Budgets under pressure

Long-term fiscal challenges in Europe

September 2023

kpmg.com/uk/en/**macroeconomics**

Executive summary

European economies face an unprecedented strain on their public finances. A succession of economic shocks, coupled with meagre growth over the past two decades, have led to a large rise in the stock of debt. Now, rapidly rising interest rates have made financing those debts more challenging. This, coupled with demographic changes and other spending pressures, could potentially jeopardise efforts to balance the books in the long run.

The ageing of Europe's population will have significant fiscal repercussions. Rising life expectancy and falling fertility rates have meant that the share of the elderly population has more than doubled since 1950. This will almost certainly put an increasing pressure on spending on healthcare and pensions. The energy transition to reach net zero emissions will also require significant investment in non-fossil energy sources and energy preservations, while governments are looking to address the need to increase defence budgets.

Just as governments' spending needs grow, the sources of revenue may now be harder to access. Weaker potential growth, slowing increases in workforce participation, and greater mobility of high-income taxpayers have all meant that traditional ways to increase government revenue may be less effective. With tax as a share of GDP already at or close to record levels across much of Europe, policymakers may need to think about alternative sources of income.

While initiatives like carbon tax provide a stream of revenue and offset the high investment costs required for the energy transition, more will need to be done. In addition, the optimal policy mix may require a reassessment of the outgoings, including cuts to some budgets in order to raise spending elsewhere.

The immediate implication of the rise in interest rates is likely to be that fiscal policy is more constrained, particularly when considering the large debt stock accumulated across many European countries. Set against that, departing from ultra-low interest rates should leave more room for central banks to respond to shocks. This will help to share the burden of supporting the economy when the next crisis strikes, but that still leaves many instances where government fiscal support will be needed.

While the economic case for some reforms may be straightforward, these changes may require a broad consensus to be reached across all sections of society. Linking retirement age to rising longevity may be one of the ways to mitigate some of the age-related rise in spending without the need to raise taxes. Addressing poor productivity growth and supporting the green transition offer further avenues to tackling long-term challenges, although there are challenges around it and some countries have more room to increase investment than others.

Many European governments will still need to face a trade-off between higher taxes or lower spending, neither being a popular option. For those European countries with high debt levels, reducing the debt burden should also be a key consideration, as it not only fosters fiscal responsibility but also serves as a safeguard against potential future crises.

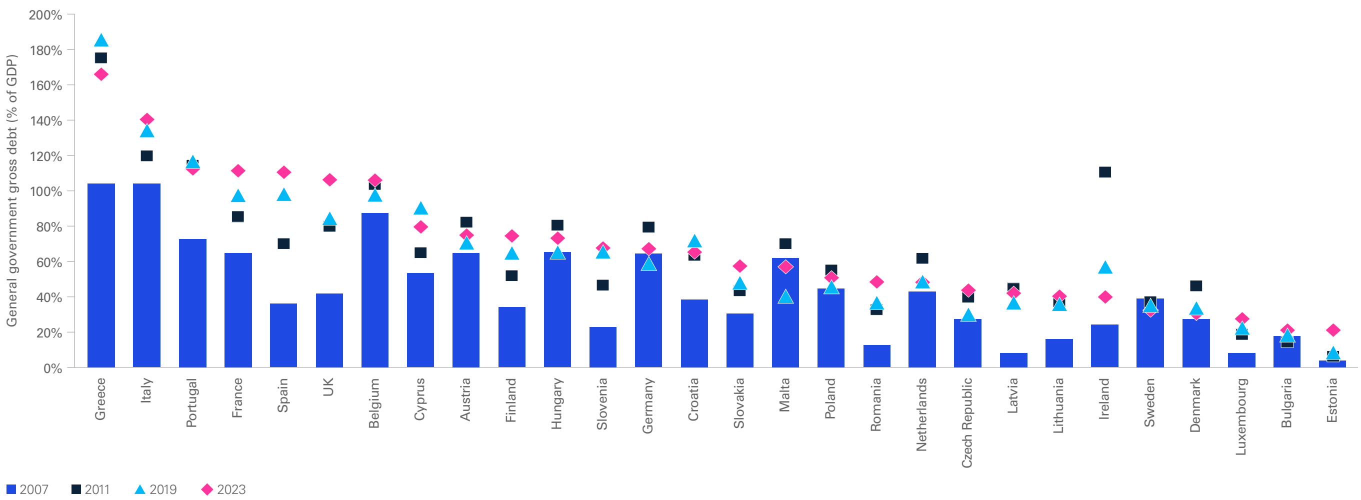
Budgets under pressure: Long-term fiscal challenges in Europe

European public debt levels have increased materially over the past 15 years across many European economies. The average stock of public sector debt has risen from 43% of GDP in 2007 to a peak of 77% in 2020[1]. The rise in borrowing has been largely driven by spending linked to a succession of economic shocks that have affected all European economies and were both large in scale and unexpected.

The Global Financial Crisis in 2007-08 was the first to hit public finances in the past two decades. It caused a sharp increase in borrowing across most economies in Europe through a combination of steps required to protect fragile financial systems as well as provide stimulus for a subsequent recovery.

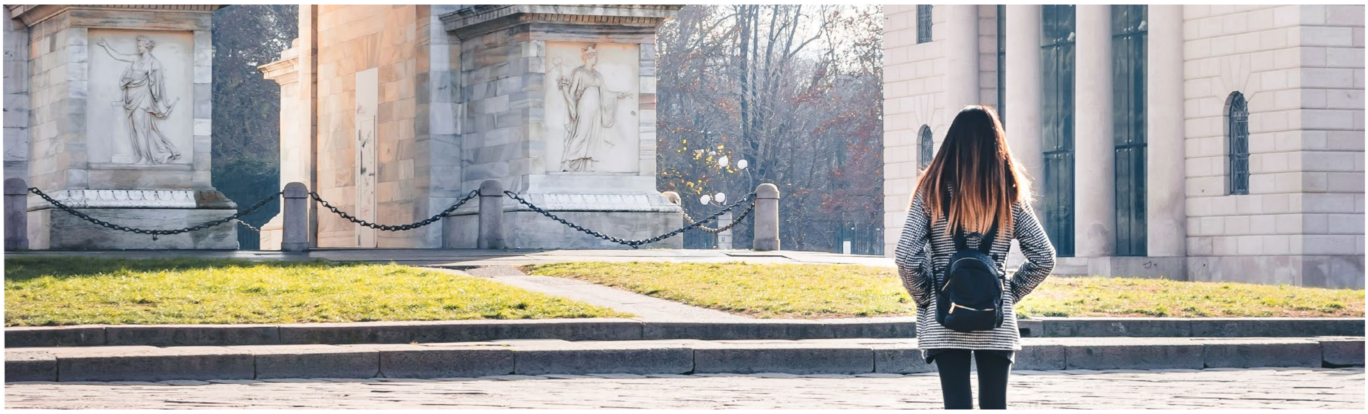
A majority of European economies subsequently continued to accumulate debt (see Chart 1). This was driven in part by weaker economic growth, which brought in less tax revenue for governments but increased demand for some benefits. The low interest rates environment, which reached record lows during this period, provided governments with access to cheaper credit and may have encouraged some proliferation of debt.

Chart 1: The evolution of government debt since 2007



Source: IMF, KPMG analysis.

1 Unless otherwise stated, in this report we refer to the 27 member states within the European Union as well as the United Kingdom.



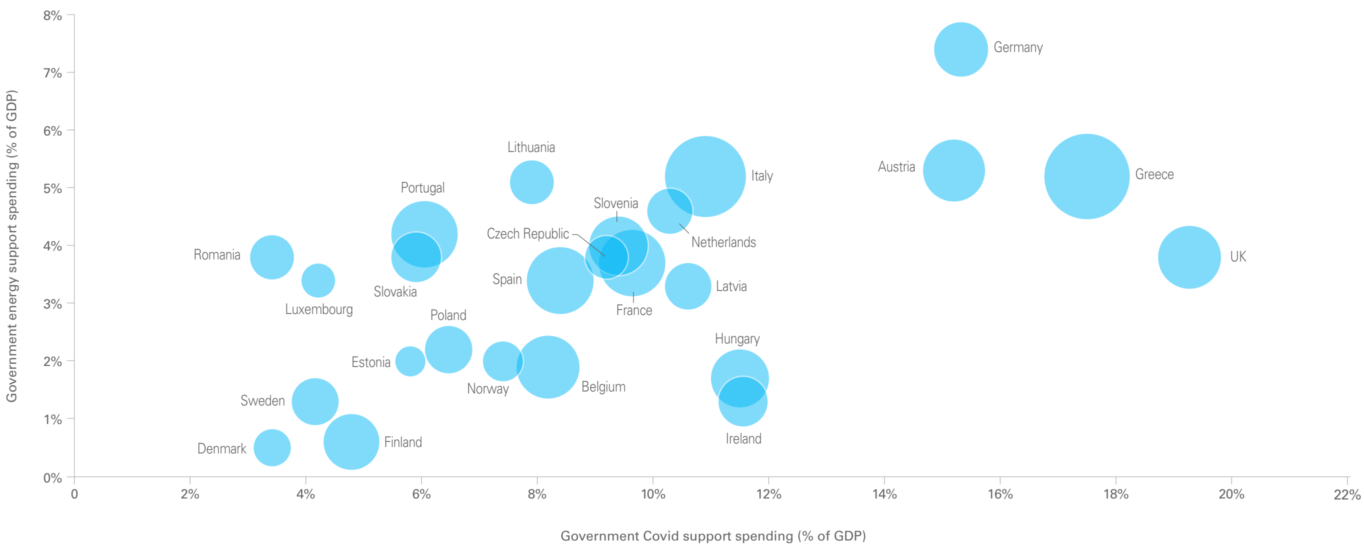
More recently, many European governments have become more willing to engage in fiscal policies to support their domestic economies. The capacity of monetary policy to respond to shocks was limited when policy interest rates approached zero. Moreover, the nature of the recent shocks lent itself towards larger fiscal responses, so even when rates began to rise lately, there was still a valid argument to pursue a strong fiscal response.

The Covid-19 pandemic and the rise in energy prices following the invasion of Ukraine in 2022-23 required a bigger role for fiscal policy in shielding the more vulnerable sections of the economy and society. The strong impact of the Covid-19 lockdowns on workers and businesses in the hospitality, travel and retail sectors in particular required significant fiscal support. Governments also spent significant sums on additional health measures during the pandemic.

Likewise, the steep rise in energy prices propelled many governments to provide support to those parts of society most affected, such as energy intensive industries and lower income households. While the fiscal response has been largely significant for both shocks, some governments implemented relief packages that were particularly large, worth over 20% of GDP combined (see Chart 2).

The challenge for the next decade is how fiscal policy levers can adapt to the changing economic environment, demographic trends, and financing costs. While weak economic growth and a slowing growth in the labour force may continue to squeeze government revenues, higher interest rates and pressing spending needs will make future trade-offs much more acute. This may require a revaluation of the scope of public good provision against the need of higher public sector investments.

Chart 2: Government spending on Covid-19 and energy support



Source: IMF, Bruegel, OECD, KPMG analysis.

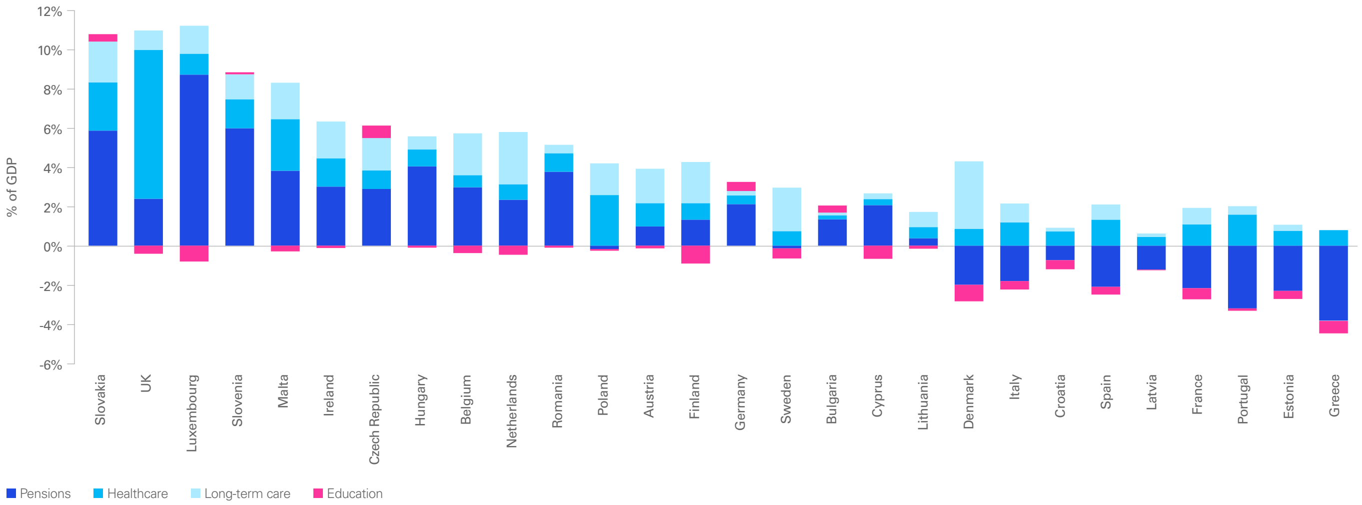
Note: The size of the bubbles represents relative debt levels in 2022.

Government spending pressures

Rising spending pressures are testing the ability of governments to meet their commitments. The next decade presents a scale of challenges unprecedented in recent history, including demographic pressures, higher defence spending, clamour to address rising inequalities, and the cost of tackling climate change among others.

Population ageing is expected to continue to be a major driver of rising public spending. The next decade is almost certain to see continued increases in healthcare spending. The majority of healthcare spending in Europe is covered either by the government or through compulsory insurance schemes. That spend has tended to rise over time, driven by a combination of population ageing, medical advancements, and a rise in chronic health conditions. Among the different components of expected age-related pressures, healthcare needs are expected to drive an increase in spending over the next 50 years (see Chart 3).

Chart 3: Change in age-related spending, 2019-70



Source: European Commission, OBR, KPMG analysis.

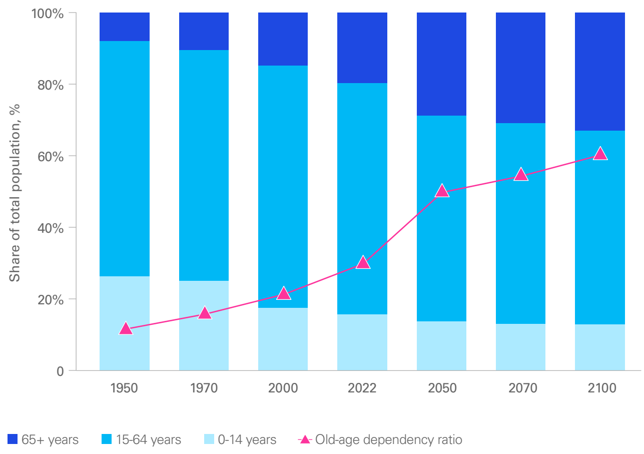
Demographic trends are also set to increase other age-related spending as a share of GDP. Public pensions spending would rise over time unless mitigated by changes in retirement age, as demographic trends point to a large expansion of the 65+ cohort and a consistent increase in the old-age dependency ratio (see Chart 4). The key drivers of that include rising life expectancy and falling fertility rates (see Chart 5). Some reforms are already underway. In countries such as Cyprus, Denmark, Estonia, Finland, Greece, Italy, the Netherlands, Portugal, Slovakia, and the UK state pension age is linked to life expectancy. However, the examples of Poland (which reduced retirement age in 2017), the UK (which delayed the decision to increase it to 68 until the next Parliament) and France (where the latest pension reform was met with public protests) underscore the political challenge in implementing such reforms.

Defence spending may now also need to rise, in a sharp break from the past multi-decade trend. The ending of the Cold War and the less fraught geopolitical environment allowed many European economies to redirect spending to other areas, the so-called 'peace dividend'. The past 30 years saw a gradual reduction in defence spending across Europe; for example, in the UK it fell from 4.1% of GDP in 1991, to 2.2% in 2022 (see Chart 6). Russia's invasion of Ukraine in 2022 and rising tensions elsewhere in the world mean that defence spending may now need to rise, both in absolute terms and as a share of GDP. Some countries have already made commitments to increase spending, with France planning to expand its defence budget by over 40% for the 2024-30 period, compared to the 2019-25 budget cycle, and Germany announcing in 2022 that it would invest an additional EUR100bn to modernise its armed forces.

The need to address climate change will require even more substantial upfront investment in order to meet governments' net zero commitments, while limited action risks bringing about real economic costs. Estimates by the European Commission suggest that achieving current targets for 2030 would require an average of EUR336bn of additional investment every year within the block. The UK's Office for Budget Responsibility (OBR) estimates that reaching net zero by 2050 would increase the size of the annual deficit by 0.8% of GDP. Nevertheless, the costs of inaction on climate change could be much greater, potentially reducing GDP by around 20% by 2100, according to the Network of Central Banks and Supervisors for Greening the Financial System (NGFS).

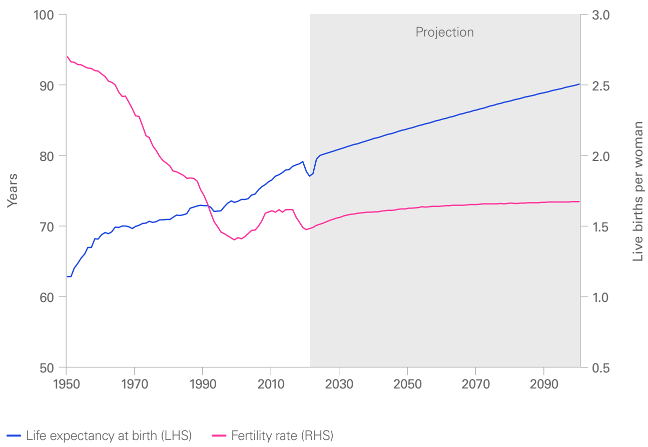
The scope of public services provided by the state could come under increased scrutiny if existing levels of provision become unsustainable. The three areas highlighted above point to a potential rapid increase in spending commitments, and while governments may now be used to the ratcheting up of health budgets, both defence and climate change among others pose new challenges, necessitating a new approach to funding in the long run.

Chart 4: Population structure in Europe



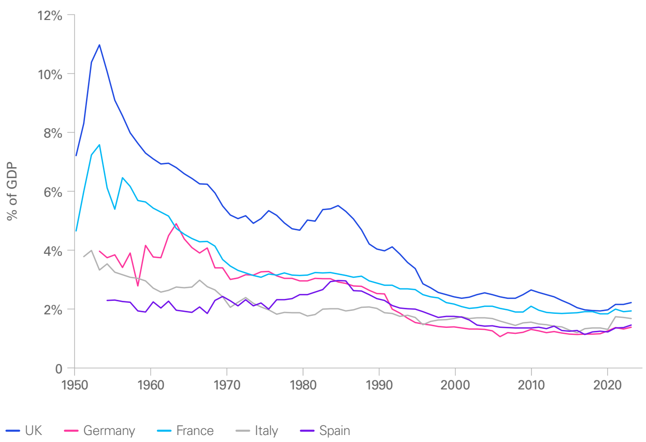
Source: Our World in Data, United Nations, KPMG analysis.

Chart 5: Demographic trends in Europe



Source: United Nations, KPMG analysis.

Chart 6: Trends in military expenditure



Source: SIPRI Military Expenditure Database 2023.

Sources of government revenue

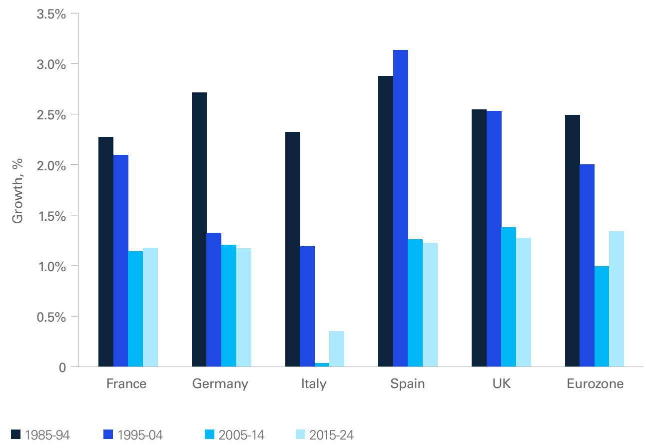
As demand for government spending is set to grow over time, an adequate tax policy will need to be in place to ensure the viability and sustainability of these commitments if they are to be met.

Strong economic growth and a steady increase in workforce participation allowed governments to broaden their tax base and facilitated a large increase in spending with the advent of the modern welfare state in the aftermath of the Second World War. Unfortunately, these trends have now gone into reverse, requiring a new source of government funding. Potential growth, a key factor in raising revenues for governments, has been on a continued decline across Europe since the 1990s (see Chart 7). With the growth outlook weak for Europe in the medium term, raising tax revenue through increased economic activity will be difficult.

Favourable demographic trends, which saw an increase in the share of the working age population across Europe and continued to drive the increase in revenues until the 2000s, are also set to prove an unrealistic lever to counter growing spending pressures in the coming decades. The second half of the 20th century saw a significant increase in female labour participation, coupled with the demographic dividend from the 'baby boom' in the 1950s and 1960s. But as the share of the elderly (aged 65 and over) population is set to increase across Europe, growth in workforce participation is expected to slow in the coming decades.

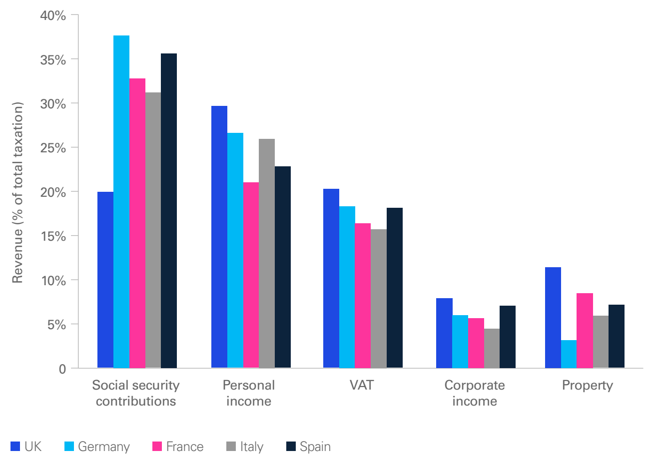
Increasing taxation on labour income has been a traditionally popular policy tool for European governments, yet these taxes are likely reaching their limit. Taxes on labour accounted for 57% of total tax revenue across Europe's five largest economies in 2021 (see Chart 8). Further tax increases on labour will be potentially risky, and unlike in the 1960s and 1970s, when marginal tax rates were at record highs, high income workers are now more mobile, putting a cap on how far governments can tax their income.

Chart 7: Potential growth has been on a downward trend



Source: OECD, KPMG analysis.

Chart 8: Revenue from major taxes, 2021



Source: OECD, KPMG analysis.

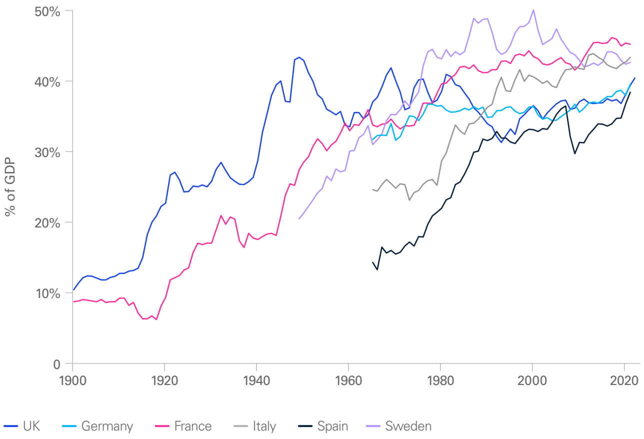
Historically companies have been able to relocate operations to lower tax jurisdictions, particularly where value is driven by non-tangible assets such as intellectual property or brands. That put limits on how high taxes on corporate profits could rise. In addition, often changing tax regulations and the temporary nature of some allowances hinder businesses from charting a clear course. The uncertainty around future tax policy exacerbates this situation, rendering it exceedingly challenging for businesses to make informed decisions about their long-term investments. Paradoxically, this may contribute to a lower tax take. However, this may be alleviated with closer coordination at the supranational level such as the OECD's work on a global minimum tax, which would support efforts to raise revenue via corporation tax.

Governments can potentially opt for higher property taxes as an additional source of revenue that may be more politically viable in some counties. While taxes on property currently only account for 7% of total tax revenue in Europe's largest economies, the challenge lies in the distortion property taxes generate between businesses that use tangible assets and those that do not.

Tax revenue as a share of GDP is currently close to or already at record levels in many major European economies (see Chart 9), indicating limited scope to increase it further unless there is a shift in public consensus.

In the last decade the main focus of policy makers has been to protect the tax base by targeting the use of low tax jurisdictions, Environmental taxation has become a permanent fixture in the tax landscape with countries taxing the negative externalities produced by polluters and making fossil fuels more expensive relative to green energy. The revenue raised could go towards the costs of green energy transition. The EU is in the process of protecting its tax base by introducing a Carbon Border Adjustment Mechanism to prevent businesses relocation to jurisdictions with more relaxed regulation.

Chart 9: Long-run trends in tax revenue



Source: Our World in Data, OBR, OECD, KPMG analysis.

> Shifting the burden of taxation over time from things we want to encourage, like labour supply, to things we want to discourage, like pollution, should form part of any long-term fiscal reform."
>
> **Simon Virley**, Head of Energy and Natural Resources at KPMG in the UK

Recently there has been a shift to incentivising green technology. The US introduced the Inflation Reduction Act in 2022 offering generous subsidies and tax credits. The EU is responding with a relaxation of state aid rules to keep green tech activity in the union.

Despite this, there is a growing view that more tax revenues need to be found. There may be some targeted tax raising measures, but the ability to raise significant funds from taxing a particular part of the economy such as the ultra-wealthy or multinational corporations is unlikely.

Tim Sarson, Head of Tax Policy at KPMG in the UK thinks that improving the efficiency of existing tax systems needs to play a key part in future policy. "In the UK the tax system can distort the choices of people and firms, it can produce unfair results, and parts are badly designed. All of these factors can result in an unnecessary drag on productivity."

Constant evolving tax reforms drive complexity which exacerbates the problem. Sarson views this as negatively impacting investment. "Taxpayers want simplicity and certainty of tax treatment. Around the world we are seeing a lot of countries' corporate tax rates settling around 25%. In such a homogenous environment simplicity and certainty can be key factors in investment decisions.

Further thinking will be required among governments on the optimal policy mix across different tax bases as well as viable avenues to bolster tax revenues.

In the UK the tax system can distort the choices of people and firms, it can produce unfair results, and parts are badly designed. All of these factors can result in an unnecessary drag on productivity."

Tim Sarson, Head of Tax Policy at KPMG in the UK

The rising cost of debt

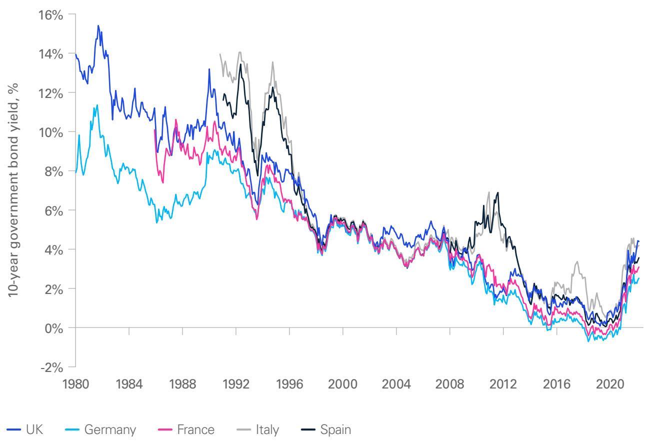
The decline in long-term interest rates over the past 40 years has enabled governments to benefit from more favourable financing conditions. Global interest rates have been on a downward trend thanks to a number of structural factors, including population ageing, a decline in trend productivity growth, and greater risk aversion following the Global Financial Crisis.

One of the central drivers of this trend is the demographic shift towards population ageing that has been unfolding across many developed economies. As people tend to save more as they age in order to finance retirement, older societies are associated with higher levels of wealth. At the same time, the decline in trend productivity growth has meant that the rate of return on investment has declined, leading to a fall in demand for capital. Taken together, these shifts have contributed to lower 'equilibrium' interest rates, which match the saving and investment patterns while keeping the economy and inflation in balance.

This trend has been arrested by the recent spike in global inflation. Central banks have raised policy interest rates in a synchronised fashion, which has led to an increase in long-term borrowing costs for the governments (see Chart 10). With inflation proving more persistent, nominal interest rates may need to stay higher for longer in order to bring it under control. The key question is where the equilibrium interest rate will end up after inflation returns to central banks' targets, and the implications that would have for government finances.

To the extent that the drivers influencing interest rates in recent decades have been slow-moving, one could expect them to continue to exert downward pressure. Ageing populations and weak productivity growth, for example, have largely not been reversed by the pandemic. Set against that, however, a more generous social safety net following Covid-19 and the energy price crisis could mean higher levels of government debt, which tends to increase the risk premia and reduce the level of wealth available to finance investment. In addition, pension reforms aimed at raising retirement ages could mitigate the impact of ageing on the demand for savings.

Chart 10: The recent surge in inflation has halted the decline in long-term rates



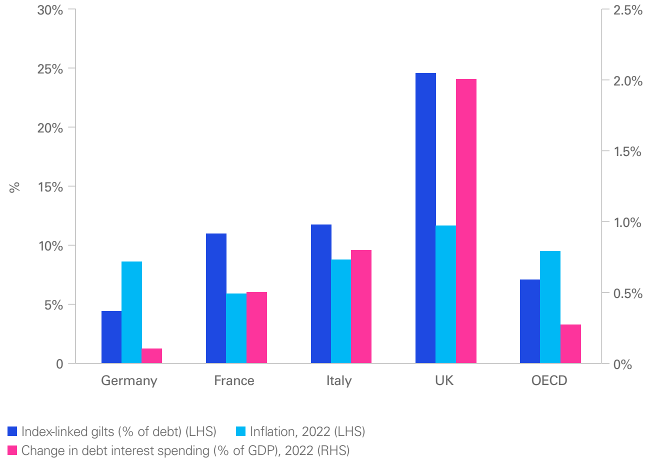
Source: Refinitiv Datastream.

The immediate implication of the rise in interest rates is likely to be that fiscal policy is constrained, particularly when considering the large debt stock accumulated across many European countries. In addition, the conventional effect of high inflation on eroding the value of debt has been mitigated by the adoption of index-linked bonds in many countries (see Chart 11). As payments on these bonds are adjusted to rise in line with a specified price index, this makes the public finances vulnerable to both higher interest rates and inflation.

Alongside directly raising interest rates, the ongoing reversal of quantitative easing policies is set to shrink central banks' balance sheets and lead to a corresponding drop in the demand for government bonds, which could also see their yields rise as a result (see Chart 12). In addition, the sale of government bonds is likely to carry a fiscal cost in itself because the market value of these assets has fallen below their purchase value. In the UK, the cost of quantitative tightening to the Treasury could potentially exceed £200bn over the next decade, although the net effect should be considered against the gains to the Treasury in the earlier years of the policy.

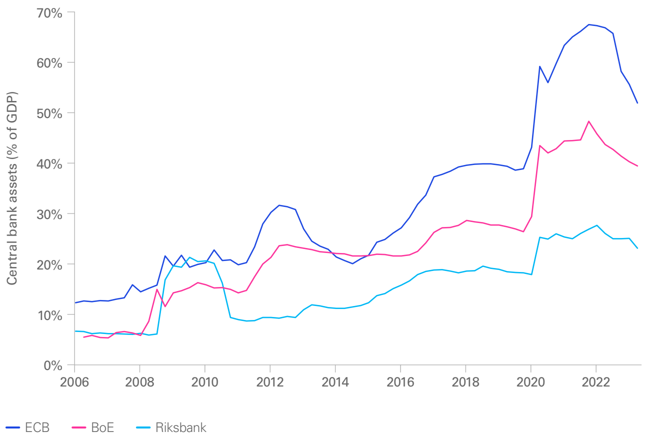
For countries in the Eurozone, in the absence of an independent monetary policy, fiscal policy remains the main tool of addressing country-specific shocks without significant risk sharing. And, given the increase in interest rates, if spending to mitigate these shocks comes from higher borrowing, that would now be more costly, especially for countries with a high stock of debt that are facing higher sovereign risk premia. Spreads between some Eurozone countries and German government bonds – which are traditionally viewed by investors as safe – have risen somewhat since the ECB started tightening policy. While these spreads have remained below the heights seen during the Eurozone debt crisis in the early 2010s, the divergence in borrowing costs would make the kind of response seen during the pandemic or energy crisis less affordable in the future (see Chart 13).

Chart 11: Debt interest spending has risen in line with inflation



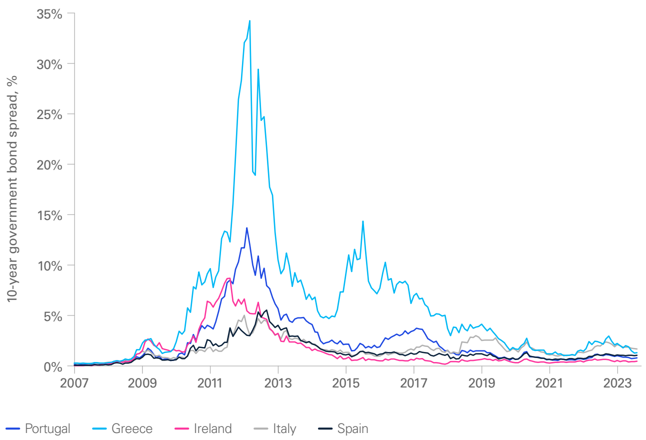
Source: OBR, Eurostat, OECD, ONS, KPMG analysis.
Inflation measure is HICP except the UK, which shows the RPI.

Chart 12: Central bank balance sheets



Source: Refinitiv Datastream, FRED, Bank of England, Riksbank, KPMG analysis.

Chart 13: European bond spreads over German Bunds



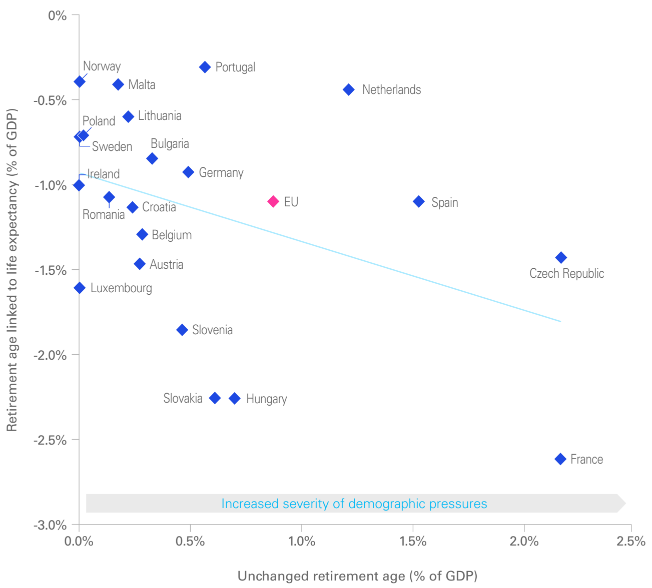
Source: Refinitiv Datastream, KPMG analysis.

The outlook for fiscal reforms

In the absence of long-term fiscal reforms, rising spending may end up unsustainable, with many governments facing tough choices against the backdrop of higher financing costs and rising debt. While the economic case for some reforms may be straightforward, these changes may require a broad consensus to be reached across all sections of society.

Linking retirement ages to rising longevity offers a potential path to mitigating some of the age-related spending. As Chart 14 shows, European economies could see improvements in their deficit position compared to a scenario where retirement age remains unchanged. Nonetheless, this policy alone would be insufficient to fully address challenges such as the escalating costs of healthcare provision. These may be alleviated by improving productivity in the healthcare sector.

Chart 14: Change in public pensions spending relative to baseline, 2019-70



Source: European Commission, KPMG analysis.

Using industrial policies could help mitigate the fiscal squeeze by driving faster economic growth, but care should be taken in the design of these policies due to a high risk of waste. Structural weakness in productivity growth, which emerged already in the early 1990s, has exacerbated many of the fiscal pressures faced by governments today. Addressing these weaknesses could help meet the spending challenges in the long term. Historical experience of state intervention in raising productivity has been patchy, however. While the UK did achieve some successes with industrial policy in the 1960s and 1970s – especially in the pharmaceutical sector – it was eventually abandoned due to the significant sums that were spent on subsidies for declining industries. In addition, the capacity of some countries to raise increase capital spending can be significantly lower than others, given their current levels of debt.

Despite the possible advancements outlined above, governments may still need to face a choice between higher taxes and lower spending, neither being a popular option. Approaching this trade-off, governments may do well by clearly setting the bounds of state intervention and public good provision and then separately address the question of how this should be funded. If tax increases are required, general principles point to broadening the tax base as much as possible, reducing complexity wherever possible, and aiming for equal treatment among different types of economic activity, as well as keeping the tax code abreast of economic and technological developments. Moreover, reducing debt levels should also be a key consideration, as it not only fosters fiscal responsibility but also provides the capacity for support that can be used in the event of future crises.

Contacts

Yael Selfin
Chief Economist
KPMG in the UK
yael.selfin@kpmg.co.uk

Dennis Tatarkov
Senior Economist
KPMG in the UK
dennis.tatarkov@kpmg.co.uk

Michal Stelmach
Senior Economist
KPMG in the UK
michal.stelmach@kpmg.co.uk

Moustafa Ali
Economist
KPMG in the UK
moustafa.ali@kpmg.co.uk

kpmg.com/uk/en/**macroeconomics**

CREATE | CRT151060 | September 2023