Public Sector Practice

The great balancing act: Managing the coming $30 trillion deficit while restoring economic growth

As they continue to grapple with a global pandemic, governments will need to manage deficits and debt-payment plans while finding the best ways to support economic recovery.

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The dual imperative of our time is to save lives and safeguard livelihoods—and governments around the world are pulling out all the stops to do so. The resulting ramp-up of relief and stimulus spending to unprecedented levels has occurred just as tax revenues have slumped. As a result, government deficits worldwide could reach $9 trillion to $11 trillion in 2020, and a cumulative total of as much as $30 trillion by 2023.

Governments will need to find ways to manage these unprecedented deficits without crippling their economies. It is this challenge which creates the need for the great balancing act: managing the $30 trillion deficit while restoring economic growth. We believe that this can be done—but it will require governments and the private sector to work together like never before to lay the foundations for a new social contract and to begin shaping a postcrisis era of shared, sustainable prosperity.

There is already concern that many countries will struggle to meet their commitments to creditors, sparking a debt crisis that would compound the economic crisis unleashed by COVID-19.[1] Yet even if governments do avoid defaults, record public-sector debt levels could seriously dampen economic recovery if not managed effectively. Increased debt-servicing costs could crowd out vital investments in areas such as infrastructure and reskilling. Decisions to "print money" at scale could prompt a rise in inflation. And a big rise in taxation could hamper business innovation and growth and harm countries' competitiveness.

Any of these paths could lead to a vicious cycle in which both economic growth and public revenues are suppressed for years to come. But governments have more power than is commonly assumed to manage larger deficits and to ensure that they sustain sound public finances and economic competitiveness for their countries—and so foster a virtuous cycle instead. For example, there are opportunities to improve the effectiveness of tax collection, including the use of accelerated digitization. And careful spending reviews can reallocate budgets to the highest priorities while delivering savings through better procurement and fraud reduction.

Potentially an even greater opportunity, and one that remains largely untapped, lies in creating transparency into governments' entire balance sheets, including assets such as land and property and state-owned enterprises. There is considerable scope in many countries to manage and monetize such assets more effectively, both to strengthen fiscal sustainability and to support broad-based economic recovery.

There are also real opportunities to hone the design and the target of the massive relief and stimulus packages precipitated by the COVID-19 crisis. The measures announced to date amount to some $10 trillion worldwide, and this spending is likely to rise as governments move from immediate support to households and businesses toward fostering long-term economic recovery. Wisely structured stimulus measures—designed and implemented in partnership with the private sector—could help prepare workforces for a technology-driven future and improve the long-term competitiveness and resilience of key industries. Indeed, we believe the crisis presents a historic opportunity for government and business to forge a new social contract for inclusive, sustainable growth.

The world's $30 trillion public-finance challenge

Governments have announced more than $10 trillion in relief measures, primarily for households and businesses. Among the G-20 nations, the fiscal measures announced in the COVID-19 crisis to date amount to an average of 11 percent of GDP—three times that of the 2008–09 financial-crisis response. In some countries, stimulus packages have reached more than 30 percent of GDP.[2]

At the same time, the immediate shock of the crisis on companies and households, along with depressed GDP growth, is likely to reduce

[1] See, for example, *New Atlanticist*, "How to deal with the coming pandemic debt crisis?," blog entry by Hung Tran, May 11, 2020, atlanticcouncil.org.
[2] Ziyad Cassim, Borko Handjiski, Jörg Schubert, and Yassir Zouaoui, "The $10 trillion rescue: How governments can deliver impact," June 5, 2020, McKinsey.com.

government revenues significantly. Worldwide, our analysis suggests that fiscal revenues could fall by between \$3 trillion and \$4 trillion (as much as 15 percent) between 2019 and 2020. GDP growth, along with government revenues, could take two or three years to recover to precrisis levels.

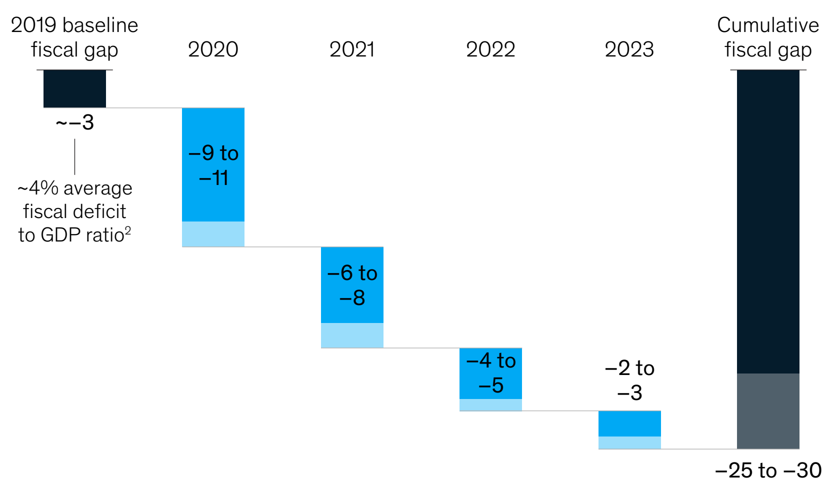
Given the combination of record stimulus measures and steep reductions in revenues, governments are taking a range of steps to manage public finances, including budget reallocation. But the bulk of the gap is being closed through debt. Our analysis suggests that the world's governments will experience a record global fiscal deficit in 2020 of between \$9 trillion and \$11 trillion—at least triple precrisis levels and equivalent to 12 to 15 percent of global GDP. By 2023, the world's governments could face a cumulative fiscal deficit of between \$25 trillion and \$30 trillion (Exhibit 1).[3]

As a result, sovereign-debt levels are likely to increase significantly across the world. The International Monetary Fund expects that sovereign debt in advanced economies will increase to 122 percent of GDP in 2020, up from a precrisis forecast of 105 percent. In emerging and middle-income countries, it is forecast to increase to 62 percent of GDP, up from 53 percent.[4]

Exhibit 1

The COVID-19 crisis could translate into an unprecedented cumulative fiscal deficit of \$25 trillion to \$30 trillion—equivalent to 30 percent of global GDP.

Projected global cumulative fiscal gap, A1 scenario,[1] \$ trillion



Note: Figures may not sum, because of rounding.
[1]Nonexhaustive, as of May 8, 2020.
[2]International Monetary Fund Fiscal Monitor estimate, April 2020.
Source: Center for Strategic and International Studies; International Monetary Fund Fiscal Monitor, chapter 1, April 2020; Organisation for Economic Co-operation and Development; World Bank; *World economic outlook, April 2020: The great lockdown*, International Monetary Fund, April 6, 2020, imf.org; McKinsey analysis

[3] These figures are based on McKinsey analysis, as of May 8, 2020, of the impact of a scenario ("A1") in which there is virus recurrence, slow long-term growth, and a muted world recovery—considered the most likely scenario in a recent McKinsey global executive survey. For further detail on our scenario analysis, see Sven Smit, Martin Hirt, Penny Dash, Audrey Lucas, Tom Latkovic, Matt Wilson, Ezra Greenberg, Kevin Buehler, and Klemens Hjartar, "Crushing coronavirus uncertainty: The big 'unlock' for our economies," May 13, 2020, McKinsey.com.
[4] *World economic outlook, April 2020: The great lockdown*, International Monetary Fund, April 6, 2020, imf.org.

How to manage record debt levels without crippling the economy

Faced with sustained high levels of debt, governments will need to put a huge effort into managing deficits and debt-payment plans to maintain their creditworthiness and their ability to service their debt. Just as important, however, they will need to find the optimal ways to support economic recovery—at the national level, for individual companies, and for citizens.

It is likely that governments will need to keep the focus on both of these dual objectives in a continuous balancing act over the next few years. That will limit their use of some of the traditional budget-balancing tools. For instance, our analysis suggests that an attempt to use austerity to close crisis-era government deficits would entail reducing public spending by about 25 percent—clearly a measure that few governments can contemplate. Likewise, using tax increases to fund the deficit would result in tax burdens rising by some 50 percent, which would severely limit corporate investment and reduce country competitiveness.

As we will discuss in a forthcoming article, countries have quite different degrees of freedom in the approaches they can take to managing their fiscal challenges. While some might be cushioned from fiscal pressure in the short term, many will have to build excellence in debt issuance and management and rethink their fiscal programs in a comprehensive manner, leveraging both income and balance-sheet measures (Exhibit 2).

Exhibit 2

Given the scale of the fiscal challenge, governments can consider a broad portfolio of available levers.

	Build excellence in debt issuance and management	**Unlock funding potential of balance-sheet assets**	**Optimize revenue streams**	**Contain expenditures**
Objectives	Debt issuance and management capability improvement for best cost/risk portfolio	Nonstrategic sovereign assets leveraged to raise short-term capital	Operational-lever analysis to increase collection without hurting economic recovery efforts	Expenditure review to improve efficiency of spend in light of new COVID-19 realities
Levers	● Upgrade debt story and communication strategy ● Optimize debt issuance with improved debt-management tools ● Partner with Central Bank to monetize part of the debt	● Create transparency and improve accuracy of assets on balance sheet ● Collateralize sovereign assets to raise more debt ● Use lending solutions to finance capital-expenditure projects (eg, PPP[1]) ● Sell nonstrategic assets ● Privatize SOEs[2] ● Leverage reserves	● Upgrade fraud deterrence and detection process ● Improve revenue collection through better citizen service ● Incentivize prepayment ● Improve management of assets to increase their yield ● Make policy changes on tax rates, brackets, and coverage	● Reallocate budget away from noncore categories ● Optimize procurement ● Use value engineering to streamline capital expenditure ● Review staff utilization and increase productivity
		Enablers of medium-term fiscal sustainability		

[1]Public–private partnership.
[2]State-owned enterprises.

Without a new approach, closing the cumulative 2020–23 fiscal deficit worldwide would require a 50 percent increase in tax revenues, or a 25 percent reduction in public spending.

For a start, governments will need to adopt bold revenue-enhancement and cost-containment strategies. On the revenue side, they can use operational-performance levers to improve revenue collection. Previous McKinsey research has highlighted major opportunities for countries to improve the efficiency and effectiveness of their tax systems, including the use of well-planned digitization efforts. For example, governments can harness new data sources and analytics tools to recover around $1 trillion a year in fiscal leakage—both unpaid revenues and unjustified outbound payments.[5]

Turning to cost containment, governments can use spending reviews to reallocate budgets to the highest priorities while delivering savings through better procurement and fraud reduction. These steps can form part of a broader drive to improve public-sector productivity, which could save the world's governments as much as $3.5 trillion a year, as our previous research has shown.[6]

Today, most governments change their spending allocations only marginally year over year, pointing to an opportunity to review and readjust spending much more decisively. Governments that have undertaken such reviews have often identified savings of around 10 percent or more of the target cost base, without sacrificing the scope or quality of services. At the same time, smarter procurement—via supply management, demand control, and processes such as e-tendering portals—can save governments around 15 percent of addressable spending while simultaneously boosting outcomes.[7]

An even greater opportunity, we believe, lies in partnering with the private sector to ensure that publicly owned assets—including land and property and state-owned enterprises—are valued properly, managed professionally, and securitized or monetized where appropriate. Armed with a new transparency on their balance sheets, governments can shape effective funding and asset-allocation strategies, and draw on the expertise of private-sector players such as the financial sector as they do so. These strategies could encompass a range of options, including using nonrecourse lending solutions such as public–private partnerships to finance capital-expenditure projects; selling nonstrategic assets, for example through land monetization; and leveraging existing reserves to manage the cost–risk ratio of government debt portfolios.

The use of balance-sheet levers could unlock considerable value for governments, with minimal procyclical effects.

[5] Susan Cunningham, Jonathan Davis, and Thomas Dohrmann, "The trillion-dollar prize: Plugging government revenue leaks with advanced analytics," January 2018, McKinsey.com.
[6] *Government productivity: Unlocking the $3.5 trillion opportunity*, McKinsey Center for Government, April 2017, McKinsey.com.
[7] Ibid.

There is room for smart, trust-based collaboration between government and business to rebuild and reimagine key sectors of the economy.

Ensuring that fiscal stimulus drives rapid, inclusive recovery

Beyond the imperative of securing sustainable public finances, governments will need to ensure that fiscal stimulus measures focus on the segments that support the recovery the most. And they will also need to find smart ways to use the current and planned support to accelerate economic transformations that are ongoing, or embed new shifts that will be needed.

Given that we are still in the early days of the COVID-19 crisis, it is understandable that the world's economic response to date has focused on relief; further interventions will likely be required to revive aggregate demand. In the United States, for example, the $3 trillion COVID-19 response has been allocated almost entirely to immediate relief measures. In contrast, the American Recovery and Reinvestment Act of 2009 allocated 55 percent of its total funding to stimulate industries and revive aggregate demand.[8]

Looking ahead, governments can work with the private sector to design stimulus measures that not only drive recovery but also support the long-term reimagination of economies and societies. For example, the COVID-19 crisis provides a prompt to accelerate government digitization and support companies to adopt new technologies—and thus strengthen productivity and citizen services. The shift to a contactless economy, driven by the pandemic, will contribute to this acceleration. Some countries have already seen individuals' preference for contactless operations increase by 20 percent or more during the crisis, with the industries affected spanning payments, retail, food, accommodation, education, and healthcare.[9]

Governments, the private sector, and educational institutions can also look to the crisis as a catalyst to reskill workforces at speed and scale, with stimulus packages incentivizing a shift to a more productive and equitable economy. In Germany, for example, the recent Qualification Opportunities Act provides for government subsidies of companies' employee-training programs; smaller businesses receive proportionally greater subsidies. Up to 100 percent of training costs for microbusinesses and up to 50 percent for small and medium-size enterprises are covered by the subsidies.[10] Governments can also achieve other objectives, such as increasing registration of informal businesses and improving female participation in the economy, in return for financial support.

There is also room for smart, trust-based collaboration between government and business to rebuild and reimagine key sectors of the economy. Sectors such as automotive manufacturing, construction, and transport have suffered significant disruption of demand and supply chains during the crisis and could require fundamental restructuring. Governments can work with industry

[8] Ziyad Cassim, Borko Handjiski, Jörg Schubert, and Yassir Zouaoui, "The $10 trillion rescue: How governments can deliver impact," June 5, 2020, McKinsey.com.
[9] Ibid.
[10] David Fine, Julia Klier, Deepa Mahajan, Nico Raabe, Jörg Schubert, Navjot Singh, and Seckin Ungur, "How to rebuild and reimagine jobs amid the coronavirus crisis," April 2020, McKinsey.com.

associations and leading companies in such sectors to forge common strategic objectives and target joint investment to support reinvented business models, new agility, and greater competitiveness.

The COVID-19 pandemic has already triggered large-scale increases in public borrowing, severely hampered economic growth, and disrupted key industries—and the crisis is far from over. In the months ahead, governments and the private sector will need to work together as never before to ensure the success of an epic balancing act: managing record levels of public debt while fostering broad-based economic recovery. Success would result in a new social contract that shapes a postcrisis era of shared, sustainable prosperity. Failure could lead to a sustained period of depression and austerity on a scale not seen since the 1930s. The stakes are high, and the need for bold, visionary leadership in the public and private sector has never been greater.

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