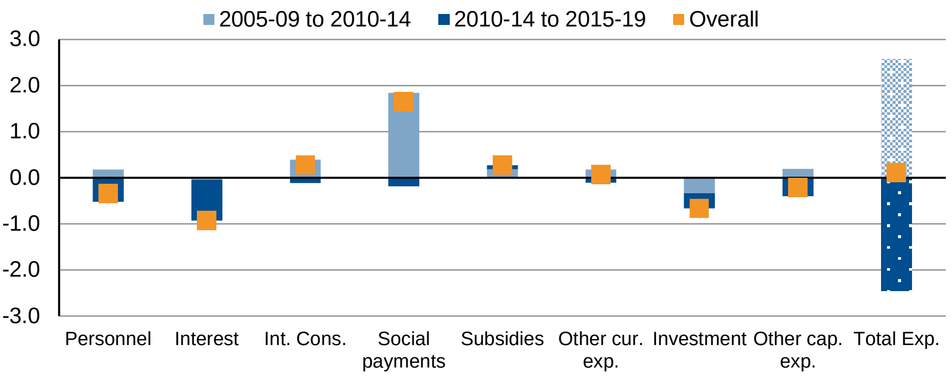
3 December 2020

# Scope Policy Insights: pension & labour market reform, public investment could ease euro area fiscal bottlenecks

**Euro area governments have limited room for manoeuvre to implement their post-pandemic fiscal plans. The objectives of raising public investment and strengthening healthcare systems need to be balanced against fiscal pressures on other expenditure items such as rising social payments, due to ageing populations and stretched labour markets. Policy makers could address this policy conundrum via pension and labour market reforms, curbing social payments, or effective public investment raising countries' growth potentials.**

Our analysis explores the dynamics of public expenditures and its components over three five-year periods, namely 2005-09, 2010-14 and 2015-19[1]. We find that annual average government expenditure as a share of GDP was higher in the period 2010-14 than in 2005-09. This relative expansion phase was followed by a relative containment phase, with average annual expenditure declining in the period 2015-19. Overall, this resulted in zero net increase in average annual public expenditures as a share of GDP between the periods 2005-09 and 2015-19. Offsetting trends have not been homogeneous across public-expenditure components: structurally higher social payments were compensated for by lower interest payments, personnel costs, and public investment **(Figure 1)**.

**Figure 1: Euro area: public expenditure, change as a % of GDP, by component**
Changes in pp. in average values over five-year periods (2005-09, 2010-14, 2015-19)




Sources: AMECO, Scope Ratings GmbH

Governments' post-pandemic fiscal plans target increasing public investment and hiring additional healthcare personnel. While this would reverse some of the pre-crisis trends in areas of underinvestment, fiscal room could further narrow as a result of continued pressures from social payment increases, in view of demographic challenges and post-shock stretched labour markets. In addition, given already-negative rates for many government borrowers, there is decreasing space for additional savings from refinancing at low interest rates. We see two main avenues to reconcile governments' fiscal plans with structural expenditure impediments:

- Reforms of pension and labour markets to ease social payment rises; and/or
- Effective public investment, facilitated by the European recovery funds, translating to higher growth and resulting in additional budgetary room over the medium term.

We further inform our aggregate results, by highlighting country-specific expenditure trends among the euro area Big-4: Germany (rated AAA/Stable), France (AA/Stable), Italy (BBB+/Negative) and Spain (A-/Negative).

[1] We took annual averages over three five-year periods to smooth out short-term cyclical effects and one-offs.

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## Public expenditure trends contrast with governments' post-pandemic policy proposals

**Common trends in government expenditure across euro area countries**

Government expenditure as a share of GDP varies across euro area countries, reflecting different social and policy preferences. Nevertheless, common trends are identifiable (**Figure 2**). In particular, most euro area countries experienced a phase of relative expansion in government expenditure (from 2005-2009 to 2010-14), with expenditure growing faster than GDP, followed by one of relative consolidation (from 2010-14 to 2015-19). Aggregate data show that, overall, these two phases have offset one another with a zero net increase in average annual government expenditure to GDP from 2005-09 to 2015-19.

**Pressures on social payments offset by lower interest costs, personnel costs and investment**

However, these zero net changes in aggregate did not come from homogeneity in trends across expenditure items. Our analysis of expenditure changes by component shows how increases in social payments (by far the largest component in government expenditure) have been offset by lower interest and personnel costs as well as public investment (as a share of GDP). This trend is highlighted in **Figure 3**, which shows changes over time in items' shares in total expenditure. Specifically, the share of social payments has continued to rise over time from 44% (on average) over 2005-09 to 47.5% in 2015-19, while others expenditure items declined in significance, notably with respect to interest payments (to 4% of total expenditure, from 6%), investment (5.7%, from 7%) and personnel costs (to 21%, from 21.8%).

**Limited scope for spending savings under fiscal frameworks**

Looking at expenditure trends in forthcoming years, government proposals to raise investment and strengthen healthcare systems, including via boosting personnel in the healthcare sector, would reverse some earlier areas of underinvestment. However, the question is: are there potential savings from other expenditure items that could provide the requisite fiscal space? In our opinion, this is unlikely absent reform.

Firstly, we do not expect further game-changing savings from lowered interest expenditure, with many euro area governments' financing rates already negative across medium-to-long maturities. In addition, government debt levels have increased significantly this year, possibly offsetting gains from refinancing at lower rates. Secondly, ageing populations and stretched labour markets after this year's crisis are unlikely to support *lower* social payments in the near future. While a quick recovery could anchor lower unemployment rates, and thus reduce benefit payments, pension and healthcare-related costs are set to increase in coming years across most euro area economies. Finally, we see limited room for manoeuvre with respect to savings in intermediate consumption, which stand at around 5% of GDP across Germany, France, Italy and Spain. Other expenditure items occupy, generally, only a more residual share in budgets.

**Figure 2: Gov. expenditure (% of GDP), changes over time**

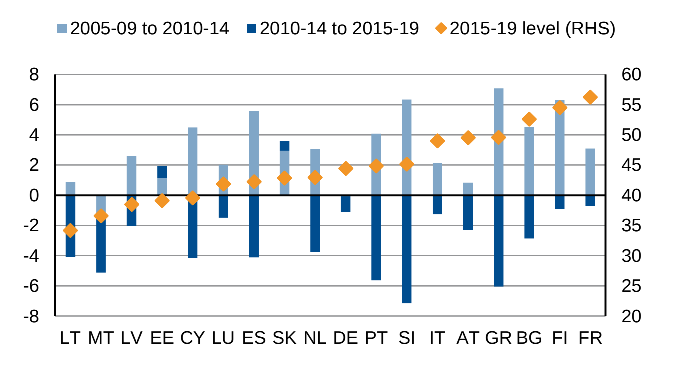
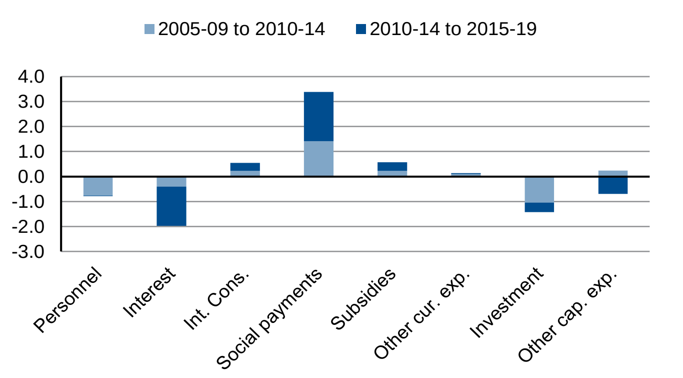



**Figure 3: Euro area: changes in public exp. shares, % of total public expenditure**




NB: excludes Ireland, due to large changes in GDP in 2015-19 vis-à-vis others

Source: AMECO, Scope Ratings GmbH

## Four budget scenarios

On this basis, we identify four budgetary scenarios in consideration of structural expenditure trends alongside the proposed fiscal agendas:

i) Pension and labour market reforms are activated that contain social payments increase, supporting sustainability;

ii) Reforms and investments enhance growth potential, strengthening budgets;

iii) Raising taxes or curtailing tax evasion increase government revenue to GDP, anchoring fiscal sustainability; or

iv) Governments run persistent deficits.

**Significant challenges for policy makers**

Of these, the third scenario may be less economically desirable after an economic crisis, while the fourth is unsustainable in the long run. A combination of the first two policy avenues may allow governments to reconcile structural pressures on public expenditures with a comparatively growth-friendly post-pandemic reform programme, support by fund flows from the European Union. Still, any such reform strategy would, nonetheless, face uncertainty due to challenges in reforming i) pension systems, ii) labour markets to raise inclusivity and employment rates, via active labour policies and greater labour market flexibility, and iii) public investments to implement growth-enhancing public works.

## Snapshot of the euro area Big-4's public expenditure trends

**Germany: expenditure stability, but debt brake could limit investment**

The weight of public expenditure in GDP in Germany has decreased over the past 15 years, as the country, unlike peers, capped social expenditure growth over the global financial and sovereign debt crises, via effective labour market reforms and comparatively resilient growth. The country has also benefitted from significant savings on interest payments. Other expenditures have remained stable, including low public investment.

Going forward, Germany is set to face rising social payments, mainly due to an ageing population. Also, we expect limited additional savings on unemployment benefits, given already-low structural unemployment, a labour-force participation rate in line with the euro area average and increases in unemployment over the 2020 crisis. At the same time, the German economy faces a drop in the size of its workforce with the retirement of the baby-boomer generation. Workforce losses are likely to reduce Germany's revenue base, while weighing on expenditure. Finally, further savings on interest payments are likely to be more limited than those for peers, as Germany already spends under 1% of GDP on debt interest. Therefore, if the country intends to raise public investment to boost growth and maintain fiscal reserves to counter ageing-related expenditures, the government will need to temporarily abandon strict expenditure controls for effective investment, for instance by either suspending the debt brake or defining exceptions for public investment expenses.

**Figure 4: Germany: public expenditure, % of GDP**

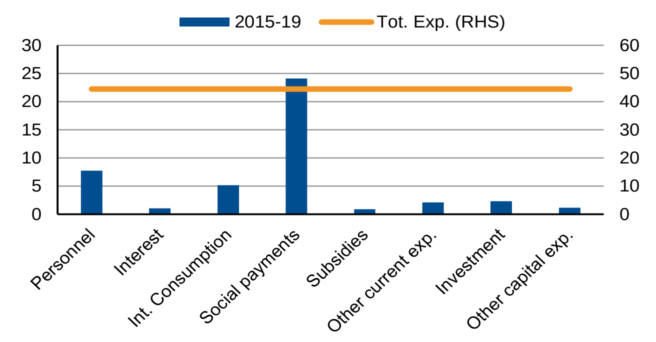
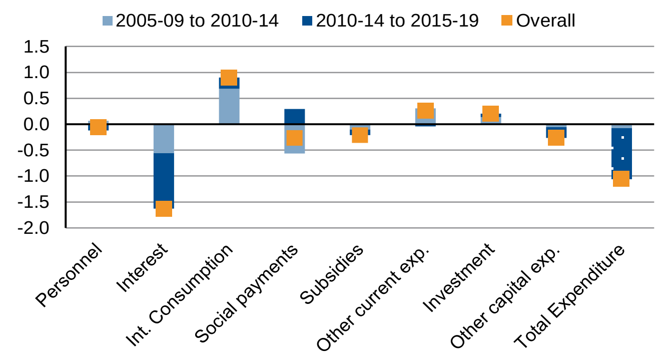



**Figure 5: Germany: public expenditure, % of GDP, change in pp**




Source: AMECO, Scope Ratings GmbH

**France: labour market reforms could open room for expenditure savings**

France saw a very rapid increase in expenditures as a share of GDP from 2005-09 to 2010-14, driven by a 2pp increase in social payments. In the subsequent five years, the overall weight of expenditure in GDP decreased, mostly via interest payment savings and cuts to public investment (relative to GDP). France is the euro area member state with the highest public expenditures to GDP, of above 56% on average over 2015-19.

Going forward, France may benefit from less severe demographic pressures than peers (see our research on demographic developments in advanced economies). The government has, moreover, recently introduced reforms to the country's pension system, although political resistance held back the scope of reforms. Savings on social payment expenditure could be achieved from additional labour market reforms. Other expenditure items appear rigid. For instance, the share of employee compensation in GDP is much higher than for peer governments. Regarding public investment, France outperforms peers both as a share of GDP and in total expenditure. To further raise investments, France would need to count mostly on its own fiscal resources, with some added support from EU Recovery funds.

**Figure 6: France: public expenditure, % of GDP**

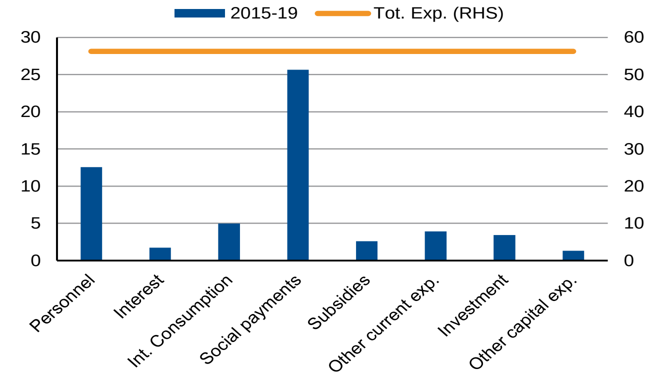
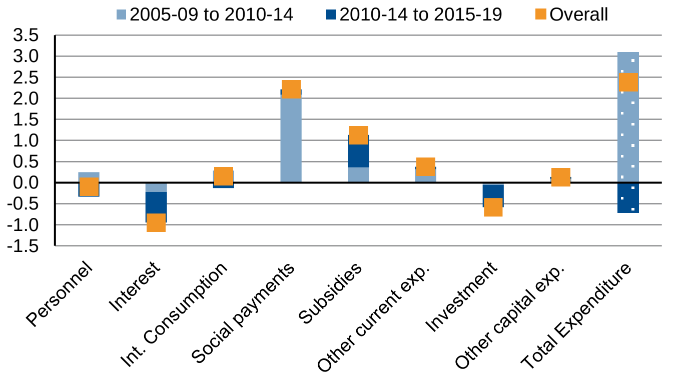



**Figure 7: France: public expenditure, % of GDP, change in pp**




Source: AMECO, Scope Ratings GmbH

**Italy: largest pressures from ageing-related spending, but opportunities for savings exist**

Italy has faced an increase in the share of government expenditure to GDP, due to rapidly rising social payments (totalling 3pp) not offset by savings on other expenditure items. Expenditure-to-GDP curtailments between 2010-14 and 2015-19 came mostly via savings on interest and personnel costs, while the share of public investment in GDP has been decreasing, by 1pp in total from 2005-09 to 2015-19. This has resulted in a significant shift in the composition of public sector spending.

Italy is likely to face further spending pressures, given more adverse demographics than peers. The government expects pension expenditure of above 16% of GDP through 2023. On this front, the government is set to consider a fresh pension reform, as the costly "Quota 100" scheme, implemented under the previous government, will not be renewed. With respect to labour markets, the current low employment and participation rates point to room for budgetary gains that could stem from reforms elevating competitiveness and labour-force participation rates. Finally, additional interest savings are still possible for Italy, given roll-over now at much lower interest rates than in the past. As the main beneficiary from the EU's recovery funds (EUR 210bn allocated to Italy over 2021-26 in grants and loans), Italy could significantly boost public investment relying on external resources.

**Figure 8: Italy: public expenditure, % of GDP**

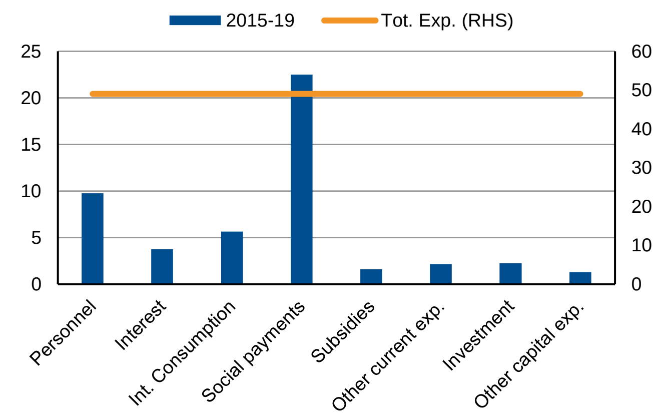
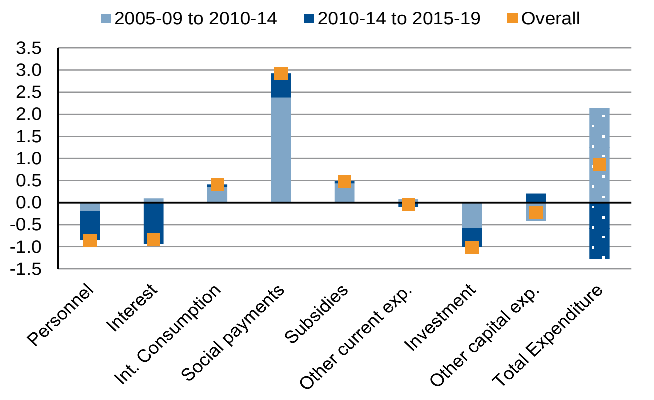



**Figure 9: Italy: public expenditure, % of GDP, change in pp**




Source: AMECO, Scope Ratings GmbH

**Spain: weak labour market is the challenge; EU-funded investment the opportunity**

The Spanish government's expenditures to GDP have been volatile over the three defined periods, reflecting a strong impact of economic crises of past years on the budget, but also robust growth in subsequent years. We likewise observe a shift in the composition of public sector expenditure in the direction of greater weight for social payments at the expense of public investment. Spain is the Big-4 economy with the lowest weight of government expenditure in GDP, at about 40%.

A key challenge to public expenditure reform is Spain's weak labour market, with the economy displaying the highest structural unemployment in the euro area (of about 14% in 2019). Moreover, the severe impact of the Covid-19 shock on key sectors of the Spanish economy, such as travel and hospitality, is likely to further aggravate labour market developments over the coming period. On the reform side, a concern also relates to an intent pre-crisis of the ruling coalition to reverse some of the structural labour market reforms implemented after the GFC, which had contributed to lowering the unemployment rate over the previous five years. In general, persistent political fragmentation has prevented the implementation of reforms. On investment, Spain will significantly benefit from EU recovery funds. The government has pledged to use the whole grant portion of the package (of about EUR 70bn) over the next three years. A centralisation of the governance of EU funds' use at the Cabinet Office may support an improvement in the spending capacity of the public sector (given a very low 39% absorption capacity ratio for EU funds over 2014-19).

**Figure 10: Spain: public expenditure, % of GDP**

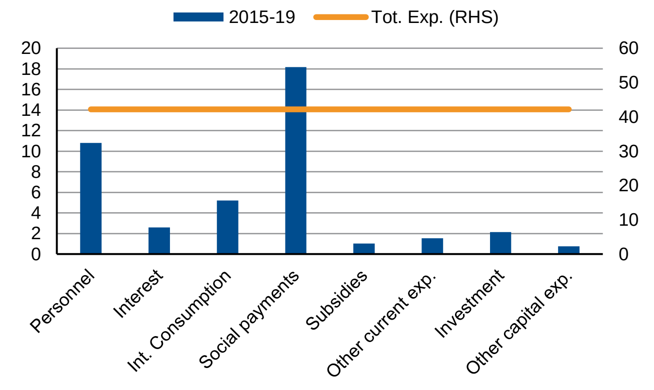
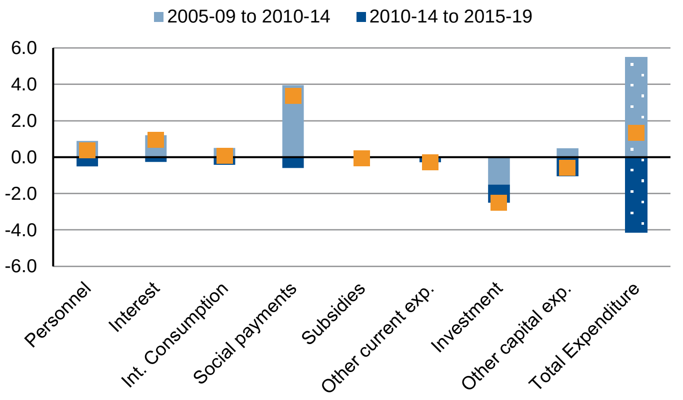



**Figure 11: Spain: public expenditure, % of GDP, change in pp**




Source: AMECO, Scope Ratings GmbH

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