

Public Investment and Sovereign Financing Costs

Public investment is central to long-term growth and macroeconomic stability, but how does it influence governments' borrowing costs? Possibly, investment-oriented fiscal policy fosters lenders' confidence, whereas consumption-heavy expenditure profiles may be perceived as less supportive of long-term sustainability. Indeed, previous literature suggests that the composition of government spending can influence how markets assess fiscal sustainability. In addition, evidence shows that investment has higher fiscal multipliers than other expenditure categories thus increasing tax revenue prospects. Also, sovereign bond spreads in the EU are known to be driven by market sentiment rather than fundamentals alone.

Our paper investigates how the composition of public spending influences the interest rates governments pay on their sovereign debt. We distinguish between investment and consumptive spending and explore whether financial markets reward an expenditure structure oriented toward long-term productive capacity. Furthermore, we explore distinct effects of specific COFOG categories of public spending. Our preliminary results show that higher public investment is associated with lower sovereign interest rates, consistent with the view that investment strengthens expected debt sustainability. We conclude that the composition of government expenditure may act as a signal to markets, having an impact on governments' borrowing costs.