

INTERNATIONAL MONETARY FUND

# REGIONAL ECONOMIC OUTLOOK NOTES

## EUROPE

How Can Europe Pay for Things That It  
Cannot Afford?

**2025**  
**NOV**



# Contents

**How Can Europe Pay for Things That It Cannot Afford? ..... 2**

- Europe’s Greatest Financing Challenge Yet..... 2
- A Policy Package for Europe ..... 5
- Time to Act before the Problem Gets Much Worse ..... 10
- References ..... 13

**Box**

Box 1. Assumptions for Debt Simulations..... 11

**Figures**

- Figure 1.1. Spending Pressures on the Rise in Europe..... 2
- Figure 1.2. Europeans Support More Public Spending, but Not Higher Taxes or Deficits..... 3
- Figure 1.3. Public Debt Will Surge without Policy Action ..... 3
- Figure 1.4. Reference Debt Path Stays below 90 Percent GDP..... 4
- Figure 1.5. Reforms Can Contribute to Bringing Public Debt under Control..... 6
- Figure 1.6. More Reform Means Less Fiscal Consolidation ..... 7
- Figure 1.7. Public Financing Plays a Major Role in Some European Countries ..... 9

# How Can Europe Pay for Things That It Cannot Afford?<sup>1</sup>

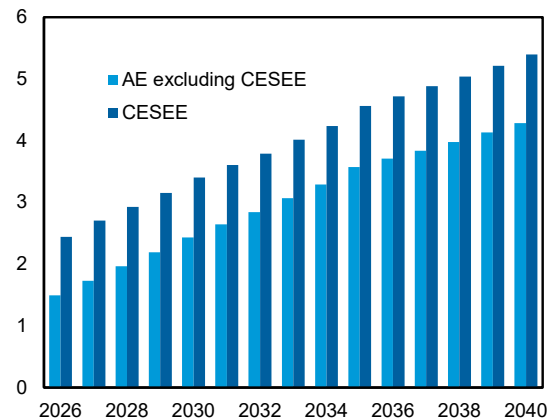
Europe is facing daunting fiscal pressures from new policy priorities (for example, defense, energy security), the escalating costs of population aging (pensions and health care), and a rising interest bill on already high debt. Without prompt policy action, public debt levels could more than double for the average European country in the next 15 years. This could drive up interest rates, slow down already sluggish economic growth, and undermine market confidence. Both structural reforms and fiscal consolidation will be necessary to deliver the difficult policy adjustment, with one-third achieved through a set of moderate reforms and two-thirds coming from consolidation. For high-debt countries, however, this policy package would likely be insufficient to meet the fiscal challenge, leaving no option other than a deeper rethink of the scope of public services and the social contract to fill the gap. Delaying policy action could be costly, as the fiscal position would deteriorate further, and make the task for policymakers even more challenging.

## Europe's Greatest Financing Challenge Yet

### European Governments Are Facing Significant New Spending Pressures

Most countries find themselves in a difficult position, with mounting spending needs and higher borrowing costs. The legacy of past shocks still looms large, with public debt having increased sharply during the pandemic and remaining high. The rising bond yields combined with elevated debt levels expose many countries to increasing interest bills that threaten to crowd out essential spending. Meanwhile, an aging population continues to drive up health and public pensions spending, while slowing labor supply risks dampening growth and revenue potential. Governments are also facing new demands, such as the recent commitment of the North Atlantic Treaty Organization to increase “core” defense spending to 3.5 percent of GDP, as well as the costs associated with energy security and digitalization. This Note considers a non-exhaustive set of spending pressures in the areas of health, pensions, defense, and climate that have been studied in a previous IMF analysis (Eble and others 2025). All together, these pressures are estimated to increase spending above current levels by about 4½ percentage points of GDP by 2040 on average in advanced economies (excluding Central, Eastern, and South-Eastern Europe (CESEE)) and 5½ percentage points of GDP in CESEE countries—an order of magnitude found in similar studies (Figure 1.1).<sup>2</sup> Although these estimates are subject to some uncertainty, particularly in the long term, and the relative importance of each spending category may differ, the overall size of the pressures is daunting, roughly equaling the size of today’s education budget in the

**Figure 1.1. Spending Pressures on the Rise in Europe**  
(Average increase in government spending relative to 2025; percent of GDP)



Sources: Eble and others 2025 and IMF staff calculations.  
Note: Spending pressures comprise health, pensions, defense, and climate. AE = advanced economy; CESEE = central, eastern, and south-eastern Europe.

<sup>1</sup> This Note was prepared by Mahika Gandhi, Giacomo Magistretti, Adil Mohommed, Mengxue Wang, and Jiae Yoo, under the guidance of Andrew Hodge and Luc Eyraud, and the supervision of Helge Berger. The authors would like to thank Alfred Kammer, Oya Celasun, Mary Goodman, Mark Horton, Kristina Kostial, Stephan Danninger, Petya Brooks, Yongquan Cao, Roberto Cardarelli, Diego Cerdeiro, Era Dabla Norris, Stephanie Eble, Mark Griffiths, Burcu Hacibedel, Gee Hee Hong, Faizaan Kisan, Claire Lazarus, Charlotte Lundgren, Moheb Malak, Zsuzsa Munkacsi, Malhar Nabar, Nico Pierri, Thomas Piontek, Alexander Pitt, Christine Richmond, Mauricio Soto, Joseph Thornton, Sebastian Weber, Rui Xu, and participants at an IMF European Department seminar for their helpful comments.

<sup>2</sup> See, for instance, Draghi (2024), Moshammer (2024), and Zettelmeyer and others (2023). The original IMF analysis of Eble and others (2025) estimated spending pressures over a longer horizon to be 5.75 percent of GDP by 2050 in advanced economies and 8 percent of GDP in CESEE countries, under existing policies. The estimates in this Note reflect recently announced changes in defense spending.

average European country. The 15-year horizon until 2040, which this Note focuses on, captures long-term fiscal pressures, while remaining relevant for today’s policymakers.

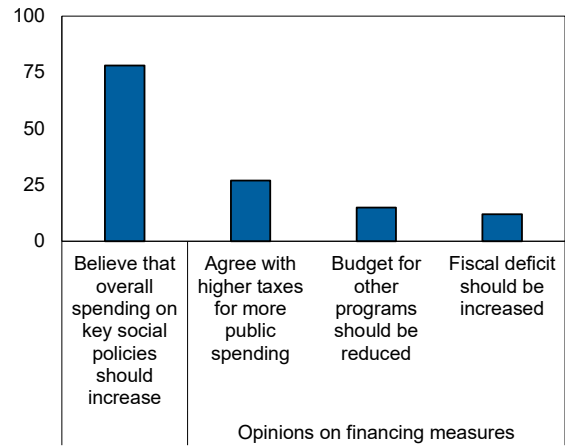
Europe now faces the thorny question of how to foot the bill. Borrowing more to pay for additional spending will likely be costly (as the era of very low interest rates is likely over) and potentially risky if a rapid surge in debt triggers adverse market reactions, which could be destabilizing for the financial system. On the other hand, raising taxes to fund higher spending will not be easy, with revenue levels currently close to historic highs in many large advanced economies and taxpayers recovering from the cost-of-living crisis. Policymakers also face a challenging political economy environment, as public trust in institutions is fraying. Voters expect governments to spend more to improve public services, while being reluctant to accept higher taxes and raising legitimate concerns about public debt levels (Figure 1.2). This will make it difficult to build political support for policies that shore up public finances.

### If Nothing Is Done, the Debt Trajectory Will Become Explosive, Hurting the Economy

If left unchecked, public debt will be on an unsustainable path. Under unchanged policy,<sup>3</sup> debt of the average European country would reach 130 percent of GDP by 2040—roughly doubling from today (Figure 1.3). This corresponds to 155 percent on a GDP-weighted average basis, as some of the larger European economies have the highest debt ratios. The simulation assumes that the primary deficit excluding spending pressures remains constant as a share of GDP, but the debt ratio would still increase because the additional spending related to aging, defense, and energy security adds to deficit levels, and this effect grows over time (see European Commission 2024, which takes a similar approach).

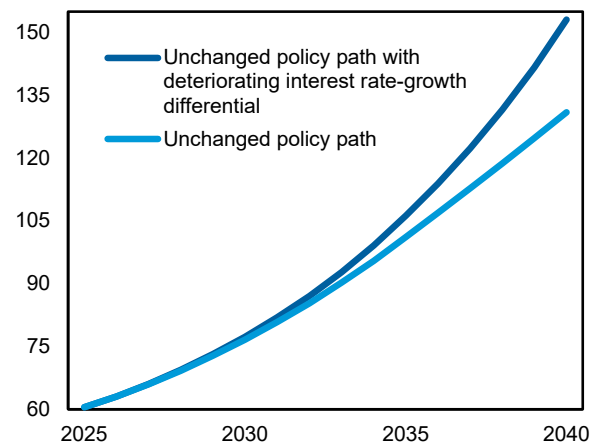
The debt trajectory could be even steeper, if the deteriorating fiscal position slows already anemic economic growth and raises borrowing costs further. The economic literature suggests that public debt can lower growth, particularly when it reaches high levels. This is because higher debt can lead to higher interest rates on government bonds, including by stoking inflation expectations, which tightens financing conditions and crowds out productive investment. It may lead to expectations of higher distortionary taxes in the future, weighing on investment plans. A weaker government balance sheet can also pose financial stability risks through banks’ exposure to sovereign debt. On average, studies find that a 10 percentage point increase in the debt ratio lowers annual real GDP growth by about 0.05–0.2 percentage points, once debt exceeds 75 percent of GDP (Salmon 2025). Taking this into account,

**Figure 1.2. Europeans Support More Public Spending, but Not Higher Taxes or Deficits**  
(Percent of respondents)



Sources: European Commission 2023; Special Eurobarometer 529, except for question on taxation, which is from European Commission 2025; Flash Eurobarometer 562.

**Figure 1.3. Public Debt Will Surge without Policy Action**  
(Simple average of European countries, percent of GDP)



Source: IMF staff calculations.

<sup>3</sup> The Note focuses on Europe’s long-term fiscal challenge *relative to a no-policy action counterfactual*. This stylized exercise is not based on IMF staff projections in the *World Economic Outlook*, nor does it reflect or assess countries’ medium-term adjustment and reform plans, including those submitted under the EU’s fiscal governance framework. All debt projections remain subject to considerable uncertainty, particularly given the potential for future shocks and the difficulty in predicting key parameters like the long-term interest rate-growth differential.

the increase in debt that would occur without policy action could slow annual GDP growth by around half a percentage point by 2040, which is considerable given potential growth of about 2 percent on average across European countries. In turn, lower growth and higher interest rates would worsen debt dynamics: the average debt ratio would reach about 150 percent of GDP by 2040 (or close to 190 percent GDP-weighted) (Figure 1.3).<sup>4</sup> The negative feedback loops between debt, growth, and borrowing costs would hurt living standards.

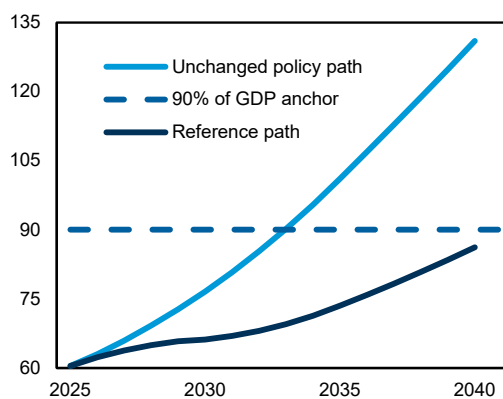
## Europe Needs an Ambitious Policy Response of Both Reforms and Fiscal Consolidation

It will take a comprehensive policy response to keep the fiscal situation under control and avoid further damage to growth. We consider policy packages based on three pillars. First, *reforms* that increase the government’s ability to handle the pressures by boosting economic growth (for example, product market, labor market and governance reforms, and a deeper European Union [EU] single market), tackle some spending pressures (for example, adjusting pension systems to mitigate the cost of aging and increased longevity), and alleviate the burden falling on national budgets (for example, through increased centralization of spending at the EU level, and catalyzation of private investment). Second, *medium-term fiscal consolidation* measures, both on the revenue and spending sides. This could include revenue mobilization, through tax policy reform and improved revenue administration, as well as stricter spending prioritization and improvements in spending efficiency. Third, a *rethink of the role of government* may be unavoidable in some countries: if reforms and medium-term consolidation are insufficient, then more radical fiscal measures could include reassessing the scope of public services and other government functions, potentially affecting the social contract.<sup>5</sup>

The policy response should be ambitious enough to accommodate the new spending priorities and contain the debt trajectory as pressures intensify. To calibrate the size of the policy response, it is important to define a debt trajectory that is sustainable. There are, of course, many possible sustainable debt paths, so the “reference” path is chosen to satisfy two criteria (Figure 1.4):

- **The reference debt path is “anchored” at a prudent level to ensure sustainability.** The principal consideration when setting medium- to long-term debt anchors (targets or ceilings) is managing the risk of debt spiraling out of control. The IMF has developed a range of tools to calibrate these anchors. The general approach is to set the anchor at a level that is sufficiently low so that, even if adverse shocks materialize, debt would remain in safe territory (Acalin and others 2025). The calibration is conducted in two steps. The first step consists of estimating the maximum debt limit (cliff) that should not be exceeded without endangering fiscal sustainability. The second step sets the debt anchor below the cliff to provide a buffer, so that if adverse shocks occur, debt would remain below the cliff with high probability. We apply this two-step approach to a sample of European economies and find a debt anchor of approximately 90 percent of GDP on

**Figure 1.4. Reference Debt Path Stays below 90 Percent of GDP**  
(Percent of GDP, simple average of European countries)



Source: IMF staff calculations.

<sup>4</sup> This assumes that the interest rate-GDP growth differential increases by 4 basis points for every one percentage point increase in the debt-to-GDP ratio above 75 percent of GDP (Checherita-Westphal and Domingues Semearo 2020).

<sup>5</sup> We recognize there may be some overlap among these three pillars, and the classification of individual measures involves a degree of judgment. In this Note, “reforms” are defined as policies that alleviate long-term spending pressures (including fiscal structural reforms like pension reforms), while “fiscal consolidation” is assumed to have a medium-term orientation and fall within the existing scope of public services and taxation levels. “Changes to the role of government” entail more fundamental measures that (1) involve a shift in the social contract by changing substantially the agreed perimeter of government activities and services, (2) are sizable, and (3) have a longer-term horizon for implementation (possibly beyond five years).

average.<sup>6</sup> This anchor is notably higher than the 60 percent of GDP threshold institutionally embedded in the EU’s Stability and Growth Pact since the 1990s, which remains legally binding. The difference reflects an increased debt-carrying capacity in many countries over the past three decades because of factors such as deeper financial markets, larger government revenue bases, and lower borrowing costs (even considering recent increases). For illustrative purposes in this Note, we apply a single anchor across all countries, though in practice debt anchors are country-specific and, in some cases, should be lower than 90 percent of GDP, as discussed in the next bullet.

- **Debt trajectories are tailored to the different needs of high- and low-debt countries.** In this Note’s stylized exercise, the reference fiscal trajectory to be targeted by policymakers would see debt remain below 90 percent of GDP on average across European countries from now until 2040. However, this would not mean that every country follows the same path.<sup>7</sup> *Countries with debt currently above 90 percent of GDP* are assumed to target debt stabilization over the next five years and put it on a declining path in the subsequent decade, broadly in the spirit of current EU practices. *Countries with debt currently below 90 percent of GDP* are assumed to keep fiscal policy “unchanged” (unless the debt drift because of spending pressures eventually leads to a breach of the 90 percent threshold); this means that these countries accommodate the long-term spending pressures, without otherwise changing their fiscal policy. This assumption is, of course, simplistic and, though it is useful for aggregate analysis, does not reflect country-specific circumstances. Several countries need to rebuild fiscal buffers given their financing constraints, exposure to shocks, and other vulnerabilities (for example, Hungary, Romania); others may have fiscal space for spending priorities beyond the pressures that are considered in this Note, like infrastructure investment (for example, Germany).

## A Policy Package for Europe

---

### Reforms Are Critical to Alleviate the Financing Challenge

There are a wide range of reforms at the national and EU levels that have fiscal benefits. Based on past IMF recommendations, we consider a set of growth-enhancing and fiscal reforms (Box 1 explains how these reforms are incorporated in the simulations):<sup>8</sup>

- **Domestic growth-enhancing reforms** that incentivize work and hiring, streamline business regulation, strengthen governance, and enhance the functioning of credit and capital markets. These structural reforms could boost growth and raise the level of output over the medium term by about 5 percent in European advanced economies and 7 percent in CESEE countries, based on the assumption that these reforms close half the gap to the efficiency frontier (Budina and others 2025). The boost to output from these reforms would expand the tax base and lift revenue collection.
- **Further deepening the single market** by lowering regulatory fragmentation, advancing the capital markets union, enhancing labor mobility within the EU, and further integrating the EU energy market, could help address Europe’s productivity challenge. The potential benefits of completing the single market are large. Just

<sup>6</sup> Country-specific *debt limits* are identified with the model-based approach of Cao and others (2025), under baseline parameters, which yields an average limit of about 105 percent of GDP across European countries. Collard and others (2023) report debt limits for euro area countries, using a different structural modeling approach, and find a similar average debt limit under some calibrations. Broadly consistent results are also obtained from a simple benchmark, dividing the maximum feasible primary balance by the interest rate-growth differential under stress (relying on data over 2000–25). *Buffers below the debt limit* are calculated with the tools of Eyraud and others (2018) and also the debt-at-risk framework of Furceri and others (2025), producing an estimated average buffer of about 15 percent of GDP. The resulting 90 percent of GDP *debt anchor* is used as an assumption in our stylized scenarios and should not be interpreted as an IMF policy recommendation. This threshold has been recently discussed in the context of the EU fiscal framework (see Pench 2025; Steinbach and Zettelmeyer 2025). There are significant uncertainties around these estimates.

<sup>7</sup> These assumptions are used for illustrative purposes and are not intended to suggest that countries deviate from their existing fiscal rules.

<sup>8</sup> The set of reforms has been selected based on their macroeconomic and fiscal relevance, as well as the availability of studies quantifying their effects. The list is, however, not exhaustive, and, for instance, does not include policies that affect demographics (see further discussion in Clements and others 2015), or financial sector reforms (see IMF 2025). Furthermore, there are large uncertainties about the size and timing of the reforms’ impact, including on growth, interest rates, and possible compensatory measures to offset adverse distributional effects.

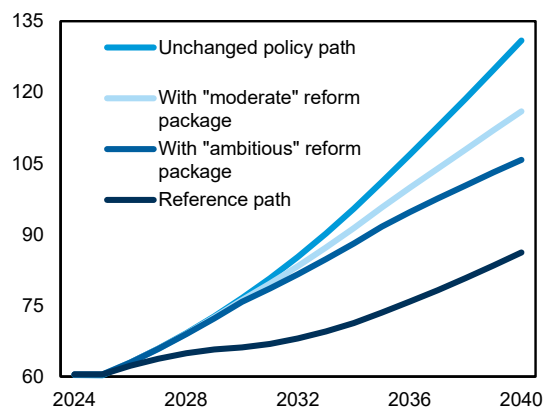
implementing a select set of first-step reforms would increase the level of output in EU countries by 3 percent over 10 years (Arnold and others 2025).

- **Centralizing the provision of European public goods**, with a doubling of the EU budget for innovation, defense, and energy, financed through joint borrowing, could shift some responsibilities to the central level and exploit efficiency gains, thus generating some savings for national budgets (Busse and others 2025).
- **Public pension reforms** aim to stabilize pension spending as a share of GDP over the long term through increasing contributions, raising the retirement age, and lowering benefits (IMF 2011; Fouejieu and others 2021). These reforms have been prevalent in Europe where pay-as-you-go systems face significant sustainability challenges. They are recommended in many recent IMF country reports (for example, Austria, Belgium, Bulgaria, Estonia, France, Latvia, Luxembourg, Poland, Slovenia, the United Kingdom).
- **Catalyzing private investment** through derisking instruments (for example, public subsidies, guarantees) can reduce pressure on the public sector by unlocking private finance in specific areas subject to market failures and with large social benefits (Ari and others 2020). This strategy has been widely discussed in the context of the transition to a low-carbon and climate-resilient economy. It may require relying on and perhaps scaling up the operations of national promotional institutions (Amico Roxas and others 2025).

Reforms can significantly reduce the strain on national budgets, with a “moderate” effort delivering one-third of the required adjustment for the average European country. If all reforms described earlier are implemented over the next five years and begin to pay dividends over 2030–40 (an “ambitious” package), then this would bring the debt trajectory of the average country about half of the way

toward the reference trajectory, lowering the 2040 debt ratio from 130 percent of GDP to about 105 percent of GDP (Figure 1.5). If the package of reforms was only half as ambitious (a “moderate” package), then the fiscal impact would be smaller, but it would still bring the average European country one-third of the way toward the reference debt trajectory, so that debt in 2040 would be about 115 percent of GDP. In terms of contributions, we find that the largest impact comes from pension reforms and growth-enhancing domestic reforms, while the considered EU-level reforms (first-step single market actions and EU budget) and catalyzation of private investment play a more complementary role.<sup>9</sup> In the remainder of the Note, the fiscal adjustment needs are calibrated assuming that countries adopt the “moderate” package of reforms.

**Figure 1.5. Reforms Can Contribute to Bringing Public Debt under Control**  
(Percent of GDP, simple average of European countries)



Source: IMF staff calculations.

### Even with Reforms, There Will Remain a Gap to Fill through Fiscal Consolidation

Medium-term fiscal consolidation is needed in most countries, since reforms alone will be insufficient to meet the rising spending needs. The assumption is that consolidation would occur over the next five years to build buffers that can absorb future spending pressures. The simulations show that consolidation is needed in close to three-quarters of European countries to achieve the reference debt path, even after implementing the “moderate” package of reforms. In these countries, the required adjustment would, on average, entail an annual improvement in the cyclically adjusted primary balance of about ¾ percent of GDP per year over the assumed five-year consolidation

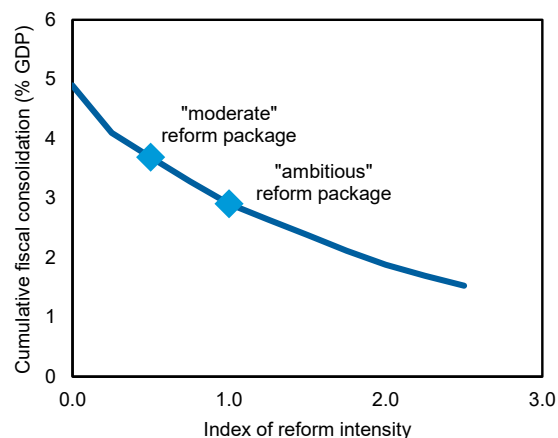
<sup>9</sup> Another way of assessing the contributions is to observe that growth-enhancing reforms (domestic + single market), as defined earlier, account for around two-thirds of the impact of the reform package.

period (cumulatively slightly above 3½ percent of GDP). This estimate may understate the true adjustment needs, since it relies on conservative assumptions regarding the interest-growth differential and a pragmatic debt anchor.<sup>10</sup>

There is a lot of heterogeneity in the region in terms of consolidation needs. Although 3½ percent of GDP is the average, the needs estimated in the illustrative simulation differ substantially across countries. Many smaller advanced economies have either no adjustment needs or modest ones of less than 2 percent of GDP cumulatively. CESEE countries tend to require more consolidation—in the 2–5 percent of GDP range.<sup>11</sup> Several large advanced economies are found to have among the biggest consolidation needs, where the cyclically adjusted primary balance would need to improve by more than 5 percent of GDP over five years to comply with the anchor in our stylized exercise.<sup>12</sup>

Crucially, the size of required fiscal consolidation will depend on the ambition of reforms. More ambitious reforms have a larger fiscal impact because of the additional increase in GDP, which boosts revenue, and greater reduction in spending pressures—together, this lowers the amount of fiscal consolidation required to achieve the reference debt path. Figure 1.6 shows different combinations of reform ambition and consolidation size in the average European country that potentially achieve the same reference debt path. Reform ambition is characterized by the “intensity index” on the horizontal axis which is normalized to one when reforms consist of the “ambitious” package. If reforms are bigger than in the “ambitious” package, then the index can exceed one. Our simulations show that increasing the intensity from “moderate” to “ambitious” reduces the cumulative consolidation needs for the average European country by close to 1 percent of GDP (from 3.7 percent of GDP to 2.9 percent of GDP). In practice, for the vast majority of countries, a combination of reforms and consolidation will be needed. This combination is ultimately a decision for each individual country. Both policies require political effort, and relevant considerations include social preferences, relative feasibility (for example, how much low-hanging fruits remain), and political acceptability, all of which can differ across countries and over time. Moreover, policymakers should remain mindful that the growth and fiscal impact of reforms tend to develop over time, and adverse shocks can occur before their full benefits are realized. This suggests that neglecting fiscal consolidation can be risky.

**Figure 1.6. More Reform Means Less Fiscal Consolidation**  
(Simple average of European countries)



Source: IMF staff calculations.

Note: Fiscal consolidation is measured on a cumulative basis over 2026–30. The isoquant is computed using the constant sample of countries that need to adjust under the “moderate” reforms. No multiplier is assumed. Along the horizontal axis, more “intense” reforms have a progressively larger impact on growth and spending pressures. Index = 1 for “ambitious” reforms.

The amount of required fiscal consolidation will also depend on how growth-friendly the fiscal measures are. The previous estimates of adjustment needs do not take full account of the potential impact of consolidation measures on economic performance.<sup>13</sup> If fiscal adjustment causes the growth outlook to worsen significantly, this would make debt stabilization more complicated. An exercise accounting for this mechanism through fiscal multipliers shows that the necessary adjustment would be larger, by about ¼ percent of GDP per year, bringing the cumulative fiscal consolidation close to 5 percent of GDP for the average country (compared to the previous estimate of 3½ percent

<sup>10</sup> An alternative estimation based on the 60 percent of GDP debt anchor (instead of 90) and a rising interest rate-growth differential indicates that consolidation needs for the average European country would be higher, at about 6 percent of GDP, after implementing “moderate” reforms.

<sup>11</sup> Bigger consolidation needs in CESEE countries relative to small advanced economies reflect larger spending pressures and a weaker initial primary balance on average.

<sup>12</sup> These simulation results do not always align with recommendations in IMF country reports, which generally have a medium-term focus, often based on the European Union fiscal framework, and can take into account announced policy plans.

<sup>13</sup> The *World Economic Outlook* GDP forecast that is used in the scenarios already reflects the effect of any fiscal tightening projected over the next five years; thus, even the no-multiplier simulations implicitly incorporate some effect of fiscal policy on output.



of GDP).<sup>14</sup> On the other hand, if fiscal reforms are implemented in a growth-friendly way, for instance, by enhancing spending efficiency, this may ease the necessary policy adjustment (October 2025 *Fiscal Monitor*, chapter 2).

When selecting consolidation measures, the priority should be to enhance efficiency on both the spending and the revenue sides. In general, IMF country reports recommend a balanced approach to consolidation in Europe, combining both revenue and expenditure measures, while protecting growth and shielding the vulnerable. On the expenditure side, enhancing efficiency, including in health care and public investment management, can yield substantial savings, while curbing current spending (for example, wage bill, social spending) remains a key priority in most countries. On the revenue side, there is room to strengthen revenue administration (especially to address tax evasion) and broaden the tax base by eliminating exemptions and loopholes. Across Europe, IMF reports recommend increasing carbon pricing and environmental taxes along with phasing out environmentally harmful subsidies to support climate goals in a fiscally sustainable manner (for example, Finland, France, Greece, Latvia). However, the same recipe does not suit all countries. In CESEE countries, there is greater scope for boosting revenue from still relatively low levels—including by raising personal income tax rates and increasing progressivity (for example, Bulgaria, Hungary), while also lifting corporate income tax rates (Hungary), and enhancing property taxation (Albania, Poland, Romania). In many advanced economies, consolidation should be more expenditure-based (Austria, Belgium, France), but scope for tax reform tends to be narrower, mostly on property taxes (Austria, Luxembourg, Sweden).

## Some Countries May Have No Choice but to Rethink the Government’s Role in Some Areas

For countries that already have high levels of debt, reforms and conventional fiscal consolidation measures likely will not be enough to align spending needs with available resources. For around one-quarter of the European countries, consolidation of above one percent per year for five years would be required to achieve the reference debt path, after implementing the “moderate” package of reforms. This scale of consolidation surpasses what has been feasible in the past: in the past three decades, the median consolidation episode in European countries has delivered a cyclically adjusted primary balance improvement of about 1 percentage point of GDP per year for only three to four years. Therefore, meeting the fiscal challenge will very likely require going beyond traditional consolidation strategies.

In these countries, a discussion on the scope and sustainability of the “European model” seems unavoidable. Although Europe does not share a single social and economic model, there are some recurring features, including relatively large governments, generous and comprehensive welfare programs with extensive social protection and redistribution, universal health care, and free or very affordable education. These features have played a critical role in supporting economic growth, social cohesion, and long-term stability in the post-World War II period. The European model now faces a sustainability challenge, with governments having to make tough decisions between competing needs. Addressing one key priority might have to come at the expense of others. A useful approach to achieve this prioritization can be to differentiate between basic and premium services across sectors such as health, education, pensions, and social protection. The package of basic services could remain publicly funded and free at the point of use, but premium services may need to be financed privately by individuals, especially those on higher incomes. In this context, systematic expenditure reviews can guide country-specific strategies by examining the government’s role and the cost-effectiveness of policy interventions, thereby supporting long-term state reform (Doherty and Sayegh 2022).

If the European model needs to be rethought, difficult choices may be required on both the tax and spending sides. Lessons can be drawn from international experience, with several countries having made significant realignments of government activities in the past (for example, Canada and Sweden in the 1990s, and the Baltic States after the

---

<sup>14</sup> About 5 percent of GDP is the average cumulative adjustment *within the sample of countries with positive adjustment needs*. The exercise assumes an aggregate fiscal multiplier of 1, on impact, which decays linearly to zero over five years.

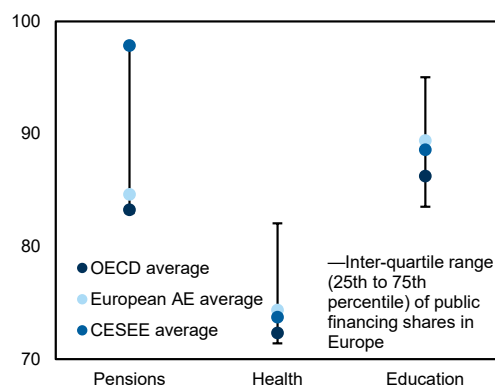
global financial crisis).<sup>15</sup> The recent IMF country reports have offered some recommendations to European countries that go in this direction:

- **Some European countries have room for a significant reduction in the provision of public goods and services.** This could include selling or closing loss-making state-owned enterprises (for example, Moldova, Serbia, Ukraine), better targeting welfare spending and enhancing the efficiency of social benefits (Belgium, France, Norway), substantially cutting energy subsidies (Germany, the Slovak Republic, Türkiye), and rationalizing the public wage bill (Austria, Croatia). Higher-income users could also face new or higher charges for access to publicly provided services, particularly health care (France, the Netherlands, the United Kingdom).
- **In some cases, tax measures may lead to a notable shift in the “socially agreed” scope of the state.** For instance, the Baltic countries have experienced tensions between retaining a competitive tax environment and moving toward a broader provision of public services and a stronger social safety net; options to support revenue mobilization should be explored to support rising spending needs.

A change in the perimeter of government activities can enhance efficiency, while protecting the vulnerable. While the size of the public sector is a matter of national preference that can differ across countries, increasing private participation can have economic benefits. For example, it could increase efficiency, quality, and variety of some services, by tapping private sector expertise, such as in the management of pensions. Furthermore, adjusting the role of the public sector is likely to affect access to services, income distribution, and social cohesion; thus, it should be implemented in a manner that is fair and takes account of distributional consequences. For instance, means-testing some benefits and introducing user charges for those on higher incomes could reallocate some costs to the private sector, while ensuring that lower-income households continue to access services free at the point of use or are, at least, protected from large out-of-pocket expenses. Similarly, deep tax reforms can be designed in a progressive way to make the tax system fairer for all.

These adjustments to the role of government are necessary to realign spending with available resources. In some European countries, the public sector is currently playing a larger financing role in certain sectors, such as health care, education, pensions, and infrastructure investment, than is common in many other OECD countries (Figure 1.7). Some large European advanced economies (for example, France, Germany) and the Nordic countries tend to have higher public financing shares for health and education than the OECD average. The public sector also plays a markedly large role in advanced economies’ pension systems (Italy, Portugal, Spain). The savings created by rebalancing the public-private split are potentially significant, as illustrated by a simple exercise: for countries with public financing shares above the OECD average in one or more of health, education, pensions, infrastructure, and climate,<sup>16</sup> aligning with the OECD average could generate fiscal savings of close to 3 percent of GDP per year for the average European country.

**Figure 1.7. Public Financing Plays a Major Role in Some European Countries**  
(Public financing in percentage of total: European countries)



Sources: OECD; UNESCO; WHO; World Bank; and IMF staff calculations.  
Note: AE = advanced economy; CESEE = central, eastern, and south-eastern Europe; OECD = Organisation for Economic Co-operation and Development.

Effective communication and consultation are critical to implementing reforms that alter the social contract and may face strong opposition. Redefining the government’s roles is a highly sensitive and legally complex process, given

<sup>15</sup> See Tsibouris and others (2006), Kumar, Leigh, and Plekhanov (2007), and Okwuokei (2014) for a review of episodes.

<sup>16</sup> The choice of spending areas used for this illustrative exercise is dictated by data availability on the public-private financing split.

its potential impact on public services and benefits. Incremental steps are most likely to be feasible and gain public support. Governments should clearly explain the rationale behind the reforms, identify the spending pressures they address, and reset public expectations. Confidence in new arrangements can be strengthened through communication campaigns that emphasize economic sustainability and fairness (for example, Australia in the 1980s), as well as robust oversight of private providers replacing public services (with safeguards to ensure that private sector involvement does not compromise service quality or accessibility). Active consultation is vital, by involving the public directly in discussions about proposed changes to build trust and understanding (April 2025 *Fiscal Monitor*, chapter 2).

## Time to Act before the Problem Gets Much Worse

---

Failing to act promptly will only exacerbate the problem. The longer that reforms and consolidation are delayed, the more spending pressures will worsen the fiscal position, causing debt to accumulate faster and borrowing costs to rise. This will raise future adjustment needs and make it more likely that the market would eventually force the adjustment that could be disorderly and not reflective of public preferences. To illustrate this point, we replicate the previous results but delay the implementation of the policy package (“moderate” reforms and consolidation) by five years. This would raise the average amount of medium-term consolidation required from  $\frac{3}{4}$  percent of GDP per year to over 1 percent of GDP per year, with tough decisions about the perimeter of the state becoming unavoidable even for the average country.

The “muddling-through” approach that many countries have adopted so far is reaching its limits, and a more strategic response seems essential to respond to rising spending pressures. Reforms, fiscal consolidation, and more fundamental changes to the role of government can all be politically challenging and face public resistance. Making changes in a piecemeal way, or tinkering at the margins, is likely to be inadequate given the necessary adjustment, while creating further distortions, confusing the public, and causing reform fatigue. Spending could become increasingly skewed to particular groups—notably, elderly individuals—at the expense of others, and services would deteriorate with budget pressures. A better approach is to pursue a comprehensive and decisive policy response, which will ensure that the public services most valued by the population are protected for generations to come and financed in a sustainable way.

To put Europe on a sustainable path to a more stable and prosperous future, any policy package should reflect key aspects of this more strategic approach:

- **No silver bullet.** A multipronged strategy is best, leveraging all policy tools at national and regional levels. Although some measures (for example, mobilizing private finance; joint EU financing) are sometimes hailed as game changers, this analysis suggests that no one measure can close the financing gap alone.
- **Combining reforms and fiscal policy.** Both are necessary in most European countries, and both entail adjustments that could be politically costly, requiring the government to carefully balance and select the best combination of policies. The greater the progress on reforms, the less onerous will be the task of fiscal consolidation.
- **Difficult choices regarding the role of government.** Even with bold reforms and fiscal discipline, financing gaps are likely to persist, especially in high-debt countries. This will leave little choice but to adapt socio-economic models and make deep reprioritization decisions. Spending reviews can be instrumental in identifying space for new policy priorities.
- **Extensive public consultation.** It will be important to initiate a public discussion about the scale of the problem, the damaging consequences of inaction, and the composition of the proposed policy package, to illustrate how the tough decisions ahead will pay off and put public finances on a more sustainable footing, with lasting

economic and social benefits for the population. In order to better inform the public, credible long-term fiscal forecasts and strategic plans should be produced and published regularly.

### Box 1. Assumptions for Debt Simulations

The **reference debt path** is calibrated using the following simulations for each country over 2026–40:

- The **starting point for the primary balance** is the country’s average cyclically adjusted primary balance during 2023–25 (rather than 2025) to smooth cyclical and one-off factors.
- Each year, **the primary balance evolves because of four factors**: (1) *Annual adjustment needs*. For countries with debt initially below 90 percent of GDP at the end of 2025, no adjustment is required, unless needed to keep debt below 90 percent of GDP during 2026–40. Countries with debt above 90 percent of GDP in 2025 are assumed to consolidate in a linear way over the first five years in order to just stabilize debt by the fifth year, and put it on a continuously declining path for the next 10 years (while not falling below 90 percent of GDP). (2) *Spending pressures* during 2026–40, in the areas of health, pensions, defense, and climate, based on estimates in Eble and others (2025). Defense pressures have been updated to reflect the commitment of the North Atlantic Treaty Organization to increase core spending to 3.5 percent of GDP by 2035. These pressures cause the initial primary balance to deteriorate over time, implying additional spending of approximately 4½ percentage points of GDP by 2040 on average in advanced economies (excluding CESEE) and 5½ percentage points of GDP in CESEE countries. (3) A *cyclical component* during 2026–30 is based on *World Economic Outlook* projections. (4) *Stock-flow adjustments*, based on the country-specific medians over time during 2001–24 (0.7 percent of GDP per year, on average across countries).
- **Macroeconomic assumptions** for GDP growth and the effective interest rate on government debt in each country are based on *World Economic Outlook* projections until 2030. From 2031 to 2040, GDP growth is assumed to remain at its 2030 pace, while the effective interest rate is adjusted gradually to align with yields on each country’s 10-year bonds during 2023–25, where available, to reflect recent borrowing costs. The average interest rate-growth differential is close to –1 percent in the sample by 2040.

The impact of selected **reforms** is incorporated in the simulations by making the following assumptions. Although fiscal consolidation occurs over five years (2026–30), reforms are implemented gradually and pay off over the longer term (during 2031–40). The effect of growth-enhancing reforms on the fiscal position is calibrated using empirically estimated elasticities, implicitly assuming that not all additional revenues are saved (Heimberger 2023). The set of reforms included in the simulations comprises the following:

- **Domestic reforms**. It is assumed that the three structural reforms with the largest payoff identified by Budina and others (2025) are implemented in a sequenced way over the next 15 years, beginning to affect growth after 2030. The reforms are to (1) business regulation, such as planning reform, cutting red tape, and easier firm entry; (2) labor markets, focusing on training, loosening employment protection, and lowering labor tax wedges; and (3) governance (control of corruption). The impact varies by country and cumulatively increases the level of GDP by 4¾ percent on average across European countries by 2040.
- **Single market**. Reforms that strengthen the single market are assumed to be implemented over the next five years and impact growth during 2031–40, lifting the level of GDP in EU countries by 3 percent by 2040, as in Arnold and others (2025).
- **Centralization**. The simulations assume a doubling of the EU budget allocation to defense and climate, financed by joint EU borrowing, as proposed by Busse and others (2025). This eases fiscal pressures on national budgets, delivers efficiency gains, and yields interest savings of 0.47 percent of GDP for EU countries during 2030–40.
- **Catalyzation**. Policy banks in all countries are assumed to increase investment by 0.3 percent of GDP (calibrated on the difference between BPI-France and KfW-Germany), which would crowd in additional private investment, so that, with a typical leverage ratio of 1.8, spending pressures are estimated to be reduced by 0.25 percent of GDP per year in all countries during 2031–40 on a net basis.
- **Pensions**. Reforms to public pensions are assumed to gradually eliminate all spending pressures from pensions by 2030 (IMF 2011; Fouejieu and others 2021).

## References

---

Acalin, Julien, Virginia Alonso-Albarran, Clara Arroyo, Waikai Raphael Lam, Leonardo Martinez, Anh D. M. Nguyen, Francisco Roch, Galen Sher, and Alexandra Solovyeva. 2025. “Fiscal Guardrails against High Debt and Looming Spending Pressures.” IMF Staff Discussion Notes 2025/004, International Monetary Fund, Washington DC.

Amico Roxas, Salvatore, Matteo Cuda, Marina Kisvarday, Filippo Munisteri, and Francesco Scotti. 2025. “The Role of National Promotional Banks and Institutions (NBPIs) in the Implementation of UN Agenda 2030 in Europe.” European Economy - Discussion Papers No 220 from Directorate General Economic and Financial Affairs (DG ECFIN), European Commission.

Ari, Anil, David Bartolini, Vizhdan Boranova, Gabriel Di Bella, Kamil Dybczak, Keiko Honjo, Raju Huidrom, Andreas Jobst, Nemanja Jovanovic, Ezgi Ozturk, Laura Papi, Sergio Sola, Michelle Stone, and Petia Topalova. 2020. “Infrastructure in Central, Eastern, and Southeastern Europe: Benchmarking, Macroeconomic Impact, and Policy Issues.” IMF Departmental Papers 2020/011, International Monetary Fund, Washington DC.

Arnold, Nathaniel, Allan Dizioli, Alexandra Fotiou, Jan Frie, Burcu Hacibedel, Tara Iyer, Huidan Lin, Malhar Nabar, Hui Tong, and Frederik Toscani. 2025. “Lifting Binding Constraints on Growth in Europe: Actionable Priorities to Deepen the Single Market.” Working Paper WP/25/113, International Monetary Fund, Washington DC.

Budina, Nina, Oyun Adilbish, Diego Cerdeiro, Romain Duval, Balázs Égert, Dmitriy Kovtun, Anh Thi Ngoc Nguyen, Augustus Panton, and Catalina Michelle Tejada. 2025. “Europe’s National Level Structural Reform Priorities.” Working Paper WP/25/104, International Monetary Fund, Washington DC.

Busse, Matthias, Huidan Lin, Malhar Nabar, and Jiae Yoo. 2025. “Making the EU’s Multiannual Financial Framework Fit for Purpose.” IMF Working Paper WP/25/114, International Monetary Fund, Washington DC.

Cao, Yongquan, Wei Jiang, W. Raphael Lam, and Neng Wang. 2025. “Maximum Sustainable Debt across Countries: An Assessment Using P-Theory.” IMF Working Papers (forthcoming).

Checherita-Westphal, Cristina, and João Domingues Semeano. 2020. “Interest Rate-Growth Differentials on Government Debt: An Empirical Investigation for the Euro Area.” Working Paper Series 2486, European Central Bank.

Clements, Ben, Kamil Dybczak, Vitor Gaspar, Sanjeev Gupta, and Mauricio Soto. 2015. “The Fiscal Consequences of Shrinking Populations.” IMF Staff Discussion Notes, 2015/021, International Monetary Fund, Washington DC.

Collard, Fabrice, Michel Habib, Ugo Panizza, and Jean-Charles Rochet. 2023. “Assessing Debt Sustainability in the Euro Area.” VoxEU Column.

Doherty, Laura, and Amanda Sayegh. 2022. “How to Design and Institutionalize Spending Reviews.” IMF How to Notes 2022/004, International Monetary Fund, Washington DC.

Draghi, Mario. 2024. “The Future of European Competitiveness: A Competitiveness Strategy for Europe.” European Commission.

Eble, Stephanie, Irina Bunda, Oyun Erdene Adilbish, Nina Budina, Gee Hee Hong, Moheb Malak, Sabiha Mohona, Alla Myrvoda, Alexander Pitt, and Keyra Primus. 2025. “Long-Term Spending Pressures in Europe.” IMF European Departmental Paper.

European Commission. 2023. “Special Eurobarometer 529, May-June 2022, Fairness, Inequality and Intergenerational Mobility”. European Commission, Joint Research Centre and Directorate-General for Communication, Luxembourg, February 2023.

European Commission. 2024. “Debt Sustainability Monitor 2023.” Institutional Paper 271, European Commission, Directorate-General for Economic and Financial Affairs, Luxembourg, March 2024.

European Commission. 2025. “Flash Eurobarometer 562, Citizens’ Attitudes Towards Taxation, Data Annex”. European Commission, Directorate-General for Taxation and Customs Union and the Directorate-General for Communication, Luxembourg, April 2025.

Eyraud, Luc, Anja Baum, Andrew Hodge, Mariusz Jarmuzek, H. Elif Ture, Samba Mbaye, and Young-Bae Kim. 2018. “How to Calibrate Fiscal Rules: A Primer.” IMF How To Notes, International Monetary Fund, Washington DC.

Fouejieu, Armand, Alvar Kangur, Samuel Martinez, and Mauricio Soto. 2021. “Pension Reforms in Europe: How Far Have We Come and Gone?” IMF Departmental Paper 2021/016, International Monetary Fund, Washington DC.

Furceri, Davide, Domenico Giannone, Faizaan Kisan, Waikie R. Lam, and Hongchi Li. 2025. “Debt-at-Risk.” IMF Working Papers No. 2025/086, International Monetary Fund, Washington DC.

Heimberger, Philipp. 2023. “The Cyclical Behaviour of Fiscal Policy: A Meta-Analysis.” *Economic Modelling* 123: 106259.

International Monetary Fund (IMF). 2011. “The Challenge of Public Pension Reform in Advanced and Emerging Economies.” IMF Policy Paper, International Monetary Fund, Washington, DC.

International Monetary Fund (IMF). 2025. “Euro Area Policies: Financial System Stability Assessment.” IMF Staff Country Reports, International Monetary Fund, Washington, DC.

Kumar, Manmohan, Daniel Leigh, and Alexander Plekhanov. 2007. “Fiscal Adjustments: Determinants and Macroeconomic Consequences.” IMF Working Paper WP/07/178, International Monetary Fund, Washington, DC.

Moshhammer, Edmund. 2024. “Longer-Term Challenges for Fiscal Policy in the Euro Area.” *Economic Bulletin Articles*, 4.

Okwuokei, Joel Chiedu. 2014. “Fiscal Consolidation: Country Experiences and Lessons from the Empirical Literature.” In *Caribbean Renewal: Tackling Fiscal and Debt Challenges*, edited by Charles Amo Yartey and Therese Turner-Jones. International Monetary Fund, Washington, DC.

Pench, Lucio. 2025. “European Union Fiscal Rules: It’s Already Time to Reform the Reform.” *Analysis*, 15 July, Bruegel.

Salmon, Jack. 2025. “The Impact of Public Debt on Economic Growth: What the Empirical Literature Tells Us.” Mercatus Center Policy Brief.

Steinbach, Armin, and Jeromin Zettelmeyer. 2025. “Germany’s Fiscal Rules Dilemma.” *Analysis*, 24 April, Bruegel.

Tsibouris, George, Mark Horton, Mark Flanagan, and Wojciech Maliszewski, 2006. “Experience with Large Fiscal Adjustments.” IMF Occasional Papers 2006/003. <https://ideas.repec.org/p/imf/imfops/2006-003.html>

Zettelmeyer, Jeromin, Grégory Claeys, Zsolt Darvas, Lennard Welslau, and Stavros Zenios. 2023. "The Longer-Term Fiscal Challenges Facing the European Union." Policy Brief 10/2023, Bruegel.  
<https://www.bruegel.org/system/files/2023-05/PB%2010%202023.pdf>