POLICY BRIEF

ADDRESSING PUBLIC DEBT CHALLENGES TO EFFECTIVELY PURSUE THE SUSTAINABLE DEVELOPMENT GOALS: REGIONAL PERSPECTIVES

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Summary

Amid rising government debt levels, higher interest rates, global economic slowdown and heightened geopolitical uncertainty, the risk of public debt distress and debt overhang in developing countries will remain elevated in coming years. At the same time, large financing needs to meet the Sustainable Development Goals (SDGs) and climate ambitions are adding more pressure on fiscal and debt positions. Debt distress in some countries has been further aggravated by existing current account deficits, tight debt redemption schedules, and lack of access to conventional lending markets.

How developing countries navigate the difficult balancing act of ensuring post-pandemic socioeconomic recovery and pursuing the SDGs while maintaining public debt sustainability is therefore a key policy consideration. In this pursuit, public debt can be a powerful tool to support sustainable development, if used judiciously and with a long-term horizon. Nevertheless, developing countries will need to continue to explore ways to strengthen fiscal positions and reduce short-term debt distress.

This policy brief, jointly prepared by the five Regional Commissions of the United Nations, outlines broad trends in public debt across the globe, discusses policy issues and options, and highlights policy experiences and lessons that governments across regions can learn from each other. The recommendations provided are designed to support the call by the Secretary-General of the United Nations for a fundamental reform of the international financial architecture and to provide the necessary resources for an SDG Stimulus at the scale required to deliver on the 2030 Agenda for Sustainable Development.

The brief argues that higher debt levels do not necessarily mean a higher risk of debt distress, nor are necessarily detrimental to economic growth. Rather, deploying resources raised from increasing public debt as investments in people and the planet offers sizeable medium- and long-term economic, social and environmental returns. Governments therefore need to achieve a balance between investing in the SDGs and managing fiscal and debt distress. Increasing fiscal revenues and improving public spending effectiveness and efficiency are key to expand the fiscal space and reduce debt distress. Better management of public debt can also go a long way in reducing fiscal risks and government borrowing costs.

For countries already facing elevated debt distress risk, this brief notes that timely sovereign debt restructuring can help mitigate the adverse socioeconomic consequences of continued debt distress or worse, debt default. In support of such restructuring, the international development community, including multilateral and bilateral creditors, should step-up its efforts to accelerate progress towards common international debt resolution mechanisms and restructuring frameworks. In this context, the brief proposes that an international sovereign debt resolution body is established by the United Nations to develop a global consensus on a common set of norms and standards to provide debt relief, facilitate coordination among debtors and creditors for dealing with debt distress, and undertake debt restructuring in an efficient, predictable, equitable, transparent, and timely manner.

I. Introduction

Amid rising government debt levels, higher interest rates, global economic slowdown and heightened geopolitical uncertainty, the risk of public debt distress and debt overhang in developing countries will remain elevated in coming years. At the same time, large financing needs to meet the Sustainable Development Goals (SDGs) and climate ambitions are adding more pressure on fiscal and debt positions.

In the past six decades, every global economic recession has led to an increase in government debt levels, as governments strived to support economic activity. The same has been true over the past decade since the 2008 global financial crisis. Much of the recent increase in public debt was during 2020 and 2021, when countries had to pursue unprecedented expansionary policies to deal with the multifaceted effects of the COVID-19 pandemic. At the same time when the governments were increasing expenditures to support people and economies, their revenue collection declined due to the ensuing economic contraction. This deepened budgetary imbalances and increased the public debt burden. Subsequently, the cost of living started to rise globally, as economies reopened, with inflation pressures exacerbated by the war in Ukraine. This led to tightening of monetary policy in developed economies. This has resulted in currency depreciations in many developing countries, lower global demand and increased borrowing costs. Such difficult economic and fiscal conditions undermine efforts to effectively pursue the SDGs while maintaining debt sustainability.

Debt distress in some countries has been further aggravated by existing current account deficits, tight debt redemption schedules, and lack of access to conventional lending markets. This may lead to debt traps where countries find themselves with high-interest loans for which they are barely able to repay interest, leaving countries in almost perpetual debt. Failing to address such challenges would hamper poverty reduction, sustained socioeconomic recovery from recent shocks, and resilience to future shocks, thus undermining sustainable development.

"Debt can be a powerful tool for sustainable development."

How developing countries navigate the difficult balancing act of ensuring post-pandemic socioeconomic recovery and pursuing the SDGs while maintaining public debt sustainability is therefore a key policy consideration. In this vein, it is worth highlighting that public debt can be a powerful tool to support sustainable development, if used judiciously and with a long-term horizon. Nevertheless, developing countries will need to continue to explore ways to strengthen fiscal positions and reduce short-term debt distress.

This policy brief, jointly prepared by the five Regional Commissions of the United Nations, outlines broad trends in public debt across the globe, discusses policy issues and options, and highlights policy experiences and lessons that governments across regions can learn from each other. The recommendations provided are designed to support the call by the Secretary-General of the United Nations for a fundamental reform of the international financial architecture and to provide the necessary resources for an SDG Stimulus at the scale required to deliver on the 2030 Agenda for Sustainable Development (United Nations, 2023).

II. Debt trends and vulnerabilities

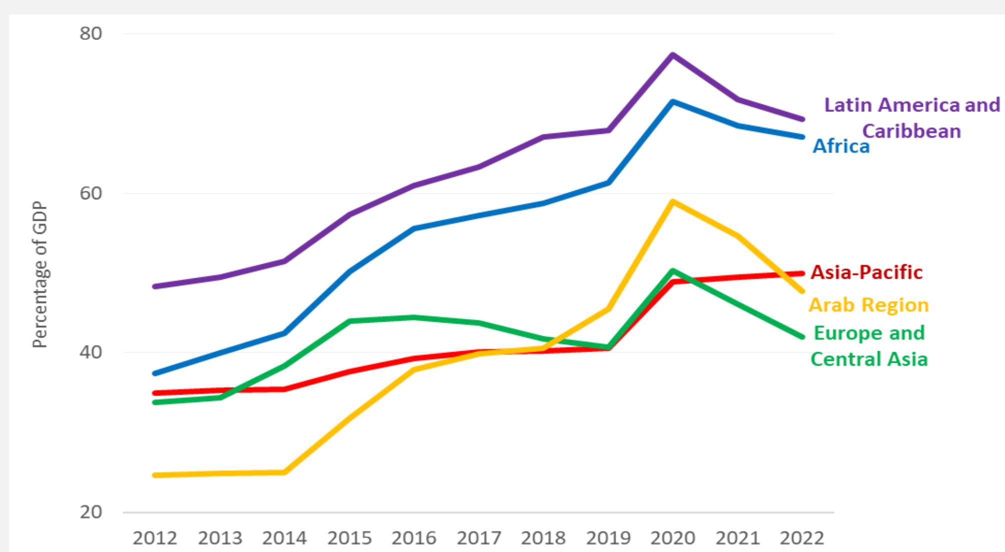
This section provides a snapshot of broad trends in public debt and related vulnerabilities in the developing regions of the world.

2.1 AFRICA

Public debt vulnerabilities remain elevated in Africa, and public debt level is projected to remain high owing to the combined effects of increased public spending and declining revenues caused by persistent exogenous shocks. Recently, public debt has soared owing to fiscal support that was deployed to vulnerable households and firms to shield them from the impact of the pandemic. The average public debt-to-GDP ratio in Africa is estimated to be around 64 per cent in 2022, down slightly from 65 per cent in 2021 (see figure 1). It is expected to decline further in 2023 to 61.9 per cent, which is nevertheless higher than the pre-pandemic level of 56.6 per cent recorded in 2019 (IMF, 2022).

The need to service and roll over large amounts of debt comes at a time when domestic and international borrowing costs are on the rise (see figure 2). This will weigh heavily on some African countries in 2023, and the situation could worsen in 2024 as more principal repayments become due for most countries. According to the Low-Income Countries' Debt Sustainability

FIGURE 1: GENERAL GOVERNMENT GROSS PUBLIC DEBT, DEVELOPING REGIONS OF THE WORLD, 2012-2022

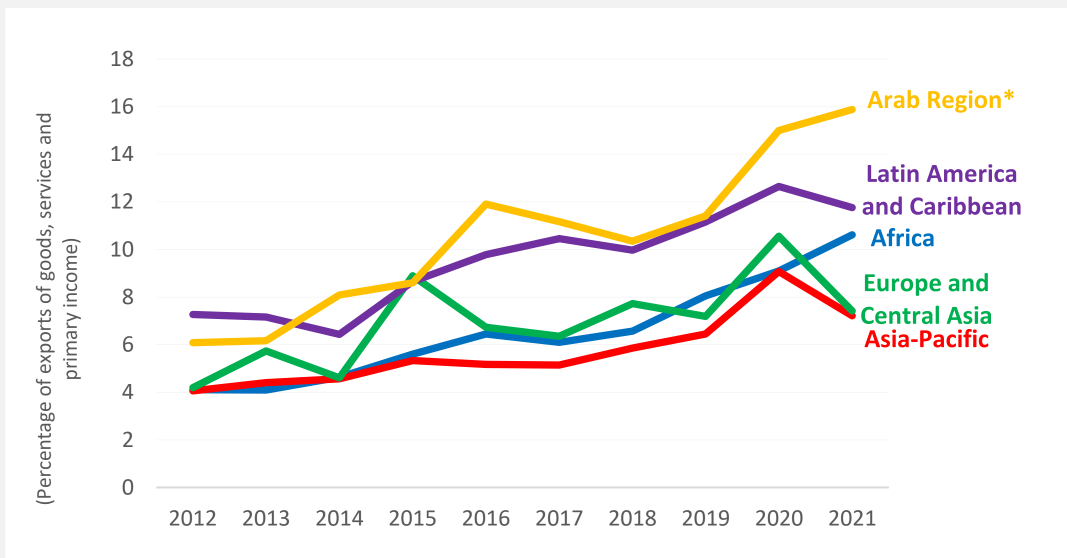


Source: IMF, World Economic Outlook 2022.
Note: 2022 figures are estimates. Regional averages are unweighted. Ukraine is not included in the figure for Europe and Central Asia.

Analysis for Poverty Reduction and Growth Trust (PRGT) Eligible Countries by the IMF, nine countries are currently in debt distress and eight of these are from Africa. Overall, 13 African countries at high risk of debt distress and several other countries on the continent are also facing major debt challenges.

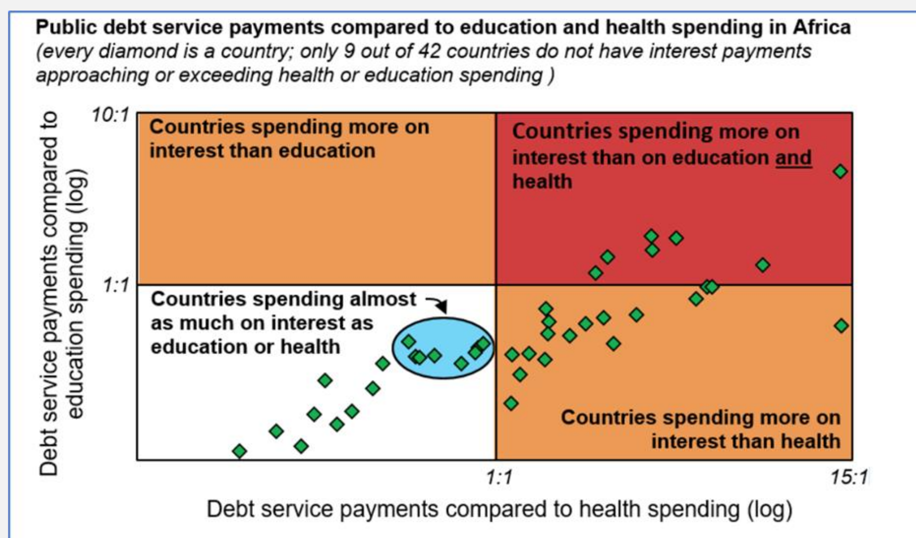
Debt servicing burden constrains essential social spending. A notable challenge for African countries, shared with many countries from other developing regions of the world, is that debt servicing is making up a higher proportion of fiscal expenditures which is undermining the focus on critical investments in health and education (see figure 3).

FIGURE 2: EXTERNAL PUBLIC DEBT SERVICE BURDEN, DEVELOPING REGIONS OF THE WORLD, 2012-2021



Source: World Bank.
Note: Regional averages are unweighted. *The reference here is to middle-income countries in the Arab region due to unavailability of data for all countries in the region.

FIGURE 3: AFRICAN PUBLIC DEBT SERVICE PAYMENTS COMPARED TO EDUCATION AND HEALTH SPENDING



Source: World Bank, "World Development Indicators Database".

2.2 ARAB REGION

Public debt has been increasing over the years following the global economic slowdown in 2008, reaching $1.4 trillion in 2020 on average, which was equivalent to almost 60 per cent of the regional GDP (see figure 1 above).[1] In 2021, though the public debt level increased in nominal terms to $1.5 trillion, it declined as a percentage of GDP to around 54 per cent. In 2022, it is estimated to have declined further to around 48 per cent of the regional GDP. This recent decline is largely due to better economic performance of Gulf Cooperation Council (GCC) countries of the region due to substantial increases in oil prices.

The middle-income countries (MICs)[2] of the Arab region hold more than half of the region's sovereign debt, which was about $765 billion in 2021 or 87 per cent of their GDP as compared to 83 per cent in 2020. Most of the least developed countries (LDCs) in the region[3] are facing high risk of debt, though they received temporary debt relief under the Debt Service Suspension Initiative (DSSI) of the G20. Several countries in the region face conflict-affected situations such as Libya and Syrian Arab Republic, which have compounded the underlying development challenges. The COVID-19 pandemic exacerbated such challenges, and led to increase in debt in these countries. Overall, the high level of debt and increasing trend puts the region at risk of debt unsustainability, especially since regional GDP growth has remained sluggish. Primary fiscal balances in the MICs and LDCs has remained negative over the past decade, reaching -3 per cent and -13 per cent of GDP, respectively, in 2020. In 2021, primary balances showed some improvement, but still remained negative at -1.9 per cent and -1.1 per cent of GDP in the MICs and LDCs, respectively.

Another point worth highlighting is that the profile of external public debt has changed dramatically over the years in the Arab region. These include (a) the MICs are borrowing more from private creditors; and (b) the share of concessional borrowing from official creditors (bilateral and multilateral creditors) is declining. This changing pattern has increased the cost of borrowing and makes countries more vulnerable to market risks as well as risks associated with external debt servicing either due to exchange rate shocks or due to any negative shock to trade balance.

2.3 ASIA AND THE PACIFIC

Prior to the pandemic, the average government debt-to-GDP ratio in developing countries in Asia and the Pacific was already at an 11-year high of 40.6 per cent in 2019 (see figure 1 above). This jumped to 49.5 per cent in 2021 with two thirds of Asia-Pacific economies reaching the highest level since 2008. Rising interest rates in 2022 have added further pressure to the debt service payments (see figure 2 above), which are expected to increase in many countries in the region in coming years. Several economies are still struggling with double or triple the size of their recent average external debt servicing, as high as 10 per cent of GDP in 2022.

"The number of countries rated at high risk of debt distress is increasing."

Along with rising public debt and debt servicing costs, the number of countries rated at high risk of debt distress has been increasing. Currently, 19 countries in the region are rated at high risk of debt distress based on the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries or equivalent credit ratings. However,

1 These inputs and figures in this document are based on the policy brief of ESCWA (2021). The data are updated.

2 Six MICs in the region included here are Algeria, Egypt, Jordan, Lebanon, Morocco and Tunisia. Lebanon has defaulted on Euro bonds in 2020 and currently seeking debt restructuring.

3 The LDCs in the region include Comoros, Djibouti, Mauritania, Somalia, the Sudan and Yemen. The Sudan has received significant debt relief in 2021 cancelling 90 per cent of its debt (about $50 billion). See www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf

not all of them have high levels of debt. In fact, six of these countries have experienced stable or even decreasing trends in their debt levels in the last decade, and their government debt-to-GDP ratios were below 20 per cent in 2021. In contrast, public debt levels of a few other countries, such as Japan and Singapore, are extraordinarily high but their credit ratings are also high. This indicates that high debt levels do not necessarily translate into high debt distress, as several additional factors are important such as the confidence in and credibility of monetary and fiscal policies; sound, prudent and transparent macroeconomic policymaking and implementation; the level and extent of financial market development; and the presence of a wider investor base.

Primary fiscal deficit is the key driver contributing to higher public debt in developing Asia and the Pacific. Currency depreciation also accounts for a large proportion of increases in public debt in several countries. Moreover, half of developing Asia-Pacific economies rely heavily on external debt but the composition of creditors has changed over time. This creates both risks and opportunities for sovereign borrowers and needs to be considered in order to navigate more effectively through rising debt levels. While borrowing more from multilateral and bilateral creditors, developing economies in the region received a lower share of concessional loans, which in coming years will contribute to higher debt service payments on public and publicly guaranteed debt. On the other hand, countries with higher domestic debt have increased issuance of local currency government bonds in the domestic market and have seen increasing participation of foreign investors in the domestic government bond market.

2.4 EUROPE AND CENTRAL ASIA

In developing countries in Europe and Central Asia,[4] the COVID-19 pandemic resulted in a sharp increase in the government debt-to-GDP ratios amid increased pandemic-induced expenditures and declining economic activity (see figure 1 above). Between 2019 and 2020, the median debt ratio increased by around 10 percentage points. This drastic increase was partly reversed as the post-pandemic recovery took hold. Based on IMF estimates and excluding Ukraine, the median increase in the government debt-to-GDP ratio between 2019 and 2022 stood at 2.3 percentage points, with 6 out of the 17 countries posting declines, leaving the median value close to 40 per cent. While the 2008-2009 global financial crisis resulted in a large and persistent jump in government debt ratios, the impact of the COVID-19 pandemic has been more limited. Meanwhile, based on IMF and World Bank data, the median of the ratio of external debt service on public and publicly guaranteed debt as a percentage of government revenues was around 8.8 per cent in 2022. While the ratio for this group of countries has not displayed an upward trend, for Tajikistan, which is considered at a high risk of debt distress, it roughly doubled in the period since 2015.

Excessive reliance on expensive and/or risky financing (due to exchange rate volatility) is a source of vulnerability in this region. Underdeveloped domestic capital markets translate into higher financing costs and reliance on external borrowing. For example, in Armenia, the interest rate on government securities was more than twice the rate on foreign currency denominated bonds in early 2023. Foreign currency debt accounts for around two thirds of the total. In the West Balkans[5], the share of external debt in total public and publicly guaranteed debt oscillates between 45-90 per cent, with a median of around 65 per cent.

4 The Europe and Central Asia region in this policy brief refers to the developing countries covered by ECE, which includes Eastern Europe (Belarus, Republic of Moldova and Ukraine), the Caucasus (Armenia, Azerbaijan, Georgia), Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) and Türkiye.

5 The West Balkans countries are Albania, Bosnia and Herzegovina, Montenegro, North Macedonia and Serbia.

2.5 LATIN AMERICA AND THE CARIBBEAN

Public debt level in Latin America and the Caribbean has been rising progressively during the decade leading up to the COVID-19 pandemic. In 2020, it expanded sharply as a result of severely deteriorated fiscal positions, reflecting the interaction of a strong contraction in public revenues and higher public spending as countries adopted wide-ranging fiscal support packages to strengthen public health systems, protect families and limit damage to the productive structure. As a result, the gross public debt for the region increased to 77.4 per cent of GDP in 2020 (see figure 1 above), compared to 67.9 per cent of GDP in 2019 and 9.1 per cent during the 2010-2014 period. The trend towards higher public debt levels was widespread across countries in the region. By 2021, 21 countries out of 30 (compared to 11 in 2012) had general government gross public debt of 60 per cent of GDP or more and, within these, 13 registered a level of indebtedness of 80 per cent of GDP or more (compared to 5 in 2012).

Moreover, the relative share of gross general government debt denominated in foreign currency is significant in some countries, increasing the vulnerability to currency shifts.[6] In the cases of Nicaragua and Paraguay, it amounts to 90 per cent. For these countries, a depreciation of the national currency means that debt service may rise significantly. In contrast, countries such as Brazil, Costa Rica and Mexico, with higher proportions of domestic financing, of more than 70 per cent of total debt, are rather more impacted by changes in domestic interest rates than exchange rates.

The above panorama across developing regions of the world of rising government debt levels, higher financing costs and an uncertain economic outlook means that the risk of public debt distress would be considerable in coming years. This implies that the scale of fiscal responses available for investing in the SDGs and for climate action is likely to remain limited. Against this background, the following sections of this policy brief examine how new perspectives on fiscal and public debt analyses and policies can help developing countries to effectively pursue not only the SDGs but also improve their long-term debt sustainability prospects.

6 Foreign currency debt is normally related to external debt, but some countries in the region also issue domestic debt in United States dollars.

III. Rethinking debt sustainability assessments

Conventional thinking on public debt assessments focuses on maintaining debt sustainability in the short term. It assumes that a rising public debt level is necessarily bad for economic growth and stability and applies a common "optimal" public debt level threshold to different countries. It undermines a governments' ability to access financial resources at a reasonable cost, contributing to suboptimal development outcomes. The cost of fiscal austerity/consolidation, imposed to ensure debt sustainability in the short term, comes with a heavy price in terms of increased poverty, worsening inequalities, and incomes and job losses due to resulting economic slowdown.

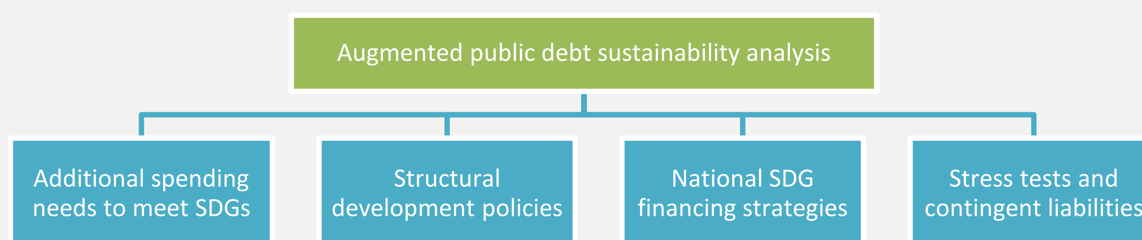
Given the urgency of investing in the SDGs and climate action, it is time for policymakers and the international development community to rethink debt sustainability assessments. We believe that "appropriate" public debt level is country-specific, and depends on progress and ambitions on sustainable development. A higher debt level for a country does not necessarily mean a higher risk of debt distress. Several other factors matter, such as drivers, purpose and composition of debt; confidence in and credibility of monetary and fiscal policies; sound, prudent and transparent macroeconomic policymaking and implementation; the level and extent of financial market development; and the presence of a wider investor base. Moreover, deploying public debt as an investment in people and the planet offers sizeable medium- and long-term economic, social and environmental returns.

In the context of Asia and the Pacific, ESCAP has proposed an "augmented" approach to analyse public debt sustainability in the long term that complements the short- to medium-term debt sustainability methodologies used by international financial institutions and credit rating agencies. A long-term approach can supplement the current exclusive focus on reducing near-term debt distress, which can compromise efforts to promote inclusive, resilient and sustainable development.

"It is time to revisit how public debt sustainability is assessed."

ESCAP's augmented debt sustainability analysis approach takes into account a country's additional spending needs to achieve the SDGs by 2030, government structural development policies that go beyond financial investments, and national SDG financing strategies (see figure 4). It also integrates climate change issues through various channels, such as investments in climate adaptation and mitigation, government transfers for disaster-affected households and fiscal support for commercial banks burdened with stranded asset values in carbon-heavy industries. By illustrating different trajectories of government debt under different scenarios of public policies and adverse shocks, this approach helps to inform policy choices for balancing reasonable fiscal risks in the near-term with long-term development ambitions. Finally, the analysis includes stress tests and realization of fiscal contingent liabilities to reflect sudden changes in economic conditions and contingent liabilities which reflect country-specific risks, such as government bailouts for major commercial banks, or large-scale investment projects under a public-private partnership modality.

FIGURE 4: COMPONENTS OF AN "AUGMENTED" APPROACH TO DEBT SUSTAINABILITY ASSESSMENTS



Source: ESCAP (2023).

Application of this approach for Mongolia shows that investing in a package of development policies to promote a greener, more diversified Mongolian economy, in addition to SDG investments, can boost socioeconomic and environmental gains in the country. Not surprisingly, these investments also result in much higher government debt, initially. Yet, the analysis shows that financing strategies to enhance fiscal resources and mobilize more private finance for development can reduce government debt significantly. Indeed, it is estimated that, by 2040, the government debt level would eventually converge to the same level as under the baseline scenario, which assumes fiscal consolidation. Under the baseline scenario, government debt level is projected to fall steadily over the period 2021-2040 amid fiscal consolidation while that under the alternative scenario rises in the first several years due to investment in the SDGs but trends down afterwards as socioeconomic and environmental benefits gain momentum. The key difference between the two outcomes is that the people and the environment are much better off under the proposed alternative scenario. This analysis emphasizes the importance for all stakeholders to consider public debt sustainability from both short- and long-run perspectives.

Besides providing a longer, more holistic view on public debt sustainability, the quantitative analysis has other policy implications. *First*, governments should aim to strike a balance between achieving the SDGs and public debt sustainability. For instance, attempts to meet statutory fiscal rules should be mindful of the broader economic situation and its social impact. The analysis for Mongolia shows that, while controlling government debt, strict fiscal deficit rules push up poverty to a notable extent. *Second*, international financial institutions and credit rating agencies can play an important role in supporting debtor countries to navigate this balancing act. For example, when public debt sustainability is also assessed by public investment quality and potential returns, and not just the government's debt repayment ability in the near term, the sovereign risk premium should become less sensitive to government debt levels. In such a case, the analysis reveals that government debt declines along with poverty amid lower interest rates and higher employment.

IV. Strengthening fiscal positions to address debt distress and pursue sustainable development

Post-pandemic macroeconomic realities have put developing countries in a policy dilemma of mounting sovereign borrowing costs and debt sustainability concerns on one hand and persistent demand for public investments to support economic recovery and sustainable development on the other. This section argues that opportunities for a better balance between fiscal prudence and long-term development considerations do exist. It proposes five policy actions that can enhance sovereign debt sustainability without sacrificing essential public spending and sustainable development investments (see figure 5).

4.1 EFFECTIVE SOVEREIGN DEBT MANAGEMENT AND MONITORING

Effective sovereign debt management and monitoring can reduce both debt distress risk and sovereign borrowing costs. Clearly articulated policy objectives and legal frameworks, procedural and institutional transparency and accountability, and strengthened debt statistics can all improve the quality and credibility of public debt management strategies. They not only provide an important anchor for responsible sovereign borrowing at potentially lower costs, but also reduce uncertainties regarding a country's debt outlook.

It is desirable that a legal framework grant the authority of public borrowing or guarantees to a dedicated debt management agency in order to centralize decision-making. For most developing countries, enforcing an appropriate level of discipline on sovereign borrowing is crucial for maintaining sovereign debt sustainability. However, such discipline is often eroded due to both socioeconomic and political pressures for additional public spending financed with additional debt. Having dedicated debt management offices and preserving their independence are thus factors of great importance for the credibility and accountability of any sovereign debt management

FIGURE 5: FIVE STRATEGIES IN ADDRESSING DEBT DISTRESS AND PURSUING SUSTAINABLE DEVELOPMENT

strategy. For these offices to function effectively, their responsibilities should be publicly disclosed and their operations should be audited regularly.

Timely collection, monitoring and reporting of accurate sovereign debt data can also be helpful in reducing debt distress and even borrowing costs. Opacity of sovereign debt profiles erodes the foundation of sound public debt management. Developing countries should aim at adopting international standards in the reporting of sovereign debt data even when confronted with institutional and capacity constraints. One area where urgent and significant effort is needed is the monitoring of sovereign contingent liabilities, such as undisclosed sovereign debt obligations, public guarantees on debt issued by state-owned enterprises, government bailouts of domestic financial institutions, or additional emergency spending in response to natural disasters or pandemics. In Asia and the Pacific, for example, estimated fiscal costs to Governments if various contingent liability events are to be realized are about 7 per cent of GDP and, under several scenarios of banking sector bailouts, this figure exceeds 30 per cent of GDP. In addition, for countries with high risk of sovereign debt distress, collection and compilation of contractual details of their outstanding debt would be important in preparation for potential debt restructuring.

Improving access to new tools and innovative ideas and best practices are important mechanisms to enhance the capacity of debt managers for formulating effective sovereign debt management and monitoring. ESCWA, in collaboration with UNCTAD, has called upon member States to establish a network of debt managers at the regional level, the Arab Debt Management Group (ADMG), to promote peer learning and share lessons on improved debt management practices. Examples include improving debt data quality, evidence-based borrowing such as to stabilize the government debt-to-GDP ratio over medium term (Altshuler and Sarangi, 2022), and developing debt optimization strategies to enhance fiscal space for financing the SDGs (ESCWA, 2022a).

4.2 PRODUCTIVE PUBLIC INVESTMENT AND EFFICIENT PUBLIC SPENDING

Productive public investment and efficient public spending can improve debt sustainability and deliver additional developmental pay-offs. By supporting economic growth and sustainable development, productive public investments enable countries to outpace the debt build-up and provide them with an option to "grow out of debt vulnerability" instead of resorting to austerity. For these beneficial dynamics to take place, it is critical that financing costs remain contained. Significant efficiency gains can also be achieved through better alignment of public expenditure with sustainable development objectives and better preparation, selection and execution of public projects. For the Arab states, ESCWA developed the Social Expenditure Monitor (SEM)[7] to assess the level and efficiency of social expenditures. The estimates suggest that by raising the efficiency of public spending to the global average could provide additional liquidity, reaching up to $100 billion annually for the Arab region (ESCWA, 2022b).

There is still substantial space for developing countries to better align public expenditure with sustainable development priorities. For instance, a simple correlation analysis for Asia and the Pacific reveals that increases in public debt were neither associated with higher gross fixed capital formation nor higher education and health-care spending in most economies in the past (ESCAP, 2023). In addition, military spending as a share of GDP exceeded the global average in about a third of Asia-Pacific economies in 2021. Both figures indicate that there is considerable space for better allocation of public funds for greater sustainable development and economic growth pay-offs. In Africa, a sustainable budgeting approach could potentially facilitate increased financing flows from development finance institutions in support of

7 Available at https://sem.unescwa.org/.

national commitments under the 2030 Agenda and Africa's Agenda 2063, by helping find win-wins in public finance efficiency and use of funds.

There is also considerable room to further enhance public spending efficiency. ESCAP estimates that fiscal savings of up to 30 per cent could be achieved for Asia-Pacific economies in public expenditure on health care and education (ESCAP, 2019). Potential savings on infrastructure investments could be even higher with better project preparation, selection and implementation. With more efficient public spending, these potential savings could then be redirected either to be used to finance additional investments in sustainable development or to reduce sovereign debt. In Montenegro, for example, reforms have been undertaken to strengthen public investment management, including amendments to procurement and public-private partnership legislation. The quality of spending can also be increased through improved procurement practices. In Kazakhstan, a new procurement law has broadened access to tenders, streamlined processes and encouraged more use of digital tools to foster transparency.

In the Arab region, ESCWA has supported governments to improve the efficiency of public spending by developing an Integrated Budget Intelligence Toolkit (i-BIT) that provides detailed fiscal incidence analysis of the intertemporal impacts of budget expenditures on SDG performance across the 17 SDGs and more than 100 measurable indicators. The i-BIT optimizes the allocation of public revenues by identifying budget lines with a proven positive influence on advancing SDG progress and captures how SDG interlinkages interact in national configurations and how to harness them to increase the efficiency of public spending. In the case of Egypt, for example, application of the tool indicates that the country's budget could be optimized by up to 25 per cent to provide maximum SDG impact by reallocating budgetary outlays while aligning with national legal and constitutional requirements.

4.3 STRENGTHENED DOMESTIC PUBLIC REVENUE MOBILIZATION

Strengthened domestic public revenue mobilization can boost fiscal resources to a notable extent. Sizeable revenue potential can be realized through the broadening of the tax base in developing countries and overall improvements in tax administration. For example, the difference between actual and potential tax collection (tax gap) in the Arab region amounts on average to 15 per cent of non-oil GDP (for hydrocarbon-exporting Arab countries) and 30 per cent of GDP (for hydrocarbon importing countries). Notably, some developing countries have managed to realize more of their tax potential in recent years. In Asia and the Pacific, for example, while the average region-wide tax-to-GDP ratio increased by 1.1 percentage points between 2010 and 2019, such an increase exceeded 3 percentage points in 10 countries, including in Armenia, Cambodia, Maldives, the Federated States of Micronesia and Nepal, where the increase was more than 5 percentage points. Some of the effective policy measures in the region included modernizing and rationalizing tax systems (Cambodia, Maldives, Myanmar, Nepal, Philippines), introducing new broad-based taxes (Maldives, Myanmar, Samoa, Tonga), incorporating the informal sector and small and medium-sized enterprises into the formal tax regime (Cambodia), improving tax and customs administration (Armenia, Cambodia, Myanmar, Nepal, Philippines) and removing excessive tax exemptions (Philippines).

Opportunities also exist to increase progressive direct taxes. Tax revenues in developing countries are skewed towards regressive taxes. Low direct tax collection, in particular personal income tax, in turn, limits the redistributive power of tax systems. Strengthened tax administration capacities, improved transparency on income and wealth of both corporations and individuals and the proliferation of digital technology have significantly reduced the barriers and costs of

enforcing progressive direct taxes in many countries.

"Strengthened domestic public revenue mobilization can play a significant role in addressing chronic debt overhang."

To broaden the tax base, a number of African countries have increased their capacity for domestic revenue mobilization in collaboration with ECA. Some examples of the measures taken include: (a) the Kenyan Capital Markets (Amendment) Bill, 2022, which seeks to introduce taxation of crypto exchanges and digital wallets and imposes transaction taxes comparable to excise duty levied on bank transactions; (b) Zambia's harmonization of corporate income tax (CIT) rates in 2022 for certain sectors, with CIT rates harmonization to continue in forthcoming years; and (c) Ethiopia's increase in excise tax on average between 15 and 20 per cent per annum in the recent past, as well as formulation of a distinct implementation plan for electronic excise tax.

It is also important to periodically assess the effectiveness and rationale of tax exemptions and preferential tax regimes, which can become a source of large tax expenditures that are no longer justified in the era of 2030 Agenda. Fossil fuel subsidies absorb public resources and prevent change towards more environmentally sustainable economies. For example, in the West Balkans, coal subsidies help to preserve the status quo and prevent the entry of companies providing energy from renewable sources. In Central Asia, the median explicit fossil fuel subsidies as a share of GDP in 2022 exceeded 5 per cent, on the basis of IMF data. By contrast, environmental revenues can help not only to align decisions with sustainability but also to shift away taxation from labour. A reform can free substantial money but it is a delicate matter, in view of the associated political costs.

In Latin America and the Caribbean, countries have taken proactive measures to bolster domestic resource mobilization, but there are still ample opportunities to increase tax revenues to finance sustainable and inclusive development. Revenue measures should be sequenced to account for the time required to achieve lasting policy reforms. In the short term, countries should consider measures to tackle tax evasion, which ECLAC estimates cost the region $325 billion in 2018, equivalent to 6.1 per cent of GDP (ECLAC, 2020). Additionally, costly tax expenditures – equivalent to 3.7 per cent of GDP on average in 2021 – should be reviewed with the aim of sunsetting measures that are not cost-effective and aligning remaining preferential tax treatments with the SDGs (see Campos Vázquez, 2022; ECLAC, 2022; ECLAC-Oxfam, 2019). In the medium term, structural tax reforms will be required to strengthen direct taxation – especially of personal income, wealth, and immovable property – to generate the revenues necessary to close existing structural development gaps and catalyze a new development path that promotes sustainable economic development and social inclusivity. Producers of non-renewable natural resources should also seek to strengthen their fiscal frameworks to ensure a just capture of the economic rent generated by the extractive sector (ECLAC, 2022). For hydrocarbons producers this will be key to generate revenues in the short term that can provide a long-term stream of development finance in the context of a net-zero emissions transition. For mining countries, the adoption of low-carbon technologies may result in a large increase in demand for some products, potentially generated extraordinary economic rents.

Digitalization opens new possibilities for the management of public finances. It is contributing to raise the efficiency of tax and custom administration, reducing fraud, and raising revenues. In the Kyrgyz Republic, for example, improved tax administration led to a large jump in tax revenues over the last two years, as a result of digitalization measures for invoicing, filling and tracking and simplification of tax procedures. On the spending side, digitalization can also be used for better targeting of social protection. This has the additional benefit of facilitating the reduction of general subsidies and cutting fiscal expenditures. The implications are positive not only for better identifying those who are most vulnerable but also for creating better behavioural incentives.

Another major priority to bolster domestic revenues could be addressing illicit financial flows (IFFs). For example, ECA estimates that between 2000 and

2016 Africa had, on average, $83 billion a year in net outflows through trade mis-invoicing. Cumulatively between 2000 and 2016, the mis-invoicing was estimated at $1.4 trillion, equivalent to 11.4 per cent of the value of Africa's trade. In the Arab region, economies fall prey to at least $60.3 billion–$77.5 billion per year in damages due to IFFs associated with trade mis-invoicing and mis-declaration. In other words, for every $1 the Arab region gained in financing, it correspondingly lost $1.05 as illicit financial outflows. By 2020, IFFs exceeded the combined aggregates of both official development assistance and foreign direct investment flowing into Arab countries (estimated at $50.5 billion in 2020) (ESCWA, 2018).

4.4 SIGNIFICANT INCREASES IN INTERNATIONAL DEVELOPMENT TRANSFERS

Significant increases in international development transfers can play an important role in addressing chronic debt overhang that is triggered by development deficits. In this regard, the new issuance of Special Drawing Rights (SDRs) by the IMF was a useful liquidity support. But it remains skewed towards benefitting high-income countries more than developing countries because of existing quotas of distribution of SDRs. For example, out of the $650 billion equivalent of SDRs issued, the share of the Arab region is only $37.3 billion, with the low- and middle-income countries in the region (15 out of total 22 Arab States) receiving only about $15 billion. Overall, the new SDR allocations to the Arab region are far below what is required (estimated $462 billion) to catch up to global average fiscal support of governments as a share of GDP (ESCWA, 2021). In this regard, IMF Member States must consider the adoption of a mechanism to re-channel unused SDRs from advanced economies to developing countries on the basis of their need, going beyond the existing quota system. Importantly, there is also a need for additional issuance of the SDRs to ease the fiscal and debt pressures of governments for social spending and support fiscal expenditures that drive sustainable development.

The international development community to realize that debt sustainability challenges in poor and vulnerable developing countries are closely linked to the fact that their own resources fall far short of their spending needs for sustainable development. Moreover, much of these spending needs, including on emergency responses to health and natural disasters and climate actions, will not be able to generate economic returns that are high enough to cover government borrowing costs. The need for these expenditures is sometimes closely related to the failure to provide appropriate finance for international public goods. In these circumstances, the international community is confronted with a choice between *ex ante* constructive development transfers and *ex post* painful debt relief and restructuring. The SDG Stimulus initiative of the Secretary-General of the United Nations to deliver the 2030 Agenda supports the former, calling for drastically scaling up external development finance for developing countries to at least $500 billion annually. The benefits of such approaches are obvious, and it should be promoted worldwide as a modality for addressing sovereign debt and development financing challenges in the poorest and most vulnerable countries.

"Governments can make greater use of innovative finance tools to support sustainable development."

4.5 GREATER USE OF INNOVATIVE FINANCE TOOLS

Another avenue for governments to acquire further financing for development is through greater use of innovative, climate-related finance tools. Climate, nature, and the environment feature prominently in many of the various debt-for-nature swaps currently being discussed at the international level. Creditors would be willing to forgive some or all of their debt if they trusted the fund would be used to protect the environment, finance climate

change adaptation, or some other worthy cause.[8] Furthermore, the debt-for-nature swaps envisage climate and nature transactions with positive environmental impacts and can also improve countries' debt sustainability. However, the use of such instruments remains at a nascent stage for developing countries. For instance, ESCWA has proposed operationalizing an innovative debt relief initiative, the Climate/SDGs Debt Swap - Donor Nexus Initiative[9], to improve financing for climate action and accelerating the SDGs, including by benefitting countries that do not necessarily have unsustainable debt burdens.

Blended financing can also serve as a means of increasing and de-risking financing by the private sector, including through the provision of guarantees and credit enhancements to address perceived default risks, thereby enabling credit ratings to be improved. This is imperative as the proportion of international financing that is highly concessional has been steadily decreasing over the past decade. This decline has been compensated to some extent by a considerable increase in private sector finance, with large interest payments. African countries, for example, pay a premium of about 2 percentage points in their holdings of sovereign Eurobonds, after accounting for relevant factors. To improve the climate for blended financing, ECA is advocating development of a regulatory framework for credit rating agencies to ensure transparency in methodology and ratings processes, provide proper oversight for credit rating agencies, and establish a fair external recourse mechanism to dispute ratings if such a situation arises.

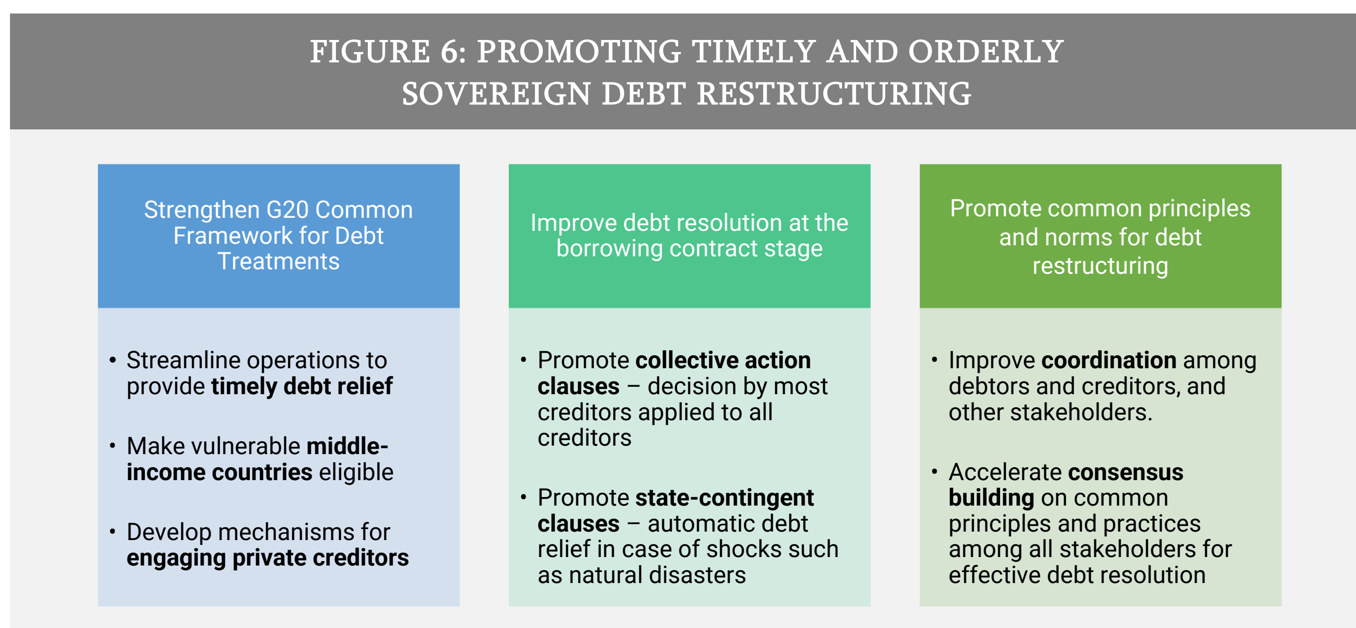
8 The Global Center on Adaptation (2021) finds that Africa could face climate change adaptation costs of $50 billion per year by 2050. For mitigation, the clean energy transition in Africa would require investments of about $190 billion per year over the period 2026-2030

9 www.unescwa.org/debt-swap.

V. Resolving rising sovereign debt distress

Preemptive, swift and adequate sovereign debt restructuring and relief can serve as a last resort in case of elevated debt distress. In this context, debt rescheduling must also give way to debt write-offs to enable economic recovery, rescue financial markets, and restart development. On the part of debtor countries, they need to overcome domestic political incentives that delay seeking debt restructuring and merely hope for economic revival. At the same time, more would be required from the international community to improve the international architecture for sovereign debt restructurings, which is currently fragmented, inefficient and has a "too little, too late" problem. In this regard, global policy efforts can be strengthened on three fronts (see figure 6).

***First*, the G20 Common Framework for Debt Treatments, as the only umbrella platform for international sovereign debt restructuring that brings together traditional and emerging market official creditors, should live up to its expectations.** Most past debt resolution initiatives have failed to provide an inclusive approach from the debtor perspective, with initiatives generally directed at a particular subset of debtor countries. DSSI, superseded by the Common Framework, excluded most middle-income countries.[10] Both encompass a group of 73 low-income, lower middle-income and upper middle-income countries that are considered "vulnerable". In the case of Latin America and the Caribbean, for example, this means that only 8 countries were eligible to participate in the DSSI owing to their classification as low-income (Haiti),[11] lower middle-income (Honduras and Nicaragua), and vulnerable upper middle-income (Dominica, Grenada, Guyana, Saint Lucia, and Saint Vincent and the Grenadines) countries. Only half of these (Dominica, Grenada, Saint Lucia, and Saint Vincent and the Grenadines) participated.



10 DSSI was implemented during May 2020-December 2021, followed by the G20 Common Framework from December 2021 onwards.

11 As of 2022, Haiti changed its classification from low to lower middle-income country.

An immediate and low-hanging adjustment should be to streamline and improve the operations of the Common Framework, expand eligibility to debt-distressed middle-income countries and develop mechanisms to engage private creditors early and effectively. For the long term, the Framework could evolve into an effective coordination platform for consensus-building on essential guiding principles and standard practices for international sovereign debt restructuring and, more importantly, for operationalizing the international consensus once reached. Undoubtedly, stronger commitment of the Framework's members is required to resolve their differences and work collectively towards these objectives.[12]

***Second*, universal adoption of enhanced collective actions clauses in sovereign borrowing contracts can be accelerated, while recent innovations, such as "anti-vulture laws", state-contingent debt clauses or debt-for-climate swaps, should be promoted.** The international development community should ensure universal adoption of enhanced collective action clauses (decision by most creditors applied to all creditors) in all new sovereign borrowing contracts to reinforce the good progress achieved and explore the chances for introducing it retroactively into outstanding debt contracts. Meanwhile, anti-vulture laws can prove highly effective for reining in current abuses by vulture capitals if they can be adopted by the New York market.[13] While both state-contingent debt instruments (automatic debt relief in case of shocks such as natural disasters) and debt-for-climate swaps face difficulties for comprehensive adoption, they can serve well when debtor countries are highly exposed to natural or climate risks.

***Third*, international consensus-building on a common set of guidelines and standard practices for sovereign debt restructuring should be accelerated.** The current environment of rising debt distress highlights gaps in the international sovereign debt restructuring architecture. No comprehensive mechanism currently exists to restructure sovereign debt in a systematic and predictable manner. As the debt landscape has grown in complexity, restructurings have become ever more complicated. Existing mechanisms need to be revisited, based on principles spelled out in the Addis Ababa Action Agenda. In 2015, the United Nations outlined nine "*Basic Principles on Sovereign Debt Restructuring Processes*", which stress the importance of sovereignty, good faith, transparency, impartiality, equitable treatment of creditors, sovereign immunity, legitimacy, sustainability, and majority restructuring.[14]

On the creditor side, one issue in undertaking restructurings has been the difficulty in engaging with the private sector, with their participation never being enforced and always thought of in voluntary terms. A main stumbling block to such participation is that a debt moratorium or debt restructuring will not be able to guarantee the full repayment of their loans. Another difficulty of recent initiatives -- including the DSSI and the Common Framework -- is that they have had to deal with a much more diverse and fragmented creditor base than past debt relief and debt resolution approaches. In this sense, a reformed global financial architecture is required to support countries to both face the challenges during debt resolution/restructuring processes and contribute to long-term debt sustainability.

There is a need to develop a global consensus on a common set of norms and standards governing sovereign debt restructuring processes. To this end, a proposal by the Secretary-General of the United Nations on establishing a global forum for sovereign debt resolution and coordination is highly relevant

12 Changes to the G20 Common Framework, an expansion of the DSSI, the issuance of a second round of SDRs, the implementation of new lending facilities, and a re-engagement with multilateral development banks and development finance institutions are all policy initiatives that are advocated by High-level Working Group on the Global Financial Architecture ("the Group"), which is coordinated by ECA. The Group comprises African ministers of finance, planning and economic development, the African Union, the African Development Bank, the African Export-Import Bank and the World Bank Group, and includes the participation of staff and executive directors of the IMF.

13 "Vulture capital" in the international sovereign bond market is a term for investors who follow a business model of "legal arbitrage" that is centered around buying stranded sovereign debt at deeply discounted prices with the intention to sue debtor countries for full payment and who are often determined to deny and derail debt restructuring proposals for their own interests. In this context, "anti-vulture laws" refer to laws to limit the payment that vulture funds can get through litigation.

14 General Assembly resolution 69/319.

(United Nations, 2021). In support of such a proposal, this policy brief proposes that **an international sovereign debt resolution body** is established by the United Nations, under the lead of the United Nations Department of Economic and Social Affairs (DESA). All Regional Commissions, together with UNCTAD, can provide support to DESA in this endeavor. Needless to say, the United Nations will need to work in close partnership with other key stakeholders, such as international financial institutions, Paris Club and other emerging creditor countries.

"An international sovereign debt resolution body should be established by the United Nations to develop a global consensus on norms and standards."

Examples of various tasks to be undertaken by this body could include:

- Develop public debt profiles of all countries, using a common methodology.
- Develop long-term Debt Sustainability Analysis approach(es) that incorporates, among other considerations, a country's SDG and climate-action investment needs and socioeconomic and environmental benefits of such investments.
- Provide technical assistance to debtor countries for a thorough assessment of the public debt situation and to manage public debt in a better and effective manner.
- Propose a (statutory) global debt resolution framework that:
  - elaborates criteria for debt relief, including debt write-offs and debt standstills.
  - promotes adoption of collective action clauses (the decision by most creditors applied to all creditors) and state-contingent clauses (government's debt service payments are linked to unexpected events such as large commodity price fluctuations and natural disasters) in government borrowing contracts.
  - facilitates coordination among a debtor country and its creditors, when requested by a debtor country, to thoroughly assess the degree and scale of debt distress.
  - initiates time-bound debt restructuring discussions among a debtor country and its creditors when the risk of a default is decidedly high.

The United Nations is already supporting the operationalization of the Sustainable Debt Coalition,[15] established with the support of the Egyptian presidency of the 2022 Conference of the Parties to the United Nations Framework Convention on Climate Change (COP27). The objectives of the Coalition are to uphold various aforementioned mechanisms to help address the debt management challenges of developing countries. The Coalition underlines the intersection of debt sustainability and climate change and aims to reduce the cost of green borrowing for emerging and developing economies, as well as improve the financing terms and ease of implementation. Debtor-defined key performance indicators aligned to climate goals improve the efficiency of financing instruments, as well as the affordability of new debt issuances. There are also opportunities for refinancing of existing expensive debt and swapping with more affordable debt mechanisms spread over a longer maturity or with lower interest rates to improve fiscal space, and space and allow investment in climate resilience and sustainable development.

15 Read more about the Coalition's Concept Note and Declaration at https://cop27.eg/#/presidency/initiative/sustainable and https://cop27.eg/assets/files/initiatives/DRAFT per cent20DECLARATION per cent20-BR-01-EGY-10-22-EN.pdf.

6. Conclusions

Rising government debt levels, higher financing costs, and an uncertain economic outlook mean that the risk of public debt distress for developing countries across the globe would be considerable in coming years. This implies that the scale of fiscal responses available for investing in the SDGs and for climate action is likely to remain limited. In this context, this policy brief calls for a significant shift in thinking about leveraging public debt for development gains.

The brief argues that higher debt levels do not necessarily mean a higher risk of debt distress, nor are necessarily detrimental to economic growth. Rather, deploying public debt as an investment in people and the planet offers sizeable medium- and long-term economic, social and environmental returns. Governments therefore need to achieve a balance between investing in the SDGs and reducing fiscal and debt distress. Increasing fiscal revenues and improving public spending effectiveness and efficiency are key to expand the fiscal space and reduce debt distress. Better management of public debt can also reduce fiscal risks and government borrowing costs.

For countries already facing elevated debt distress risk, this policy brief notes that sovereign debt restructuring can help mitigate the adverse socioeconomic consequences of continued debt distress. In support of such restructuring, the international development community, including multilateral and bilateral creditors, should step-up its efforts to accelerate progress towards common international debt resolution mechanisms and restructuring frameworks. In this context, the brief proposes that an international sovereign debt resolution body is established by the United Nations need to develop a global consensus on a common set of norms and standards governing sovereign specific aspects of the debt restructuring process.

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