GOOD DEBT, BAD DEBT

On the economics of debt following UN's Antonio Guterres "Dagger trough the Recovery's Heart" speech

By Bart Le Blanc

- *IMF's initial optimism on a post-pandemic recovery is fading. The low-income, non-commodity producing countries will again be the victims of this serious public health cum socio-economic crisis.*
- *The pandemic has pushed many countries to previously unimaginable debt levels. The UN Secretary General fears that the pandemic debts of vulnerable emerging countries might put "a dagger through the recovery's heart".*
- *The philosophy and economics of debt help us to better understand the concept of debt and its morality: what is a 'good' debt and what makes a debt 'bad'. Good debt is used for investment purpose: its resulting growth and value creation support future repayment.*
- *Most pandemic public spending was aimed at protecting and building of infrastructure, of existing productive economic capacity, and of built-up human capital.*
- *Not having spent on pandemic support would NOT have resulted in lower government debt levels, on the contrary! But it would have wrecked many countries' communities and economies. Thus, any debt resulting from pandemic prevention could surely be seen as 'good debt'.*
- *There is however also 'bad' and 'ugly' debt! 'Bad debt' originates from government expenditure being structurally unsustainable, or criminal (corrupt practices, fraud) or simply wasteful (also criminal!).*
  Such debt requires international condemnation and fierce corrective action!
- *But there is no reason to worry too much over pandemic related debt levels.*
  'Good debt' is for good, and for growth!
  It is 'bad debt' that puts daggers through the heart of society, of the economy and of peoples' life….
  And governments should not forget the ongoing sustainability and financeability tests.
  The investor community is a 'herd' community…

1. The recovery's hobbling path

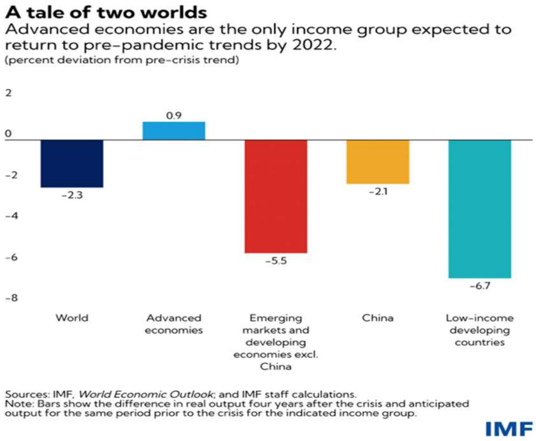
The new World Economic Outlook ('*Recovery during a pandemic: Health Concerns, Supply Disruptions and Price Pressures*') and the Global Financial Stability Report (*COVID-19, Crypto and Climate*) are worthwhile reading side-by-side to get a clearer view on the many complex socio-economic and financial risks surrounding a post-pandemic recovery.
The IMF describes the path to recovery "*hobbled by the pandemic*". After reading these recent IMF reports, one is left with the feeling that the initial recovery optimism is fading due to uncertain pandemic dynamics, supply-chain disruptions, inflationary pressures, vaccine inequalities, high public debt levels, and possible tightening of financial conditions.
As always, the weaker countries in the low-income category and their people will bear the brunt.

The IMF growth projections also illustrate a slight hesitation, shifting the earlier anticipated recovery to (hopefully) next year: in IMF-speak: "*the momentum has weakened".* The numbers in the new World Economic Outlook overview table below confirm this uneasy picture.

Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

		Projections		Difference from July 2021 WEO *Update*[1]		Difference from April 2021 WEO[1]	
	2020	2021	2022	2021	2022	2021	2022
World Output	**–3.1**	**5.9**	**4.9**	**–0.1**	**0.0**	**–0.1**	**0.5**
Advanced Economies	**–4.5**	**5.2**	**4.5**	**–0.4**	**0.1**	**0.1**	**0.9**
United States	–3.4	6.0	5.2	–1.0	0.3	–0.4	1.7
Euro Area	–6.3	5.0	4.3	0.4	0.0	0.6	0.5
Germany	–4.6	3.1	4.6	–0.5	0.5	–0.5	1.2
France	–8.0	6.3	3.9	0.5	–0.3	0.5	–0.3
Italy	–8.9	5.8	4.2	0.9	0.0	1.6	0.6
Spain	–10.8	5.7	6.4	–0.5	0.6	–0.7	1.7
Japan	–4.6	2.4	3.2	–0.4	0.2	–0.9	0.7
United Kingdom	–9.8	6.8	5.0	–0.2	0.2	1.5	–0.1
Canada	–5.3	5.7	4.9	–0.6	0.4	0.7	0.2
Other Advanced Economies[2]	–1.9	4.6	3.7	–0.3	0.1	0.2	0.3
Emerging Market and Developing Economies	**–2.1**	**6.4**	**5.1**	**0.1**	**–0.1**	**–0.3**	**0.1**
Emerging and Developing Asia	–0.8	7.2	6.3	–0.3	–0.1	–1.4	0.3
China	2.3	8.0	5.6	–0.1	–0.1	–0.4	0.0
India[3]	–7.3	9.5	8.5	0.0	0.0	–3.0	1.6
ASEAN-5[4]	–3.4	2.9	5.8	–1.4	–0.5	–2.0	–0.3
Emerging and Developing Europe	–2.0	6.0	3.6	1.1	0.0	1.6	–0.3
Russia	–3.0	4.7	2.9	0.3	–0.2	0.9	–0.9
Latin America and the Caribbean	–7.0	6.3	3.0	0.5	–0.2	1.7	–0.1
Brazil	–4.1	5.2	1.5	–0.1	–0.4	1.5	–1.1
Mexico	–8.3	6.2	4.0	–0.1	–0.2	1.2	1.0
Middle East and Central Asia	–2.8	4.1	4.1	0.1	0.4	0.4	0.3
Saudi Arabia	–4.1	2.8	4.8	0.4	0.0	–0.1	0.8
Sub-Saharan Africa	–1.7	3.7	3.8	0.3	–0.3	0.3	–0.2
Nigeria	–1.8	2.6	2.7	0.1	0.1	0.1	0.4
South Africa	–6.4	5.0	2.2	1.0	0.0	1.9	0.2
Memorandum							
World Growth Based on Market Exchange Rates	–3.5	5.7	4.7	–0.3	0.1	–0.1	0.6
European Union	–5.9	5.1	4.4	0.4	0.0	0.7	0.5
Middle East and North Africa	–3.2	4.1	4.1	0.0	0.4	0.1	0.4
Emerging Market and Middle-Income Economies	–2.3	6.7	5.1	0.2	–0.1	–0.2	0.1
Low-Income Developing Countries	0.1	3.0	5.3	–0.9	–0.2	–1.3	0.1

Within the context of the softening prospect for the average *global* growth, the gap between the advanced economies and the low-income, non-commodity producing countries will unfortunately become bigger again. This dramatically affects the outlook for the poorer countries and the moment they can revert to their pre-pandemic growth levels seem to be sliding away. The graph below show that the advanced economies reach their earlier expected growth path next year. The pandemic induced set-back for the rest of the world and particularly the emerging markets (EMs) and low-income countries (LICs) is much bigger and will take many years to overcome (see the *Tale of Two Worlds* graph below).

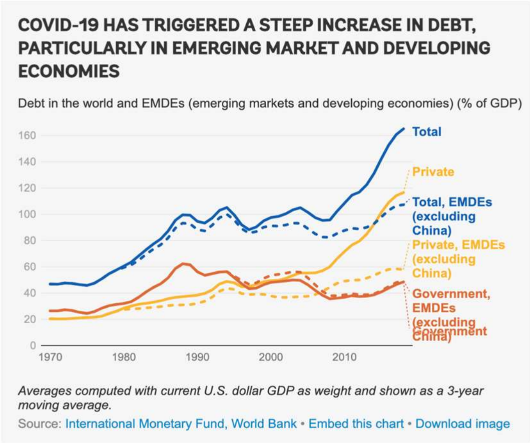


The IMF Managing Director Kristalina Georgieva, recently spoke about a 'hobbled' recovery and pointed at the current 3 main risks: **Inequalities, Inflation and Debt** (*speech at Milan's Bocconi University on 5 October 2021*).
This year and next will test the stability of our financial systems writes the IMF in the recent Global Financial Stability Report (October 2021). Divergence between advanced economies and the emerging world in terms of public health (vaccine inequalities) and economics in a scenario of rising inflation and monetary tightening may seriously shake the main institutions of international finance. An earlier Global Financial Stability Report (April 2021) highlighted already the frightening picture of growing debt, particularly in the poorest countries: '*COVID-19 has dealt a major blow to world's poorest countries, causing a recession that could push more than 100 million people into extreme poverty.'*

With more dramatic use of words, UN Secretary General António Guterres characterised the debt burden of the emerging world as "***the dagger through the heart of global recovery****….*" (*Statement at the opening of the UN trade conference on the 4th of October 2021*).
He called for multilateral action to avoid the situation that '*countries cannot build back from the pandemic if they are held down by debt'.*
It seems therefore high time to dig a bit deeper in this gloomy and frightening landscape of DEBT.

2. The Concept of Debt

It should come as no surprise that the COVID-19 pandemic has accelerated debt of all economic actors, all over the world. The imposed pandemic restrictions and lockdowns have seen incomes falling and expenses increasing for households (loss of work and income, inflation), businesses (sales dropping and cost increases), and governments (higher public health and welfare expenditure, less tax revenues).
No wonder thus that levels of indebtedness of all economic actors have skyrocketed, with a particular worrying trend among emerging and low-income countries (see graph below).



Before further reviewing this, it seems prudent to take a step back from the statistics and reflect on the debt as a socio- economic phenomenon and define its concept and underlying principles.
The first thing to note is that the word 'debt' is laden with (mostly negative) connotations and emotions. For example:
'Debt' and 'Guilt' and 'Sin' are seen to be close relatives. In some languages, they even carry the same name (e.g. in German: "*Schuld*"*)*. No wonder then that repaying debt is seen as an honourable thing: one needs to 'honour' one's debt!
And in *Hamlet,* William Shakespeare lets *Polonius* observe: *"Neither a borrower nor a lender be for loan doth oft lose both itself and friend and borrowing dulls the edge of husbandry."*
So, debt is generally not perceived as a happy thing to have….

De-mystifying Debt
While debt is such a basic feature in daily life and the world of market economics, it is generally ill-defined. It is frequently used in a catch-all way, meaning many things in different circumstances and difficult to pin down for a discussion on good debt or bad debt.

Let's start with a step back from the economics and morals of debt.
In a fascinating philosophy study *The Philosophy of Debt' (Routledge 2016)*, *Alexander Douglas* takes us to the roots of debt. The word 'debt' seems to originate from the Latin verb 'debeo' meaning 'to owe'. The root of the word *debeo* is thought to be a combination of the words '*de'* as in the possessive term '*of*' or '*from*', and '*habeo*' meaning '*to have, to own*'. In merging the meaning of 'debeo'/'debt' we can word-playfully characterize the borrower's position as 'having but not owning' while 'owning but not having' captures the position of a lender.

Four rules of debt
The philosophy of debt can help clarifying the basic features of debt.
It starts with the assumption of parties acting in good faith. The borrower will use the debt to create value/extra income/reduce costs. Such use of proceeds should generate the means to repay/return the debt. In addition, it would allow the borrower to pay compensation for the lender's opportunity-cost of a temporary loss of possession (interest charge). On the other hand, the lender accepts in good faith the risks implied in the debt agreement. She/he will not unreasonably approach any delayed or cancelled repayment in case that the anticipated value creation does not fully and/or timely materialise. Finally, the debt's interest charge should be a reasonable reflection of the lender's opportunity cost, plus a risk premium, but never reach disproportionate, usury levels.

From this we can derive four simple rules for 'Good Debt':

- ***It is a contract for funding***: both parties the borrower and the lender have obligations
- ***It needs to have clarity of purpose***: use of debt must support the borrower's repayment capacity. It must aim at investment, value creation and returns, rather than consumption. In other words, the debt should mature before the value of the funded asset is depreciated to zero.
- ***Repayment and risks are part of contract***: the lender needs to acknowledge risks of non-repayment and accept them, but borrower needs to mitigate them as much as possible.
- ***Default triggers enforcement action***: when defaulting on repayment obligations the borrower can lose the asset through collateral recuperation. This could ultimately lead to bankruptcy but also possibly credit losses for the lender.

To make it simple: debt that does not follow these basic rules could be classified as *doubtful or bad debt.*

These rules apply to all borrowers whether they are households, businesses, or governments.
However, for an economist there are also many differences between debt from private households and businesses on one hand, and government debt on the other.
So, next stop: 'public finance'.

3. The Economics of Debt and the Theory of Public Finance

Much of the modern economic thinking on government expenditure and finance stems from ground-breaking work of Richard Musgrave, the father of public finance theory (see his *The Theory of Public Finance*, 1959). As an economist born in Germany and studying and working most of his life in the US, Musgrave brought with him the continental European thinking around the public good and the various socio-economic roles of government.
He developed government's responsibility in three distinct but complementary areas:

- macro-economic support for national prosperity: *the government's '**stabilisation branch'**, aiming to secure the nation's growth and full-employment mission.*
- allocation of *accessible for all* and *non-exclusive* public services which private initiative and markets cannot provide: t*he **'service allocation branch'** providing the public goods and services the nation requires.*
- income distribution promoting societal welfare: *the '**distribution branch'** of government delivering a 'proper state' of distribution of income and wealth among the nation's citizens.*

Musgrave's views move us far beyond the classical 'small state' concept in Adam Smith's economic thinking and further developed by Milton Friedman. His views are more in line with the Keynesian concept of a policy driven state that intervenes when needed. Keynes introduced the concept of deficit-spending to reflate a flagging economy back to growth and higher employment levels.
An important element in Musgrave's theory relate to the *non-selectivity* of public services: The public good is for everyone and not for the few.

This helps to better understand the government interventions during the COVID-19 pandemic. Logically government interventions to prevent and fight the COVID pandemic have led to significantly increased government expenditure at every stage.
The table below tries to simplify some of historical phases in the development of the theory of public finance.

	STABILISATION FUNCTION	ALLOCATION FUNCTION	DISTRIBUTION FUNCTION
THE 'NIGHT WATCH' STATE: GOVERNMENT FOR BASIC PUBLIC SERVICES: DEFENCE, EDUCATION, LAW & ORDER *Classical and neo-classical views: the Night-watch State (Adam Smith and Milton Friedman)*	*Minimal state intervention, invisible hand of markets steers towards equilibrium*	*Traditional state provision limited to justice, defence, security, education*	*Minimal state intervention.* *No role for government in income and wealth distribution.*
MODERN WELFARE STATE: INTERVENTION WHEN NEEDED *Modern economic policy, welfare economics and public finance: (J.M. Keynes, Richard Musgrave, e.a.)*	*Macro-economic stabilisation policies, including deficit-spending for public investment programs. State intervention to dampen cyclical unemployment*	*State provision of infrastructure in transport but also in building human capital through education and public health policies*	*Income distribution policies through progressive taxation and social security/welfare programs*
INTERVENTIONIST STATE: PRO-ACTIVELY RESPONDING TO PANDEMIC *Pandemic forced public health and interventionist economic policy* (see *examples in the OECD Database on COVID-19 policy measures)*	*Protection of public health. Socio-economic restrictions incl. lock downs, work-from-home plus monetary and fiscal policy to stabilise economy and support households and businesses. Labour market and education support to preserve human capital.*	*Public health interventions, mass vaccination.* *New income support schemes arising from employment crisis.* *New educational tools and infrastructure for home schooling*	*Fighting rising inequalities through pro-active benefit support, furlough schemes, taxation on income and wealth.*

Even with the debate about the effectiveness and efficiency of some of the COVID-19 measures, there was little or no political or academic opposition to the pro-active role governments around the world have undertaken to fight the pandemic and save the economy.

In analysing the pandemic government action, we would argue that all these interventions had a clear purpose and clearly aimed at protecting people, the nation, and its economy.
The complex of policies and measures were aimed at creating longer term value through:

- protecting public health
- preserving the country's productive capacity and avoiding capital destruction
- supporting the economy and its competitive businesses
- investing in education and training of the current and future workforce
- avoidance of loss of skills caused by illness or unemployment.

This booming pandemic-related government expenditure triggered of course a financing question: how to pay for it?
Through taxes or other government duties? Or by additional government borrowing and debt.
And in the case of the latter, should we worry?

4. Government debt: The Good, the Bad and the Ugly

Government debt is a debt *for* everyone and *of* everyone. It brings liabilities for current and future generations of citizens.
But the contract between borrower and lenders is complex: many domestic investors in government bonds are frequently also the (in)direct beneficiaries of public services (e.g. domestic savers, national pension funds, etc).

A walk around in this complicated and interconnected world of government finance makes us realize some crucial differences between private debt and public debt.
The morality of government debt (what is 'good debt' or 'bad debt') is therefore far from easy to assess. Let us therefore check it against the above stated four basic rules of debt (contract, purpose, repayment, default risk).

Re. Contract
The issuance of government bonds is the most used public financing tool and dominates local and international capital markets. It sets the benchmark for the presumed risk-free rate of interest and has a wider value in financial markets. But it is a contract with a borrower committed to use the money for good causes (and nothing else) and carries an obligation to repay the lender..
Re. Purpose
Government debt is created to fund services for common use on a non-discriminatory and non-exclusive basis (very different from borrowing for personal and competitive business purposes). It directly derives from laws, government budgets and programs which in most countries require parliamentary majority approval representing "the will of the people" (or at least most of them). The spending purpose creating the debt should thus be clear.
Re. Repayment
It is essential that government is transparent about how to meet the future burden of debt service and repayment. The funds for repayments could come from higher tax revenues created by higher growth, or from higher direct or indirect tax charges on household and/or business income which usually also require parliamentary approval. Governments could of course influence monetary policy which opens -in theory- an unlimited funding source. However lax monetary policies could result in uncontrolled inflation and destroys the economic health of a nation. Independent central banks are a safeguard and provide de facto a brake on government abusing the money printing press.
Re. Defaults risk
Contrary to private debtors, governments generally borrow in an unsecured way without security or collateral. Thus, in the case of default, restructuring (mainly later repayments) is the only option (plenty historical examples available). Secured public sector or quasi-government borrowing is normally structured through non-governmental structures in PPF and development finance institutions with sometimes a certain form of government support. Collateral recuperation is in principle possible but a difficult and lengthy process if it requires government contribution.

Our test shows that much of government borrowing, is generally in compliance with our basic four rules of good debt.
Most government expenditure is thus for investment, particularly in the case of pandemic interventions, and most government debt therefore earns the title 'good debt'.
But does this go for *all* government debt?
My honest answer is NO .... bad government debt exists!
For example, if it finances expenditure that is (1) structurally unsustainable or (2) hidden away or (3) corruptly, fraudulently designed and/or executed, and/or just wastefully spent (also criminal).

It seems however that we are one step closer to a balanced answer to the question of worry about the sharply increased government debt.

5. Good Debt, Bad Debt, Hidden Debt and Worse

To test the "dagger through the recovery heart" view, we may need to kick the tires of this good debt/bad debt argument.

Elaborating on the above observations we see the following categories of government debt:

- **Good debt**: for investment and growth, good debt gets repaid (*and is not inflated away*)
- **Hidden debt masks the real government liabilities and can turn all debt into bad debt:** full off-budget expenditure disclosures required and only fully disclosed growth generating schemes to remain
- **Good debt turning into bad debt**: repayment requires rescheduling, and support for restoring future *financeability*
- **Structurally unsustainable debt is bad debt**: conscious overestimating repayment capacity demands *corrective action*
- **Debt from corruption, fraud, misappropriation or waste is bad debt:** illegitimate government expenditure under mines the government's borrower status in financial markets; this is more prominent in vulnerable countries with weaker governance structures

Below we elaborate these points a bit further.

Good debt gets repaid, in real terms (but not through inflation).

Any government action that would prevent a slowing down of GDP growth should positively contribute to the longer term's debt/GDP ratio. Actions aimed at preventing and controlling the COVID-19 pandemic should thus classify as positive for future debt repayment obligations (see schedule above). Thus good debt expects to be repaid through the benefits of real economic growth (itself leading to relative lower expenditure for example lower unemployment benefits) and higher tax revenues from growing profits, income, and spending.

But, as we have already seen, the post-pandemic recovery could also spur sharp rises in inflation. And inflation can over time diminish the real value of nominal debt obligations and lead to a relative reduction of debt levels in GDP terms. Inflating debt away spreads the burden of repayment to households and businesses who need to absorb the costs increases of inflated prices. It is a regressive form of taxation as the weaker and low-income households and businesses will carry relatively most of this burden.
It is no surprise then that traditional economics abhor such optical debt reduction. They fear that in the longer term, the real economy will only suffer from structurally higher inflation levels. The Chicago school economist *John Cochrane* expressed this eloquently: '*Inflation is a form of sovereign default. Paying off bonds with currency that is worth half as much as it used to be, is like defaulting on half of the debt. And sovereign default happens not in boom times but when economies and governments are in trouble.' (Inflation and Debt, National Affairs, autumn 2011).*

Hidden debt is deceptive and can create bad debt

Less attention has been given to another persistent practice of hiding government expenditure through off-budget schemes. While traditional government interventions follow one of the three methods: public spending (including promotional subsidies), taxation (including used charges) and/or regulation, governments all over the world have always looked at 'inventive' ways to avoid higher public expenditure or higher taxes. They could have the label "Privatisation" or "Public Private Partnerships" (PPP) or Private Finance Initiative"(PFI).

But as long as government remains the policy setter, it also stays the financier of last resort. In case of financial difficulties, the schemes still relied on the government's ultimate bail-out. We all remember of cases where these transfers to the private sector were only 'nominal shifts' to the private sector; 'privatisations in name only' (PINNOs).
However, these consequences were never authorized nor reported through the budgetary process and continued to have an impact the government's future financing capabilities. But nobody was aware of them…until they hit the buffers!

The OECD has been studying this phenomenon since the Latin-American debt crisis in the 1990s. It unearthed many clever practices to pursue government action without requiring budgetary expenditure: "*Strictly defined, off-budget expenditures refer to financial transactions that are not accounted for in the budget. Off-budget expenditures… are more likely to involve special transactions such as the activities of public enterprises, credit provided or guaranteed by government, or subsidies channelled through the tax system" (Allen Schick: Off-Budget Expenditure: an economic and political framework, OECD Journal on Budgeting 2007).*
In agreeing with the danger of hidden public expenditure, the UK's House of Commons Treasury Select Committee recommended full disclosures of these practices: "*The Treasury should remove any perverse incentives unrelated to value for money by ensuring that PFI is not used to circumvent departmental budget limits …and include PFI liabilities in future".*

In a period of budget constraints and a widespread call for a more active government including for action on the Climate Change, many governments might be tempted to pursue new off-budget routes. For example, ideas for the creation of new national development finance institutions (DFIs) such as a Green Bank are floating around in many places. These could be formidable tools for mobilising capital funding for important public policy goals, but proper and transparent disclosure is vital to avoid future quasi-government debt crises.

Good government debt turning into bad debt and needs restructuring and support
In government (as in business) initial investment objectives may not materialise.
Some government programmes may turn out to be less effective than hoped-for and/or unexpected external factors de-rail the growth expectations.
History has shown that it frequently relates to overly optimistic economic modelling used at the time of budget approval. These can spiral out of control: a government expenditure programme built on over-optimistic growth projections could lead to a debt crisis if growth does not materialize, the expected additional revenues do not appear, while simultaneously lower growth negatively impacts employment and social welfare benefits balloon. The initially intended repayment-undertakings may therefore be impossible to meet.
In such cases governments need to fully disclose all relevant data so that bondholders and rating agencies can assess the significance of the deteriorating debt service outlook.

As the pandemic recovery might be challenging for vulnerable emerging economies, extra international support may be needed for these countries to avoid defaults on their government borrowings. Multilateral initiatives have been approved such as the IMF additional SDR allocation to emerging countries and new support mechanisms through the G20 Debt Service Suspension Initiative (DSSI).
However, as the IMF writes in the World Economic Outlook of October 2021 this might not be enough: *" in cases where sovereign debt is not sustainable or where financing needs are large, liquidity relief may not be enough. The Common Framework for Debt Treatments beyond the DSSI endorsed by*

the Group of Twenty last year aimed to provide a mechanism for timely and orderly debt restructurings that can prevent the higher costs of protracted debt crises, but its implementation in the initial country cases has been too slow, calling for urgent improvements in this area." (World Economic Outlook, October 2021).

Structurally unsustainable debt is bad debt

Government debt that cannot be repaid in accordance with the agreed terms and conditions at the time of issuance is unsustainable.

There are many examples when governments issued debt not bothering too much on the repayment obligation that is attached to it. History is scattered by incidents where governments were mute on the funding of repayments or even of the interest charges coming with the debt and there was no realistic expectation that such would become remotely feasible in the future. In these cases, restructuring was never a realistic option.

The ultimate station for defaulting borrowers is bankruptcy and the question of a state bankruptcy has kept many commentators awake. Although theoretically a state bankruptcy might be possible. However, for a realistic bankruptcy case it would never fly as a government's asset base would always be larger than its liabilities. In addition, any future debt service could theoretically be supported by government's raising additional tax revenues or cutting expenditure.

However, tackling unsustainable debt levels requires significant political courage and extensive international support. The Greece/Euro crisis in 2012 has painfully shown how hard it is for a structurally over-indebted country to come back from the brink of default and even bankruptcy. It took the country almost a decade to restore its position as a bona fide borrower in the international financial markets, and current generations suffered for it. Imagine the suffering in a vulnerable emerging country outside Europe ….

Corruption, fraud, misappropriation, and waste create bad debt

The most obvious category of bad government debt stems from misappropriation of government funds, systematic waste, and all types of corrupt or fraudulent expenditure. By the nature of this type of expenditure, very little is known about the size and the impact of this bad government expenditure and related bad debt as data on its prominence is not easy to collect.

For many years the OECD and the World Bank have been researching these practices and assisting governments to address the many complex issues around the fight against corrupt practices. In their analysis it emerges that it not only exists in developing countries with weaker governance systems. The OECD recently published a report on the macroeconomic implications of corruption: *"Using a panel of OECD countries over the period 1995–2015, we provide evidence that corruption increases public debt and that this effect is independent of the size of government expenditure. Our estimates suggest that if corruption was halved, public debt would decrease by 2% in the short term…".*

A coordinated fight against corrupt practices in government spending is therefore very important from an economic point of view important.

It also supports good governance in the public sector and builds trust in government particularly in vulnerable countries. Significant multilateral support and assistance is available, for example from the IMF, the World Bank and the OECD.

6. The 'financeability' test for government debt

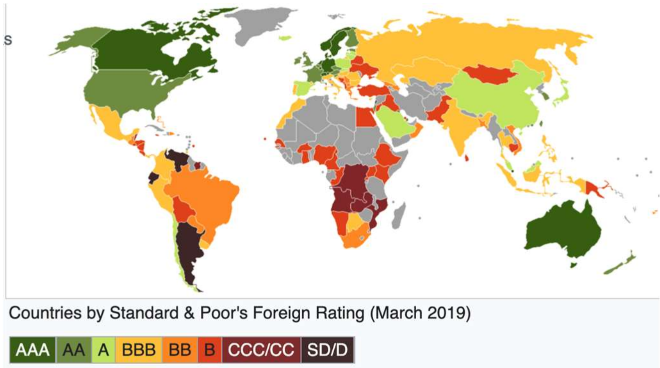
The gist of our reasoning is that most government debt is 'good debt'. There certainly is also 'bad debt', but in relative terms it is not at significant quantitative levels.

Does this mean that there are no limits to the levels of good government debt?

The answer is: NO.

Any borrowing is limited by willingness of lenders, domestic and international, to provide finance at reasonable terms. The ongoing financeability of debt is not a given.
Financial markets can be fickle; they sometimes react to many factors beyond the credit rating of a given country. Rating agencies can continuously challenge a country's credit outlook and model new data for their long-term projections of debt service and defaults.
But the investor community is a herd community… and if one in the herd panics, the herd will flee. Investor appetite, even for 'good government debt' is not eternal and unlimited. Governments need to set *prudential limits* for their relative debt levels (mainly GDP/ debt and debt service ratios) as we will argue below.

Academic research has focussed very much on macro-economic context mainly expressed through debt and debt service to GDP ratios to determine the sustainability and f*inanceability* of government debt. Almost all governments rely on borrowing programmes as they finance their annual budgets partly through deficit spending. For some the reliance on international markets is non problematic, for others, mainly in the emerging markets group, access to market has many hurdles. The world map of government ratings illustrates how unequal access to reliable funding is (see S&P pre-pandemic ratings-geography below).



Countries by Standard & Poor's Foreign Rating (March 2019)

Country ratings dictate the potential for governments to borrow in international markets and their borrowing's terms and conditions (interest rates, maturity, etc.). Green to yellow indicate an investment grade credit rating and relatively comfortable ongoing access; orange, red and beyond is below investment grade, or junk status, or worse with major roadblocks to the markets or undisputable No-Entry signs.

Many financial markets economists feel that on a longer-term structural level, debt/GDP ratios of up to 50% are acceptable. Higher levels could become increasingly dangerous and could reach a tipping point when spiralling debt becomes uncontrollable.
But what is high for one country can be acceptable for another as the S&P ratings picture illustrates: the very generous domestic savings ratio of Japan makes it possible for the Japanese government to finance the current extreme levels if government debt standing at over 250% of GDP (Japan has high investment grade rating). On the other hand, low-income countries such as Tanzania and Bangladesh have Debt/GDP levels around 40. They rely however heavily on international markets as they have a small domestic savings base. As a result these countries are below investment grade and face difficulties in funding.

With access to financial markets being very important It is not surprising that many governments have some form of debt ceiling arrangement laid down in law or even constitution. We all observe the annual political 'rituals' around the Federal Budget Debt Ceiling in the US.

In the years before the COVID-19 pandemic, the EU's 'Maastricht criteria' (*Debt/GDP max. 60% and Budget Deficit below 3% of GDP*) were infamous in their impact on budgetary austerity policies of many member states. It is not surprising that since the COVID-19 pandemic, the validity of these strict Maastricht criteria is very much under discussion. A recent report of the European Fiscal Board (EFB) (an advisory body to the EU Commission) is defending a more flexible and balanced approach to the EU budget rules: "*the future focus should be on one primary objective, a long-run anchor for public debt, with one main operational rule – an expenditure benchmark- to target a gradual reduction of the debt ratio at a pace tailored to country circumstances*…"(*Fifth Annual Report EFB, November 2021*).
So, unlikely to see repeats of the Greek/Euro debt crises..

However, while the tide of strict disciplinary government budget limits may be turning, the need for ongoing attention for financeability is vital. Most governments run budget deficits and rely on access to international markets for funding.
Many investment grade countries have their public borrowing agencies in constant dialogue with rating agencies and international banks. There is clearly a need for vulnerable countries to get assistance and support in building up their position for future funding access. Multilateral institutions such as IMF, World Bank and OECD are active participants in this area, but more can be done by the international banking and investor's community. Development assistance is not only a government/public sector obligation.

7. Most government debt is for investment

The growing anxiety and fear around increased levels of government debt is generally overdone. No need to dramatize.
De-mystifying some of the drama demands analysis and reflection beyond the admittedly sometimes scary numbers. I revisited some former stations (*national budget office in the Netherlands, public finance academic, long-time international banker/investor*) and my summary conclusions are very simple:

- Most government debt carries an investment mission; no need to worry too much about pandemic induced debt levels
- Watch out for uncontrolled inflation; debt not be inflated away but needs proper repayment through real economic growth.
- Hidden debt be banned and disclosed; new 'off-budget' finance initiatives only with ruthless transparency and only in case of proven growth/climate change transition support tools (e.g. national DFIs, green banks, transition finance institutions)
- International support for vulnerable countries struggling with good debt turning bad; G20/IMF Debt Service Suspension Initiative (DSSI) and other multilateral assistance and international finance support to be pro-actively offered.
- All government borrowers to undertake ongoing sustainability and financeability tests. Not to forget: the international investor community is a 'herd' community; when one in the herd panics, the whole herd flees in a pack…
- Action against bad debt, particularly from corrupt practices, to be internationally coordinated and punished. It is bad debt that takes a dagger to the heart of the community, the economy and people's life.

For the rest… little need to worry.

Bart Le Blanc, November 2021.

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