Addressing high public debt: selective expenditure restraint matters

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In dealing with significant fiscal challenges posed by ageing and the climate transition and the risk of rising future debt burdens, countries can draw on the lessons from past episodes of large and sustained reductions in debt-to-GDP. Work in the November 2023 OECD Economic Outlook found that there have been 34 sustained debt reduction episodes in OECD countries since the late 1970s, with 25 countries having experienced at least one such episode during this time. Reductions in the debt-to-GDP ratio have mainly hinged on achieving and sustaining a primary surplus over several years, largely via expenditure restraint, as well as favourable cyclical conditions and low interest rates. Expenditure restraint has often been accompanied by growth-friendly shifts in the composition of public spending.

What has made debt-to-GDP ratios fall?

Debt reduction episodes are defined as ones that persist for a minimum of five years and bring down the gross debt-to-GDP ratio by at least 10 percentage points. All episodes start in the year after the debt ratio peaks and end when the debt-to-

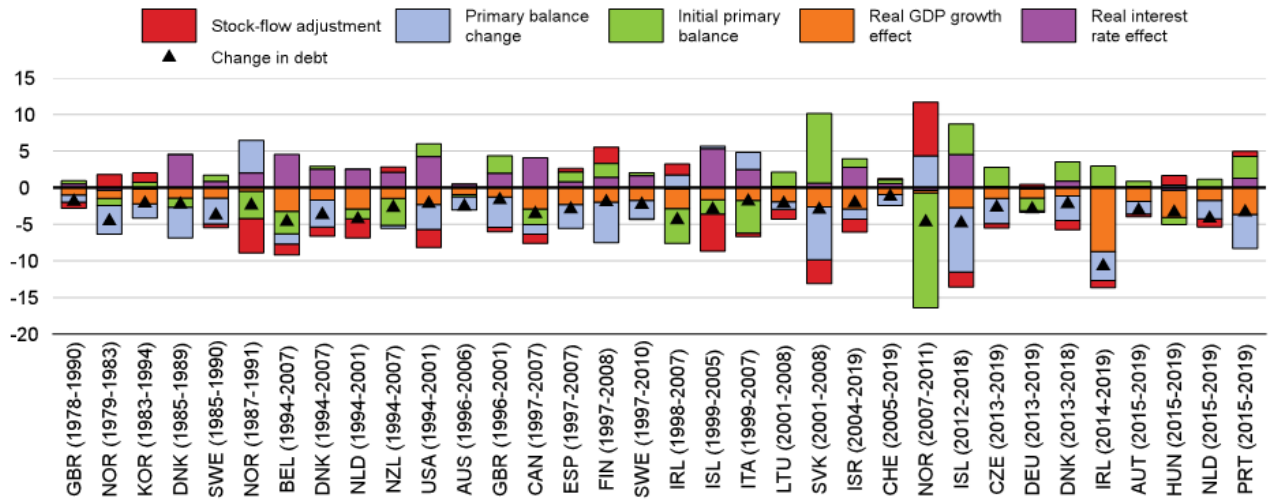
GDP ratio bottoms out. The analysis spans from the late 1970s to 2019, though data availability is limited for some countries.

Accounting decompositions of changes in the debt-to-GDP ratio typically consider three components (Rawdanowicz et al., 2021): the primary balance-to-GDP ratio (hereafter the "primary balance"), the interaction of debt and the differential between interest rates and GDP growth (the so-called "snowball effect"), and a residual stock-flow adjustment that summarises changes in gross debt unaccounted for by the budget balance. In turn, the average primary balance over each debt reduction episode can be decomposed into the initial balance when the debt ratio peaks and the average primary balance change over the length of the episode relative to the initial balance. Likewise, the aggregate snowball effect can be split to show separate impacts from real interest rates (with inflation measured by the GDP deflator) and real GDP growth.

The final decomposition of each debt reduction episode is shown in Figure 1. This highlights two key factors:

- In all but three episodes the primary balance is on average in surplus, helping to reduce the debt ratio. In around 80% of the episodes, this is due to improvements in the primary balance during the episode itself.
- In about two thirds of the episodes, and in all but one of the 14 episodes that have begun since the year 2000, the snowball effect contributes positively to the debt reduction. Cyclical conditions have almost always improved relative to those when the debt ratio peaked, and the real interest rate has often been only marginally positive or even negative.

Figure 1. Decomposition of the average annual change in the debt-to-GDP ratio during debt reduction episodes



Note: Episodes are ordered chronologically by starting year. See Annex 1.B. in OECD (2023) for further details.
Source: OECD Economic Outlook 113 database; and OECD calculations.

Expenditure restraint and shifts in the composition of public spending

Improvements in the primary balance during debt reduction episodes have mainly occurred due to declines in the primary expenditure-to-GDP ratio. This has taken place in over 80% of the 34 episodes considered. In contrast, the primary revenue-to-GDP ratio has risen in fewer than half of the episodes, mostly for ones that began in the 1980s and 1990s.

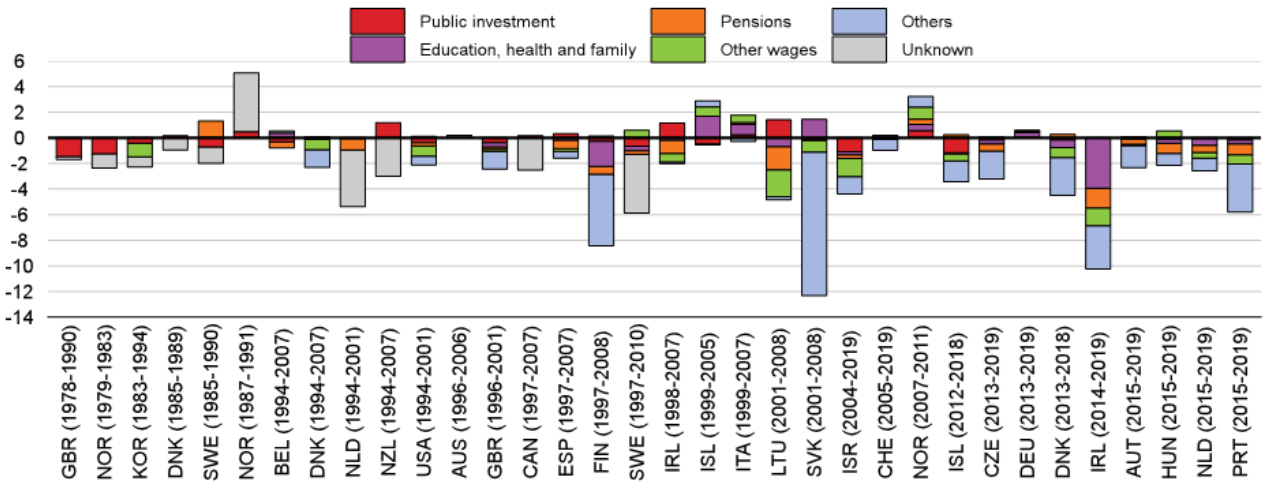
Expenditure restraint has often been accompanied, and likely made more sustainable, by relatively growth-friendly shifts in expenditure composition. Public investment as a share of GDP declined in about two-thirds of the episodes (23 out of 34; Figure 2), but these declines were often smaller than declines in other expenditure items, in contrast to the large public investment cuts often seen in consolidation episodes (Pina, 2016). Spending on education, health and family and children, generally regarded as growth- and equity-friendly (Cournède et al., 2014; Fournier and Johansson, 2016), has generally been

better preserved than spending on pensions and the bulk of non-education, non-health wages and intermediate consumption. Declines in the GDP share of the remainder of public expenditure, including subsidies, unemployment, sickness and disability benefits, other current transfers, and capital transfers have typically been the largest factor behind spending restraint. Many of these items are not growth-enhancing, though some can be very important for poorer households.

A positive differential between GDP growth and interest rates cannot be relied upon to decrease the debt-to-GDP ratio in the coming years, and attaining primary surpluses via expenditure restraint may prove difficult (Arslanalp and Eichengreen, 2023). This reflects the multiple future spending pressures governments face. Reductions in the debt ratio may thus be harder to achieve in the coming decade than in the past. However, past debt reduction episodes illustrate that it is possible to make significant savings in spending items which often harm growth, such as subsidies and certain transfers. In the current context, where the composition of public expenditure needs to change to address new challenges, that lesson remains highly relevant. However, such changes need to be accompanied by improvements to the overall targeting and design of spending programmes to maintain support for those who need it most.

Figure 2. Growth-friendly expenditure has typically been spared during debt reduction episodes

Changes in ratios to GDP, percentage points, average over each debt reduction episode



Note: The chart decomposes the average annual change in primary expenditure as a share of GDP over the length of each episode relative to its initial value into several expenditure components as defined in the OECD Public Finance Dataset (Bloch et al., 2016). In some earlier episodes not all components can be identified due to data limitations. Episodes are ordered chronologically by starting year. See Annex 1.B. in OECD (2023) for further details.
Source: OECD Economic Outlook 113 database; OECD Public Finance Dataset; and OECD calculations.

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South Africa: Improving productivity and the efficiency of public spending to bolster living standards

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OECD Economic Survey of South Africa examines the impact of the COVID-19 crisis on South Africa’s economy and proposes reforms to overcome long-running structural weaknesses and raise living standards.

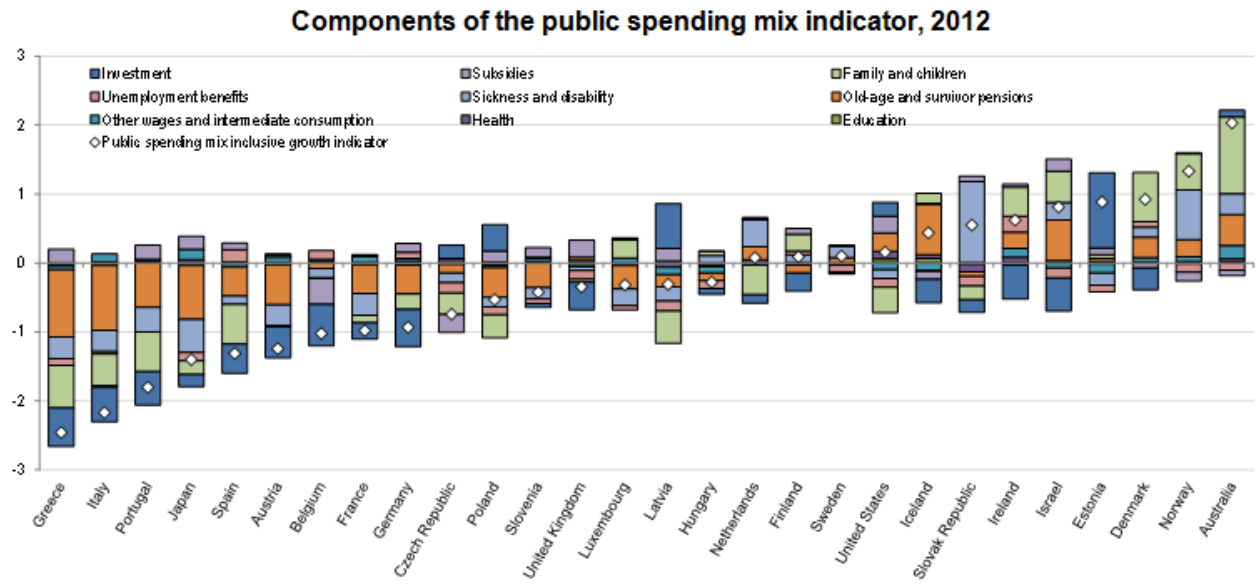
Does public spending foster inclusive growth in your country?

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written by oecdecoscope | December 19, 2023
by Debbie Bloch, Public Economics Division, Economics Department

Governments today need to balance the policy goals of boosting economic growth and improving equity when making budget decisions. How can public spending choices promote inclusive growth? What can be learned from previous spending decisions in times of crisis?

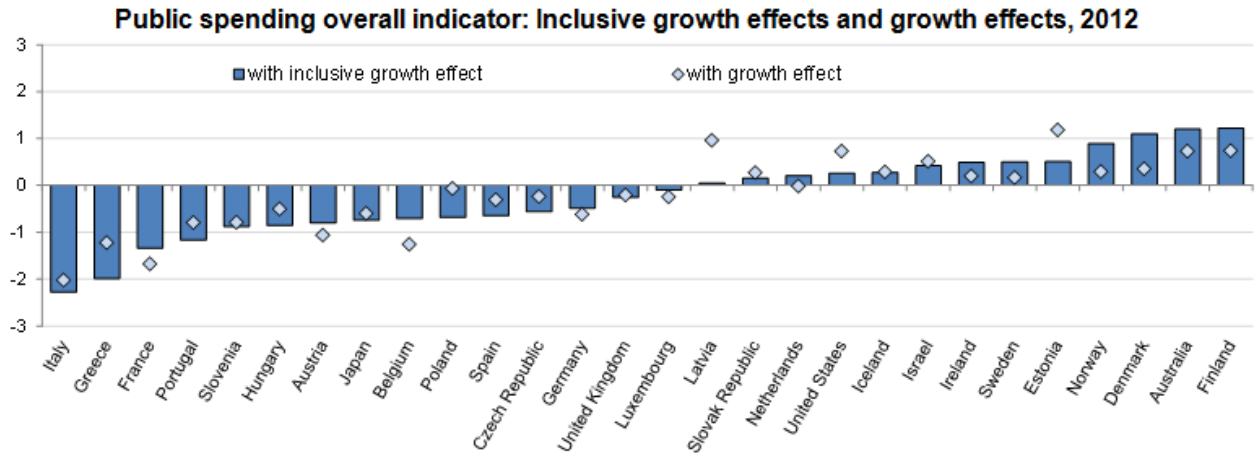
As it becomes increasingly important for policymakers to look at public finances in terms of both growth and income equality, a new set of indicators has been developed to help governments assess how public spending can be geared toward achieving these twin goals.

A first set of indicators combines information on the mix of public spending. Each spending item share is multiplied with an estimated coefficient from growth and inequality equations to build both a growth and an income distribution component, which is then summed up to an aggregate inclusive growth indicator. The outcomes show that public investment and family and child benefits help butress inclusive growth, while old age pensions and government subsidies hurt the most. The indicator below shows that the public spending mix is least conducive to inclusive growth in Greece and most conducive in Australia.



Source: Bloch, D. and J. Fournier (2018), "The Deterioration of the Public Spending Mix during the Global Financial Crisis: Insights from New Indicators", OECD Economics Department Working Papers, No. 1465, OECD Publishing, Paris, https://doi.org/10.1787/2f6d2e8f-en

Taking the analysis further, a second set of indicators adds information on the size and effectiveness of governments to the public spending mix analysis, providing an overall indicator on the effects of public spending on inclusive growth. This indicator shows that countries with large but efficient governments, such as Nordic countries, along with those favouring inclusive-growth friendly spending items do well in the indicator ranking, while those with less-effective governments, and with high old-age pension spending tend to do worse.



Source: Bloch, D. and J. Fournier (2018), "The Deterioration of the Public Spending Mix during the Global Financial Crisis: Insights from New Indicators", OECD Economics Department Working Papers, No. 1465, OECD Publishing, Paris, https://doi.org/10.1787/2f6d2e8f-en

Policymakers need to be aware of these effects when facing hard choices, particularly during times of economic crisis. Analysis based on these new indicators have shown there is a striking link between the growth component of the public spending mix indicator and the output gap: the capacity of the public finances to support inclusive growth deteriorated markedly in the countries hardest hit during the recent crisis, as governments slashed budgets with little regard to which items would underpin inclusive growth.

What can we take away from this? Countries facing pressure to reduce spending during an economic downturn need to consider which spending items would be most – and least – condusive to inclusive growth, to ultimately help them come out stronger after a crisis. Increasing public investment and family benefits, for example, while targetting reductions in less productive spending items should help assure healthier, fairer economies.

Reference:

Bloch, D. and J. Fournier (2018), "The Deterioration of the Public Spending Mix during the Global Financial Crisis: Insights from New Indicators", *OECD Economics Department Working Papers*, No. 1465, OECD Publishing,

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Further reading:

Fournier, J. and Å. Johansson (2016), "The Effect of the Size and the Mix of Public Spending on Growth and Inequality", *OECD Economics Department Working Papers*, No. 1344, OECD Publishing, Paris, https://doi.org/10.1787/f99f6b36-en.

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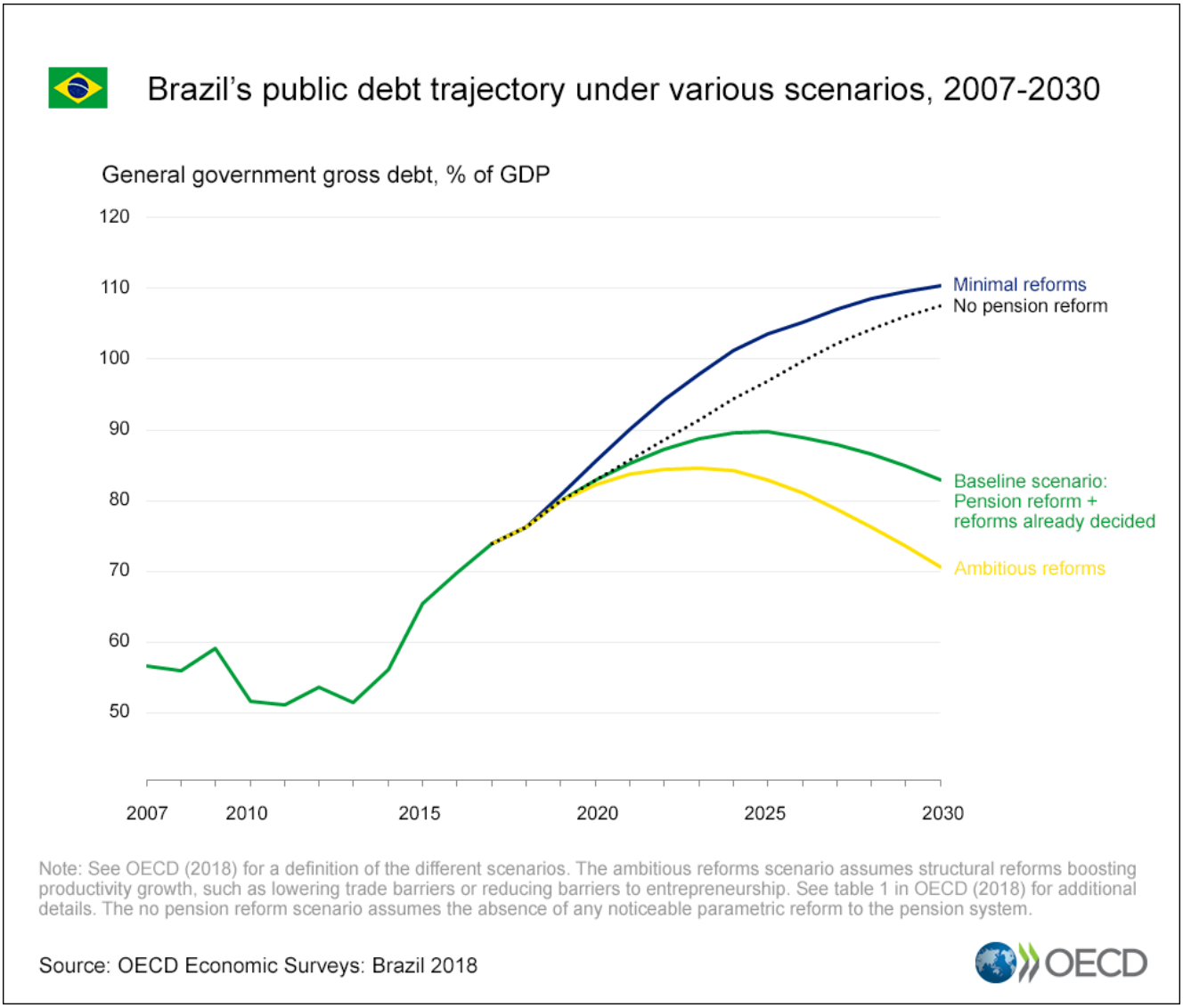
Towards a more prosperous and inclusive Brazil

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By Jens Arnold and Alberto González Pandiella

Over the past two decades, strong growth combined with remarkable social progress has made Brazil one of the world's leading economies. However, Brazil remains a highly unequal country, recent corruption allegations have revealed significant challenges in economic governance and the situation of its fiscal accounts is challenging with high and rising public debt (OECD, 2018). This calls for wide-ranging reforms to sustain and continue progress on inclusive growth.

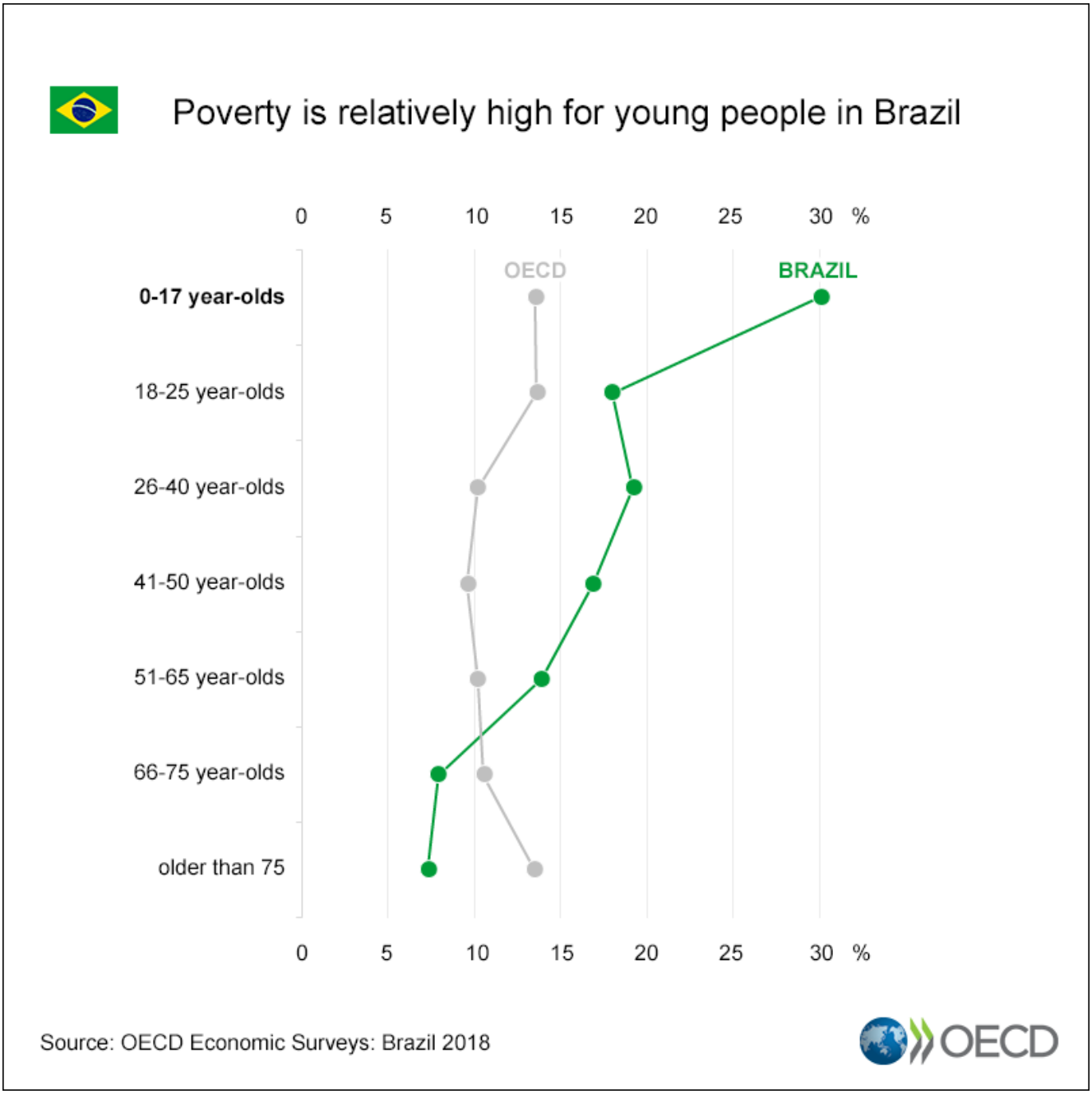
The government has started to put in place significant reforms, including a fiscal rule and a financial market reform that aligns directed lending rates with market rates. The long and deep recession is over and growth is projected to accelerate significantly this year. But more needs to be done to improve the living standards of all Brazilians.

The overall budget deficit is close to 8% of GDP driven by rising expenditures. Gross public debt has increased by approximately 20 percentage points of GDP over the last 3 years and stands around 75% of GDP. Implementing the planned fiscal adjustment and achieving fiscal targets is crucial for restoring the credibility of fiscal policy and avoiding a fiscal crisis. A comprehensive social security reform has become the most urgent element of the fiscal adjustment, as much of the worsening of the deficits is due to rising pension spending. A pension reform is also an opportunity to make growth more inclusive through better targeting of benefits. Aligning Brazil’s pension rules with those practiced in OECD countries could be done in a way to preserve the purchasing power of pensioners while significantly improving the sustainability of the pension system. For example, in OECD countries people retire on average when they become 66 years old, while the effective retirement age in Brazil is 56 years for men and 53 for women. Establishing a formal minimum retirement age would help, in addition to rethinking the current benefit indexation mechanisms. Without reform, pension expenditure will more than double by 2060 (OECD, 2017), which would lead to unsustainable fiscal dynamics (Figure 1).



Improving the effectiveness of public spending, and in particular public transfers, will also be crucial for further social progress. At present a large and rising share of social benefits is paid to households that are not poor, which reduces their impact on inequality and poverty. Already, poverty is more than three times higher among children and youths than among those aged above 65 (Figure 2). Limiting future increases in those social benefits that do not reach the poor would be a first step. That would instead allow shifting more resources towards transfers that do reach the poor, such as Bolsa Família, which is highly regarded across the world and reaches the poor like hardly any other social programme in Brazil. This would help particularly children and

youths. Currently Bolsa Família only represents 0.5% of GDP out of the 15% of GDP that Brazil spends on social transfers (OECD, 2018). There is also scope to reduce transfers to the corporate sector, which have increased markedly over recent years. These transfers, often granted in the form of tax exemptions or subsidised lending, have not been associated with visible improvements in productivity or investment, but they benefitted primarily the more affluent, besides creating fertile ground for corruption and political kick-backs.



Further advances in living standards will also hinge on

finding a new inclusive growth strategy, ensuring that the benefits of growth will be broadly shared across the population. Productivity will have to become the principal engine of growth in the future, because the demographic bonus that has supported growth in Brazil is reversing. But raising productivity will require significantly higher investment and trade. Brazil has one of the lowest investment rates among OECD and emerging market economies and it is also less integrated into global trade. Boosting investment and trade would raise productivity, helping Brazilians to access higher wages and living standards.

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