trajectory: the three DSA-based criteria

By the end of the adjustment period and without further budgetary measures:

- 1) **Debt is put or remains on a plausibly downward path**, (or stays below 60% of GDP), over the 10 years following the adjustment period
- 2) **Debt declines with a probability of at least 70%** in the 5 years following the adjustment period
- 3) **Deficit is brought (or kept) below 3% of GDP** and maintained below it over the 10 years following the adjustment period



The **deterministic scenarios and stochastic projections** of the DSA are used to stress-test the paths of the plans

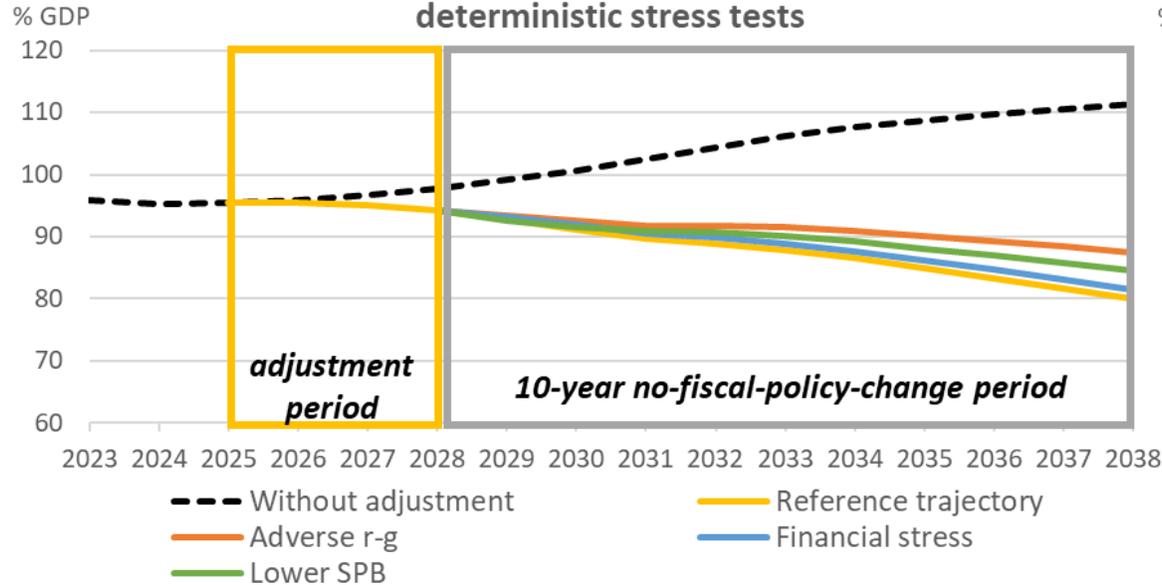
# Reference trajectory: a risk-based approach

The art. 10 criterion “**debt is put or remains on a *plausibly* downward path**” is anchored in the **DSA methodology**:

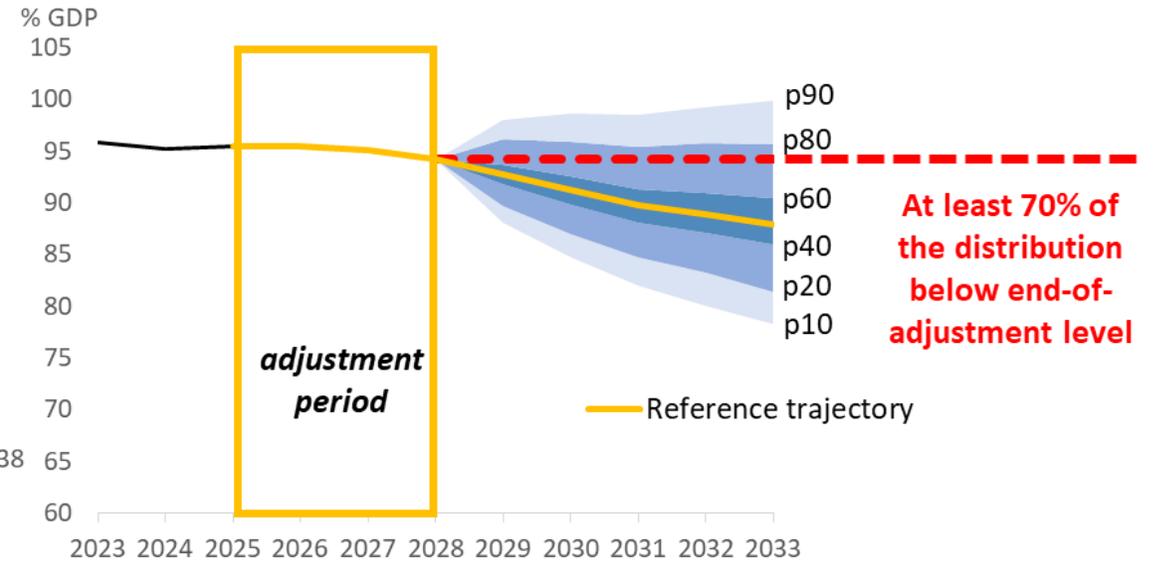
- Debt declines under the **adjustment scenario**
- Debt also declines under **3 adverse deterministic stress tests** starting after the adjustment period:
  - ✓ **‘Lower SPB’ scenario**: SPB reduced by 0.5 pp. of GDP (0.25 pp. over the first 2 years) and remains at that level afterwards, plus changes in the cost of ageing
  - ✓ **‘Adverse r-g’ scenario**: interest-growth rate differential permanently increased by 1 pp. over the no-fiscal-policy-change period
  - ✓ **‘Financial stress’ scenario**: market interest rates temporarily increase for one year by 1 pp., plus a risk premium for high-debt countries
- The criterion “**the risk of the general government debt ratio not decreasing** in the five years following the adjustment period [...] **is sufficiently low**” is assessed using the **stochastic DSA methodology**.

# Illustrative example with 4y adjustment period

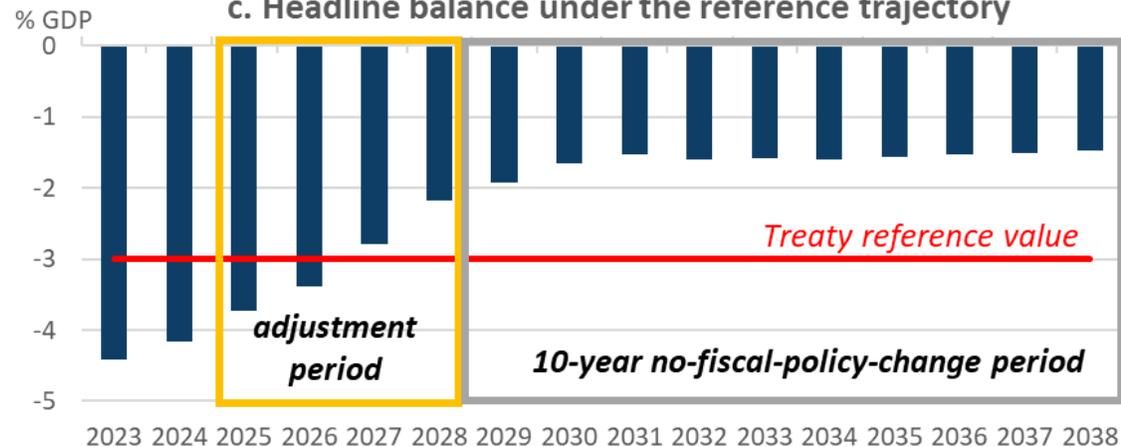
a. Debt projections under the reference trajectory and the deterministic stress tests



b. Stochastic debt projections around the reference trajectory



c. Headline balance under the reference trajectory



# Additional provisions: benchmark and safeguards

- **No backloading:** The fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is linear as a rule and at least proportional to the total effort over the entire adjustment period.
- **Consistency with corrective arm (“deficit benchmark”):** minimum annual adjustment of 0.5 pps for countries in EDP
  - Transition period of 2025-2027: 0.5 pps in terms of structural *primary* balance; thereafter (as from 2028): 0.5 pps in terms of structural balance
- **Debt sustainability safeguard:** annual average debt decline of at least 1 pp of GDP as long as debt > 90% of GDP, and at least 0.5 pps of GDP as long as debt > 60%
  - Period starts in first year of adjustment (calculated against level in year before start of adjustment) or after abrogation of EDP (year after deficit ≤ 3% of GDP). Period ends with the adjustment period
- **Deficit resilience safeguard:** common margin of 1.5% of GDP, in structural balance terms, with respect to 3% of GDP Treaty reference value
  - Minimum annual adjustment of 0.4 pps of GDP (0.25 pps in case of extension) if structural deficit > 1.5% of GDP

Benchmark and safeguards can only **top up DSA-based requirements**, not reduce them.

The two safeguards ensure a minimum annual reduction in debt and deficits ex ante.

# Reference trajectory: equivalence between change in Structural Primary Balance and net expenditure growth

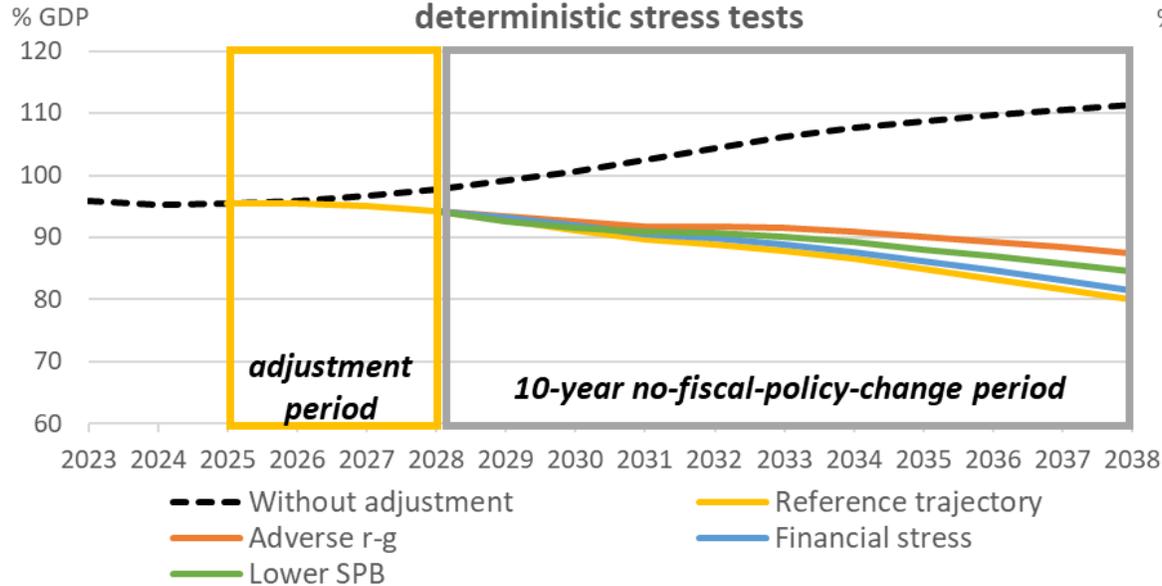
- 1) **Reference trajectories computed in terms of change in SPB**  
(debt projection model based on SPB and some articles of the regulation refer to this metric)
- 2) **Then translated in terms of net primary expenditure growth**  
using this standard formula (already used in the EU fiscal rules):

$$\begin{aligned} & \textit{Nominal net primary expenditure growth} = \\ & \textit{yearly potential GDP growth + inflation (as measured by the GDP deflator)} \\ & \quad - \textit{required change in the SPB / primary expenditure-to-GDP ratio} \end{aligned}$$

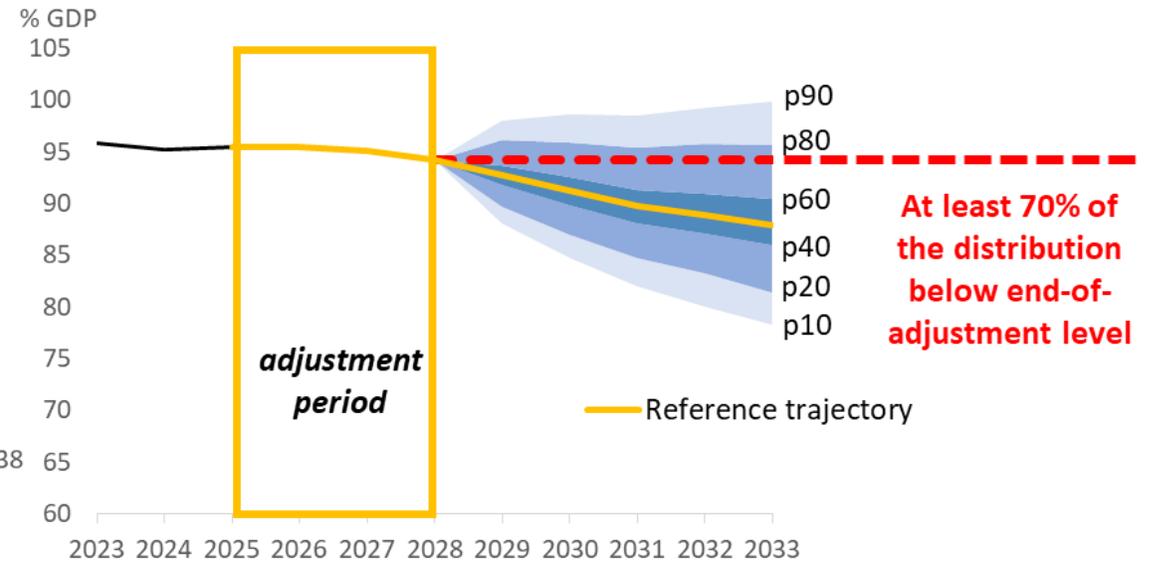
**Reminder:** Endorsed net expenditure path that MS committed to in its plan will be the only reference during implementation

# Illustrative example with 4y adjustment period

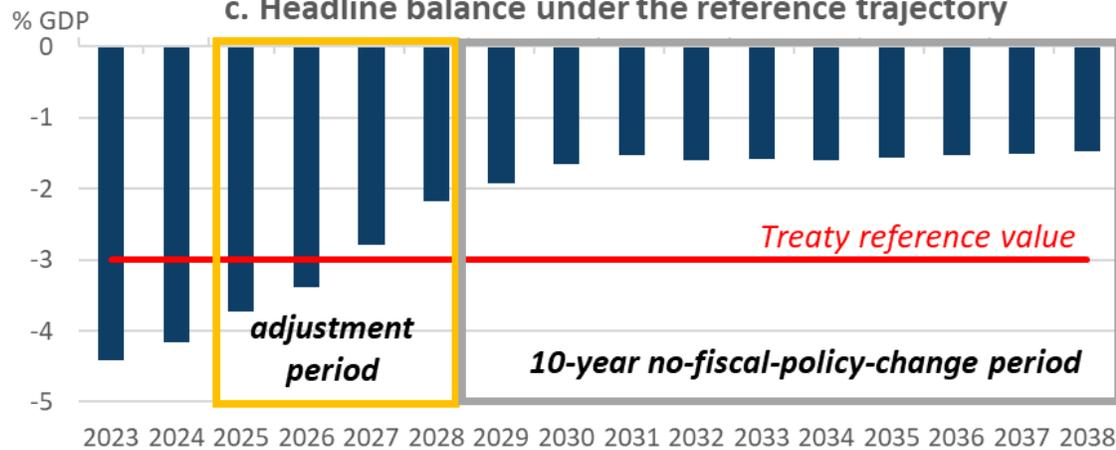
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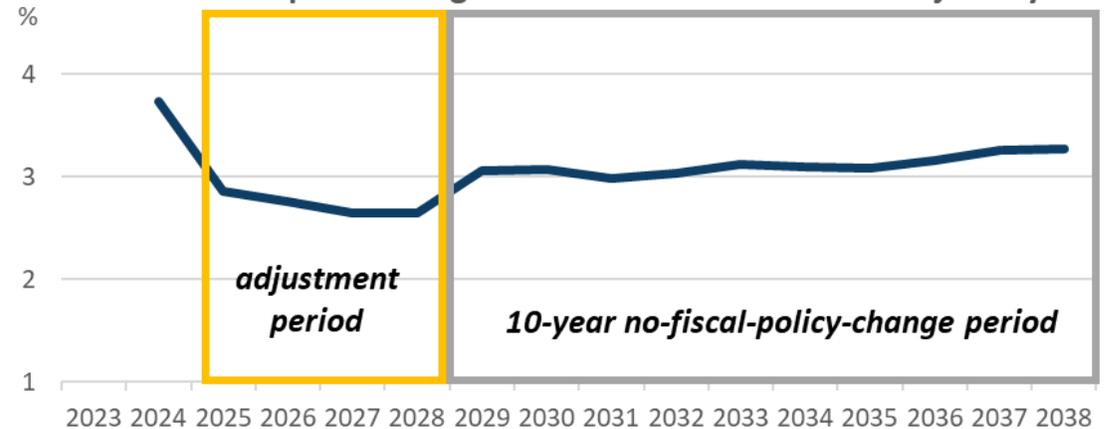
b. Stochastic debt projections around the reference trajectory



c. Headline balance under the reference trajectory



d. Net expenditure growth under the reference trajectory



# Escape clauses

- The new EU fiscal framework provides for the possibility to activate **two escape clauses allowing for a deviation from the net expenditure path** as set by the Council, *provided that it does not endanger fiscal sustainability over the medium term*
- Differences between the two types of escape clause relate to the country coverage, reason for triggering the escape clause, duration of initial activation period and process for extension
- The **general escape clause** (GEC) (Art. 25 of Regulation (EU) 2024/1263) in case of a severe economic downturn in the euro area or the Union as a whole
  - ✓ Triggering for one year and extension are subject to a Commission recommendation to be adopted by the Council
- The **national escape clause** (NEC) (Art. 26) in case exceptional circumstances outside the control of the Member State have a major impact on the public finances of the Member State
  - ✓ Triggering (initial activation period can exceed one year) and extension at the request of the Member State, subject to Commission recommendation adopted by the Council

Thank you