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The fiscal consequences of AI

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An underrated risk

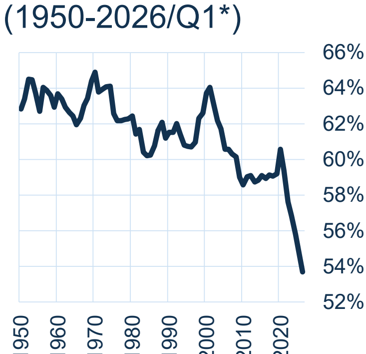
Artificial intelligence (AI) is everywhere these days – and not just in equity markets. Most recently, an OpenAI application caused a stir by hacking its way into another company's system on its own. The lack of control raises uncomfortable questions and inevitably calls to mind HAL 9000, the computer in Stanley Kubrick's film "2001: A Space Odyssey," where the loss of control over AI becomes a matter of life and death.

AI will hit the labor market

That is not the issue at hand. Instead, the focus here is on a largely overlooked macroeconomic consequence of AI. There has long been broad agreement that AI will fundamentally reshape labor markets. Even if the services sector has not yet seen mass layoffs, employment is likely to suffer over time. For white-collar workers, AI will have effects similar to those that automation had years ago on their blue-collar counterparts. Machines are taking over tasks – and, with them, jobs.

That brings several challenges. To begin with, the concentration of wealth and income will continue to rise. Many rich societies are already experiencing record levels of inequality. In the U.S., for example, the share of value added that accrues to labor income is at its lowest level since World War II (see fig. 1), and the trend is sharply downward. Fittingly, U.S. consumer confidence is hovering near an all-time low – lower even than during the pandemic. In Germany, the share of income accruing to the top 10% has increased steadily since the turn of the century to reach over 26% of the total. By contrast, the [bottom 10 %] only make up for around 2 % of income – an all-time low. [Inequality in wealth] is even starker: the bottom half holds only 2 % of all the wealth in Germany.

Fig. 1: Share of US-GDP accruing to Labor income (1950-2026/Q1*)



Source: Federal Reserve St. Louis, Bureau of Labor Statistics, , LBBW Research
*Values for 2024 and 2025 interpolated

If inequality in income and wealth keeps rising, society changes. Social cohesion erodes, and populist movements gain ground.

The Donald Trump phenomenon is rooted in these developments, among other things. U.S. industrial workers have experienced economic decline through globalization and automation. Trump promised that American manufacturing would revive once he became president. There is no sign of that so far. Investment and employment in the manufacturing sector are falling. But by now, no one is really surprised by Trumps empty promises.

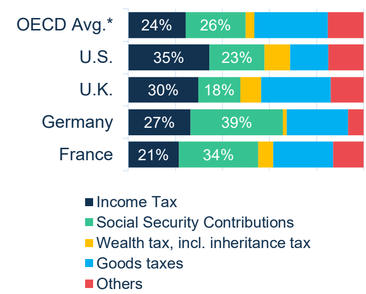
Public finances are already unsustainable

AI will lead to lower tax revenues

The shift in income and wealth is not the only problem. Public finances in Europe, the U.S. and Japan are already in disarray. Debt binges wherever you look. Deficit ratios are rising and rising. In the rich, so-called advanced economies, public debt has reached almost 110% of GDP, compared with less than 70% at the start of the century.

As AI spreads through the economy, the fiscal predicament will only worsen. Most tax systems rely on taxing labor income, including social-security contributions. Figure 2 shows that in almost all countries more than half of tax revenues come from income taxes and social contributions – in other words, from employment. As the labor share of value added declines, these tax revenues will start to dry up. Fiscal imbalances will grow.

Fig. 2: Tax Revenue Composition General Government, 2024



Source: OECD Global Revenue Statistics, LBBW Research
*OECD average refers to 2023

Governments could respond by cutting public services, but that would likely bolster populists on the right and the left. In any case, vast savings are hard to come by. Aging societies inevitably mean higher spending on pensions, health care and long-term care. And Elon Musk and his DOGE followers have shown that durable spending cuts are easier said than done. In Germany, the federal government's plan to supplement the pay-as-you-go pension system with a partially funded pillar is laudable in this context – but it comes roughly a generation too late.

Tax systems need reform

Alternatively, governments would have to overhaul their tax systems and focus more on what will grow with AI – namely, wealth, dividends and capital income. This, too, is likely to prove difficult. Powerful interest groups will move heaven and earth to prevent such an outcome.

Business as usual is not an option

Yet if AI delivers even a fraction of the efficiency and productivity gains that have been promised, a business-as-usual approach to public finances will not be sustainable. A timely change of course would be helpful. We already have ample experience with problems that are visible from afar but do not go away simply because they are ignored. Pensions are a case in point.

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