Fiscal Ownership and the Role of Donors. Will HIPC Matter?

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Introduction

Within this program that deals with the mobilization of public resources for poverty reduction, this contribution discusses the role of foreign financing and the impact of donors. This is particularly relevant when referring to countries where foreign financing (in the form both of grants and loans) represents a high percentage of the total level of public resources available. As this foreign assistance by donors is generally conditional, it is important also to give attention to the incentives and rules created by donors and how they possibly influence the final outcome.

In this respect, recent initiatives such as the HIPC-Initiative have been launched by donors and aim explicitly at tackling the external debt problem within the broad goal of promoting (human) development and reduce poverty. For those countries, the introduction of the PRSP framework reinforced the focus on poverty alleviation and human development. We will try to assess the impact of this initiative, and the underlying changes in donor behavior, on matters of public resources and fiscal policy and ownership.

This contribution has three sections. The brief first section is purely descriptive. It explains what the HIPC-Initiative and the PRSP entails by describing the basic mechanism of the HIPC-Initiative and the core principles of the PRSP framework in very general terms, focusing only to what is needed for the following sections.

The second section is more conceptual and factual. Here, we provide a simple macroeconomic framework that focuses on the fiscal impact of foreign savings. The framework is then applied to the countries involved by giving some factual data on the level of foreign savings, as related to other elements of the macro-economic identities, as well as to the different types of interventions, and some historical evolutions. Moreover, on the conceptual level, we introduce the notion of donor incentives and rules, as represented mainly by conditionality, and give an historical overview of how donors have applied this in the past.

Section three is analytical and presents a fiscal analysis of the likely consequences of recent changes in donor-beneficiary relations in general and of the HIPC process in particular on public resources and policy targeted on basic human development and poverty alleviation. We first introduce a distinction between impact in more quantitative terms, i.e. in terms of net public financial resources available, and impact arising from a higher ‘quality’ of using these resources. With respect to resource availability, we discuss issues such as cash flow savings arising from debt reduction (the ‘debt reduction dividend’), degree of additionality, the impact of debt overhang and the achievement of long-term debt sustainability. The more ‘qualitative’ analysis tries to analyze recent changes in donor behavior (the ‘new conditionality) on issues such a governance, country ownership and effectiveness of interventions.
1. The HIPC-Initiative and the PRSP Process

1.1. The HIPC-Initiative

In September 1996, at their Annual Meeting, the IMF and World Bank announced the HIPC Debt Initiative (now known as HIPC-I), to allow to poor debt-ridden countries to “exit, once and for all, from the rescheduling process” and to resume “normal relations with the international financial community, characterized by spontaneous financial flows and the full honoring of commitments”, whereby the multilateral creditors for the first time would “take action to reduce the burden of their claims on a given country”, conditional on good policies in the recipient countries. Within this framework also the Paris Club agreed to go beyond what was then common debt reduction practice (Naples terms) and provide 80% Net Present Value (NPV)\(^1\) debt reduction (the so-called Lyon terms). Renewed calls to expand the program, emerging both the internal review process and more impressively from a worldwide mobilization of public opinion by a coalition of NGOs (such as Jubilee 2000), resulted in a proposal to enhance the Initiative, made at the June 1999 G-8 meeting in Cologne. This enhanced HIPC-Initiative (known now as HIPC-II) was endorsed by the IMF and the World Bank at their September 1999 Annual Meeting, and is now the common standard by which the international community wants to solve the debt problem of poor debt-ridden developing countries.

To start the description and analysis of the enhanced HIPC-Initiative, we formulate its basic principles:

- Application to a targeted set of countries, the HIPCs;
- Aiming at reducing debt to the point of sustainability, in repayment terms, using a Debt Sustainability Analysis (DSA), executed by IMF and World Bank;
- Comprehensiveness with respect to all types of creditors, and seeking fair burden sharing on the basis of some principle of ‘full equiproportionality’;
- Debt reduction conditional to a ‘track record’ of sustained adjustment;
- Additionality-in-principle by stating that concessional assistance should remain at the same level as before the Initiative, an assumption also used in the DSA.

HIPC II strengthened the focus on two additional features:

- Link to a development and/or poverty reduction effort, as spelled out in the Poverty Reduction Strategy paper, PRSP (see the following section);
- Coherence with other (future) donor efforts.

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\(^1\) The nominal size of an outstanding loan is not the only factor to determine the debt burden. The interest rate and the maturity of the loans are also important. Economists therefore prefer to measure debt not by the nominal value but by the Net Present Value (NPV), which is the discounted sum of all future payments due (principal and interest). For a commercial loan, the NPV equals the nominal value, but for concessional loans it will be lower. The NPV notion is discussed in more detail section 3.2.1.
The next page is a reprint of the chronogram of the HIPC process as it appears in World Bank documents.
HIPC DEBT INITIATIVE: Flow Chart

**First Stage**

Country established three-year track record of good performance and develops together with civil society a Poverty Reduction Strategy Paper (PRSP); in early cases, an interim PRSP may be sufficient to reach the decision point.

- Paris Club provides flow rescheduling as per current Naples terms, i.e. rescheduling of debt service on eligible debt falling due during the three-year consolidation period (up to 67% reduction on eligible maturities on a net present value basis).
- **Either**
  - Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors is adequate for the country to reach sustainability by the decision point.
  - OR
  - Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors is not sufficient for the country to reach sustainability by the decision point.

  
  =====> Exit
  (Country is not eligible for HIPC assistance.)

  
  =====> Decision Point
  (World Bank and IMF Boards determine eligibility.)

- Other bilateral and commercial creditors provide at least comparable treatment.
- Multilateral institutions continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and donor community.

  
  All creditors (multilateral, bilateral, and commercial) commit debt relief to be delivered at the floating completion point. The amount of assistance depends on the need to bring the debt to a sustainable level at the decision point. This is calculated based on latest available data at the decision point.

  
  World Bank and IMF provide interim assistance.
- Other multilateral and bilateral creditors and donors provide interim debt relief at their discretion.
- All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and donor community.

  
  "Floating" Completion Point

  
  Timing of completion point is tied to the implementation of policies determined at the decision point.
  - All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts towards this assistance:
    - Paris Club goes beyond Naples terms to provide more concessional debt reduction of up to 90 percent in NPV terms (and if needed even higher) on eligible debt so as to achieve an exit from unsustainable debt.
    - Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.
    - Multilateral institutions take additional measures, as may be needed, for the country's debt to be reduced to a sustainable level, each choosing from a menu of options, and ensuring broad and equitable participation by all creditors involved.

  
  World Bank and IMF provide interim assistance.
- Other multilateral and bilateral creditors and donors provide interim debt relief at their discretion.
- All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and donor community.

Second Stage

Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (interim) PRSP.

- World Bank and IMF provide interim assistance.
- Other multilateral and bilateral creditors and donors provide interim debt relief at their discretion.
- All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and donor community.

"Floating" Completion Point

- Timing of completion point is tied to the implementation of policies determined at the decision point.
- All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts towards this assistance:
  - Paris Club goes beyond Naples terms to provide more concessional debt reduction of up to 90 percent in NPV terms (and if needed even higher) on eligible debt so as to achieve an exit from unsustainable debt.
  - Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.
  - Multilateral institutions take additional measures, as may be needed, for the country's debt to be reduced to a sustainable level, each choosing from a menu of options, and ensuring broad and equitable participation by all creditors involved.

"Floating" Completion Point
A country must satisfy a set of criteria to be eligible for special assistance. Specifically, it must:

- be eligible for concessional assistance from the Poverty Relief and Growth Facility (PRGF) of the IMF and from the World Bank (IDA-only borrower);
- face an unsustainable debt burden, beyond the available debt-relief mechanisms such as bilateral debt reduction under Naples terms. Countries must first make full use of these “traditional” debt relief mechanisms (involving a stock-of-debt operation providing a 67 percent NPV reduction on eligible debt from the Paris Club and comparable treatment from other non-multilateral creditors) to be eligible for debt relief under the HIPC Initiative;
- establish a track record of reform and sound policies through IMF- and World Bank-supported programs.

The Initiative is a phased mechanism that works as follows (see also the chronogram on the previous page):

**First phase.** To qualify for assistance, the country must adopt adjustment and reform programs supported by the IMF and the World Bank and pursue those programs for three years. During that time, it will continue to receive traditional concessional assistance from all the relevant donors and multilateral institutions, as well as debt relief from bilateral creditors (including the Paris Club).

**Decision point.** At the end of the first phase, a debt sustainability analysis will be carried out to determine the current external debt situation of the country. If the external debt ratio for that country after traditional debt relief mechanisms is above 150 percent for the present value of debt to exports, it qualifies for assistance under the Initiative. In the special case of very open economies (with exports-to-GDP ratio above 30 percent) with a high debt burden in relation to fiscal revenues, despite strong revenue collection (above 15 percent of GDP), the NPV of debt-to-exports target may be set below 150 percent. In such cases, the benchmark is set so that the NPV of debt would be 250 percent of fiscal revenues at the decision point.

At the decision point, the Executive Boards of the IMF and World Bank will formally decide on a country's eligibility, and the international community will commit to provide sufficient assistance by the completion point (see below) for the country to achieve debt sustainability calculated at the decision point. The delivery of assistance committed by the Fund and Bank will depend on satisfactory assurances of action by other creditors.

**Second phase.** Once eligible for support under the Initiative, the country must establish a further track record of good performance under IMF/World Bank-supported programs. The length of this second period under the enhanced framework is not time bound, but depends on the satisfactory implementation of key structural policy reforms agreed at the decision point, the maintenance of macroeconomic stability, and the adoption and implementation of a poverty reduction strategy developed through a broad-based participatory process.
The use of "floating" completion points would permit strong performers to reach their completion point earlier. During this second phase, bilateral and commercial creditors are generally expected to reschedule obligations coming due, with a 90 percent reduction in present value. Both IDA and the IMF are expecting to provide "interim relief" between the decision and completion points, and other multilateral creditors are considering also advancing some of the assistance from the completion point.

**Completion point.** Remaining assistance will be provided at this point. This will imply the following:

- **For bilateral and commercial creditors:** a reduction in the stock of eligible debt of up to 90 percent in present value terms by the Paris Club (or more if needed), subject to fair burden sharing, with at least comparable action by other bilateral and commercial creditors. Many bilateral creditors have announced that they will also provide debt forgiveness over and above HIPC Initiative assistance, particularly on ODA debt.

- **For multilateral creditors** (the IMF, the World Bank, and the other multilateral institutions): a (further) reduction in the NPV of their claims on the country based on broad and equitable action by all creditors sufficient to reduce the country's debt to a sustainable level.

- The IMF's participation in providing HIPC assistance will be made principally in the form of grants financed from the resources of the PRGF-HIPC Trust. This assistance will be used only to meet debt service obligations to the IMF.

- The **World Bank** is committed to take action during the second stage—through the selective use of IDA grants and allocations—and at the completion point. The principal vehicle for Bank participation at the completion point, together with some other multilateral creditors, is the HIPC Trust Fund. This Fund provides relief to eligible countries on debt owed to participating multilaterals and is administered by IDA, with contributions from participating multilaterals and from bilateral donors. The Bank has made transfers from its IBRD net income and surplus to the HIPC Trust Fund to provide relief on debt owed to IDA.

A group of 41 countries was identified as HIPC in 1996. Since then, Nigeria and Equatorial Guinea have been removed from the initial list as they are no longer IDA-only countries, while Malawi, The Gambia and more recently Comoros were added to the list as the NPV of their external debt has been found to be unsustainable. Currently, the group of HIPC consists of 42 countries.

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1.2. The Poverty Reduction Strategy Framework

In September 1999, the World Bank Group and the IMF determined that nationally owned participatory poverty reduction strategies should provide the basis of all their concessional lending and for debt relief under the enhanced HIPC-Initiative. In this section, we will briefly touch upon these aspects of the PRSP framework that are relevant for the present paper.

There are six core principles underlying the development and implementation of poverty reduction strategies. The strategies should be:

- **country-driven**, with the country’s public sector being in the driver’s seat, involving broad-based participation by civil society and the private sector in all operational steps;
- **results-oriented**, and focused on outcomes that would benefit the poor;
- **comprehensive** in recognizing the multidimensional nature of poverty, and in recognizing that relying solely on economic growth is inadequate to realize sustainable poverty reduction.
- **prioritized** so that implementation is feasible, in both fiscal and institutional terms;
- **partnership-oriented**, involving coordinated participation of development partners (bilateral, multilateral, and non-governmental);
- based on a **long-term perspective** for poverty reduction.

Country ownership implies that there is no blueprint for building a country’s poverty reduction strategy. Rather, the process should reflect a country’s individual circumstances and characteristics, and should also build on comprehensive plans that already exist or being designed in the country.

Nevertheless, there are three key steps that typically characterize the development of effective poverty reduction.

1. **Develop a comprehensive understanding of poverty and its determinants.** Beginning with an understanding of who the poor are, where they live, and their main barriers to moving out of poverty is key. Further, the multidimensional nature of poverty (low income, poor health and education, gender, insecurity, powerlessness, etc) needs to be carefully considered.

2. **Choose the mix of public actions that have the highest impact on poverty reduction.** A solid understanding of the nature and causes of poverty allows a foundation to select and prioritize macroeconomic, structural, and social policies based on their expected impact on achieving a country’s poverty targets.

3. **Select and track outcome indicators.** An appropriate framework for selecting and tracking measures to indicate progress for chosen poverty outcomes is needed to test the effect of policies and programs and adjust as needed.

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3 More details are outlined e.g. in the World Bank Sourcebook on PRSP.
4 This also implies the integration of the macro-economic framework and the poverty reduction or social sector investment framework. Rather than designed and negotiated separately, it should include ex-ante assessment of the likely impact of macro-economic projections and structural reforms on poverty and human development.
For HIPC countries that are currently not in a position to fully develop a PRSP, and in order to prevent delays for them to seek debt relief under the enhanced HIPC-Initiative or other countries that seek assistance from IDA or the IMF, an interim PRSP can be formulated. This is meant to outline a country’s existing poverty reduction strategy and to provide a road map for the development of the full PRSP (a timeline for poverty diagnostics, recognition of policy areas that need evaluation and reform, envisaged participatory process, etc).

Currently, a PRSP, I-PRSP, or an annual progress report on its execution supported by the Boards of the Bank and the Fund within the preceding 12 months is a condition for:

- HIPC countries to reach a decision or completion point;
- Approval of the IMF’s PRGF arrangements or reviews;
- IDA (World Bank) concessional lending. Country assistance Strategies (CAS) by the World Bank should be timed to follow PRSPs and I-PRSPs along with their accompanying Joint Staff Assessments (JSAs).

From July 2002, all CASs in IDA countries will be based on a PRSP.

The Boards of the Bank and the Fund will consider the overall strategy in the PRSP or I-PRSP as an integrated whole. However, each institution will focus upon and endorse those policies and programs within its area of responsibility. Other donors are invited to coordinate and schedule their interventions in accordance with the countries’ PRSP framework.

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5 Some middle income countries, for example, Guatemala, which are not seeking HIPC debt relief and are not seeking loans under the Fund’s PRGF arrangements or from IDA, are also pursuing the development of a comprehensive poverty reduction strategy.
2. Some Theory and Simple Facts about Foreign Aid and Debt Relief

2.1. Foreign Aid and Debt in a Three-Gap Model

Some basic facts about the macroeconomic effects of debt relief can be gleaned from the familiar macroeconomic accounting identities.

(1) \[ I - S = M - E \]

(2) \[ I - S = F \]

where:
- \( I \) : domestic investment
- \( S \) : domestic saving
- \( F \) : net capital inflows from the rest of the world
- \( M \) : imports (GNFS: goods and non-factor services)
- \( E \) : exports (GNFS)

In an open economy, the excess of investment over savings is equal to the trade deficit, which in turn equals foreign savings. Foreign aid, foreign investment and lending and other similar flows allow the country to invest in excess of its domestic savings capacity. We will explore this aid – investment connection in more detail in what follows, but we start by mentioning some other macroeconomic effects. We do not have to bother too much about an inflationary effect of aid. In fact aid is in general deflationary. Consider food aid that is sold by the recipient government to private operators in the country. The sales augment the budget and will, when spent, increase the money supply, but the payment by the private operators has led to a corresponding destruction of money, while the availability of additional imported food leads to a downward pressure in the food market and elsewhere. Overall, this operation will thus have a deflationary effect. Or consider debt relief that frees recurrent budget resources subsequently spent on social priorities like primary health care and education, and that thus contributes to money creation and inflationary pressure. But at the same time it frees foreign exchange which, when sold to the private sector, destroys money (the value in national currency paid to the Central Bank to acquire the foreign exchange). And again, the additional imports exert a downward pressure on goods markets.\(^6\)

We may be more worried about the effect aid may have on the exchange rate. By bringing in foreign exchange, aid exerts an upward pressure on the exchange rate, making exports less profitable and putting domestic production

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\(^6\) This does not mean that under certain circumstances aid may not have inflationary consequences. This will in particular be the case when the donor insists on counterpart funds being spent years after the original aid transaction, and its corresponding deflationary effect, have expired. See Roemer (1989).
under pressure from competing imports. If aid is long-term and steady, and put to good use, increasing the productivity in the economy, there is no reason to worry about so-called Dutch disease (Van Wijnbergen 1986). If on the other hand aid comes in short bursts, and is not put to good use, the higher exchange rate may seriously harm export prospects.

Returning to the effect of aid on investment, the fact that it not only supplements domestic savings, but also brings in foreign exchange, may make it extra useful, as highlighted in the so-called two-gap models. Let us look at this a little closer. Remember that equation (1) was identified as an accounting identity. But this is not necessarily correct in an ex ante, planning sense. Imagine a country putting forward a desired rate of growth of GDP, deemed necessary to bring significant poverty reduction within a reasonable time horizon. From this rate of growth a corresponding level of investment can be derived, e.g. by assuming a constant marginal capital-output ratio. The level of savings and of imports can likewise be linked to the level of GDP through simple equations. Exports can be modeled on the basis of past experience and the evolution of world demand. In this way all the variables in equation (1) are independently estimated. There is no convincing reason why, when this exercise is performed, the equality would hold. The fact that equation (1) may well be an inequality in an ex ante planning sense, is not in contradiction with the postulated ex post identity however. Both can occur in sequence. As explained in the literature on the two-gap model, for planning purposes the largest of the estimated ex ante gaps will be “binding”. Suppose that in a given country and for a given year the savings gap is estimated at US$ 120 million and the trade gap US$ 105 million. Foreign aid is provided to the tune of the larger of these two gaps, US$120 million, so that the country can achieve its desired rate of investment. This means that there will be US$15 million more foreign exchange than strictly necessary. This will be ‘absorbed’ by extra imports, and the two ex post gaps will be equal at US$120 million. If the ex ante trade gap is binding, there will be similarly some slack on savings so that the ex post savings gap will have grown to the same size as the foreign exchange gap. In either case, there will be an unexploited potential, either of savings or of foreign exchange.

The two-gap model has been used extensively from the mid-1960s onward to estimate the financial needs of developing countries, and it continues to be of practical use. The model has also more theoretical applications. For instance, it has been used to validate the claim that aid is more useful in countries suffering from an ex ante trade gap. In such countries aid not only spurs investment directly, but also unleashes the unused domestic saving potential, leading to an extra effect on domestic investment.

The theory has been expanded to include other possible gaps as well, notably a fiscal gap. This will be briefly presented here, as it is directly related to the subject matter of this module. First, we detail investment and savings into their public and private segments.

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7 A basic reference is Chenery and Strout (1966).
8 See Easterly (1997) for a somewhat caustic look at the continued success of the two-gap model.
\( S = S_p + (T - C_g) \)  

(4) \( I = I_p + I_g \)  

where:
T : taxes (government revenue)  
C : consumption  
g (subscript) : public  
p (subscript) : private  

Using (3) and (4) in (2) we can write:

(5) \( I = S_p + (T - C_g) + F \)  

Now suppose that private investment critically depends on a minimum of government investment. This is formalized in the manner of Bacha (1990):

(6) \( I_p \leq kI_g \)  

with \( k > 0 \). The factor \( k \) determines the maximum level of private investment that will be forthcoming for any level of public investment. If planned private investment is larger than the RHS of equation (6), it will be held back at that level, and the corresponding private savings will not find an outlet and remain idle. In such a situation, aid which flows into the budget and feeds into public investment spending will **crowd in** the additional, pent-up private saving and investment.

We further assume that domestic private excess saving is hoarded in the form of some non-productive, non-monetary assets such as real estate, livestock, or jewels.

(7) \( (S_p - I_p) = \Delta H \)  

where:
\( \Delta H \) : increase in non-productive, non-financial assets held by the private sector

Considering the lack of public investment a binding constraint on private investment, and thus reading (6) as an equality, and further using (4), (5) and (7) we obtain

(8) \( I = (1 + k)\{\Delta H + (T - C_g) + F\} \)  

If we assume that
then we can use equation (5) and (8) to establish that the marginal effect of an increase in aid in the case of a savings equals unity, and in the case of a fiscal gap (1+k).

It may be noted that a fiscal gap is a special sub-category of the savings gap. Its existence assumes that it is impossible to transfer the private savings slack into public hands either by increased taxation, public borrowing, or inflation taxing9. Otherwise there can be only one, overall, savings gap.

The assumption in equation (9), that aid is fully translated into investment without being used to reduce taxes or increase public recurrent spending, is quite optimistic. Economic theory suggests a different outcome, as Griffin (1970) already demonstrated thirty years ago. If aid flows to the budget, without any strings attached by the donor, then it can be expected that the government will devote a smaller or larger fraction to public consumption, depending on its indifference function between consumption and investment.

What if the donor insists that aid be used only for investment purposes, e.g. by limiting his aid to selected projects? This would be a way of exogenously imposing equation (9). To this type of conditionality the recipient may retort by decreasing his own investment, and allocate the resources thus freed to whatever corresponds to his preferences. This illustrates aid fungibility, which will be discussed in more detail later on.

There are other weaknesses to the three-gap model. For instance, it does not consider any other factor of production than capital and usually assume a constant marginal productivity of capital that is identical across public and private sectors of the economy. It also does not allow for the role of institutional factors and the quality of government, as modern growth theory would do. This is an important limitation in the context of the present discussion where a critical issue is whether aid fosters better policies in recipient countries. This kind of discussion completely eludes the simple mechanical three-gap model. We will return to this debate later on. Notwithstanding these obvious limitations, gap models neatly highlight the basic macroeconomic effects of aid.

What does change if we systematically replace aid by debt relief in the above analysis? Not very much. At the macroeconomic level aid and debt relief are basically indistinguishable. Whether you provide US$ 10 million in project aid or forgive a debt service of US$10 million does not make a difference. This holds as long as the debt would have been serviced in the absence of the relief action. As we will explain later, this is a crucial assumption, which is far from being always satisfied. If debt relief concerns service payments, which would not have been made anyway, then the macroeconomic resource transfers described in the previous paragraphs just do not materialize. Note

9 This explains the somewhat awkward assumption behind equation (7).
also that if debt is forgiven that would not have been paid back in the absence of the relief measure, and the donor insists that the country increases e.g. social spending, and then inflation becomes an issue unless some other compensating measures are being taken by the monetary or fiscal authorities.

An important feature of debt relief is that it benefits the recurrent budget. This is in contrast to project aid, which targets investment rather than recurrent spending and more often than not bypasses the budget. In the analysis in the preceding paragraphs this again does not make a difference. This changes if, by analogy with the fiscal gap we presented before, we postulate the existence of a recurrent-fiscal gap. This would apply if, for instance for reasons of limited tax capacity, some crucial recurrent spending cannot take place that would provide the minimum quality of public services in areas as law and order, road maintenance, basic health or education services. Such expenditures may well have an important bearing on private investment. A second condition for the occurrence of a recurrent-fiscal gap would be that there is some unused development budget, which for some reason cannot be transferred into the recurrent budget. This may well be a good description of the situation in some aid-dependent developing countries where donors are funding investment projects up to the point where they face absorption capacity limits on the recipient side, and yet are reluctant to divert some of these unused resources to the recurrent budget. In those circumstances, debt relief, which frees recurrent budgetary resources, would be more effective in stimulating development than traditional project aid. Note that this advantage of debt relief is the direct consequence of an imbalance caused by donor conditionalities. We return to this important issue below when discussing the qualitative effects of HIPC.

2.2 Aid and Conditionality

Aid has different dimensions. It brings in funds in the form of foreign exchange that will be converted in real resources such as roads, schools, recurrent spending on health, and the like. These effects are only part of the story, and in some cases not even the most important one. It has always been understood by donors that domestic saving, and the own export efforts of the country are far more potent forces of economic growth and transformation than aid. Aid has therefore been cast in the role of triggering off rather than just replacing such domestic efforts. For this reason, apart from resources, aid was intended to bring knowledge. In projects this transfer typically occurs through on the job training by long-term expatriate experts and the introduction of new technology. Thirdly, aid has been used to influence policies, structural adjustment lending being the most conspicuous example. Donors package their aid as a bundle of resources, knowledge and policy leverage through some form of conditionality. We use the notion of conditionality here in a broader sense than is customary in the literature. We define it, as any limitation imposed by the donor who makes that aid is not a free budget resource the recipient can dispose of at will. Looked at in this

10 We must keep in mind though that most donor-funded development projects include substantial amounts of recurrent spending.
way, it can be said that aid has historically almost always been subject to some conditionality or other. Broadly, one can distinguish three types of conditionality. **Micro conditionality** is the oldest form, and still the most widely practiced by donors. Technical assistance and project financing fall into this category. The donor funds a particular activity, which is the subject of a formal agreement before start-up, and of extensive donor supervision during implementation (approval of annual reports and accounts, tranched disbursement, imposition of donor management procedures, long-term technical experts being de facto in charge of the project). As a conditionality, it zooms in on the lack of physical and human capital in the recipient country, which is seen as the major constraint to development. By funding investment projects, donors make sure that aid supplements domestic savings in financing investment in the economy, and that these resources are not diverted to some less desirable uses such as military spending or a Swiss bank account. And they do so in ways that also transfer knowledge. There are additional reasons that make micro-conditionality attractive to donors. Making the output of aid visible and tangible facilitates accountability in the donor country. It is helpful, when defending aid programs in Parliament or trying to convince public opinion, to be able to show e.g. a picture of a health clinic attended by poor people and paid from the aid budget. Micro conditionality also allows the donor to tie aid to the use of donor country experts and to purchases in the donor country. Although procurement tying of aid is condemned by the donor community through its major mouthpiece, the Development Assistance Committee (DAC) of the OECD in Paris, individual members continue to apply it in practice. Project aid and technical assistance are the natural vehicles for aid tying. Micro conditionality further allows individual donors to ‘protect’ their own interventions from the weaknesses in the public sector in the recipient country. By creating their own islands of development rather than contributing to a collective effort of improving overall recipient performance, they believe that the particular interventions they are supporting will actually work. Lastly, micro conditionality allows donors to withdraw from frustrating efforts at coordination.

The second type of conditionality can be labeled **macro conditionality**. It acquired prominence in the guise of structural adjustment support from the 1980s onward. Here the donor is less interested in steering the allocation of the resources he provides, and more in the policy changes which he hopes to provoke. The international context explains in part the growing importance of this form of conditionality. The world economic and financial crisis of the early 1980s left many poor developing countries in a state of macroeconomic shock, characterized by huge balance of payments and fiscal deficits, overvalued currencies, and debt service defaulting. What was required was altogether different from project aid with its lengthy bureaucratic gestation period and its myopic attention to the micro-level. Quick disbursing balance of payment support was needed instead, combined with efforts to address the underlying macroeconomic policy failures.

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11 In this paper we abstract from from aid that goes to other actors, such as NGOs, as well as from humanitarian aid.
An interesting distinction in this regard is that between budget support and balance of payments support. In terms of the macroeconomic accounting identity (1) the distinction is strictly speaking meaningless. Budget aid to the public sector, coming of necessity in the form of foreign exchange, is also balance of payment support, whereas balance of payments support to the public sector is, for similar reasons, budget support. The distinction comes into its own, however, once conditionality is allowed for. In the case of balance of payment support, the donor turn his attention to the way the additional foreign exchange is being allocated, and makes this the subject of his conditionality clauses. He is less bothered by the ensuing budgetary consequences. In the case of budget support, the donor wishes to control not so much how the foreign exchange is used, but rather how the resulting additional budget resources are being allocated.

To be complete, a third type of conditionality should be mentioned. Political conditionality became popular with bilateral donors only after the end of the Cold War. It commits resources in support of efforts to organize elections, improving the working of the judiciary, and the like. As all forms of conditionality, there are two sides, corresponding to the carrot and the stick. In the case of political conditionality, the stick consists of withdrawing aid from countries that violate human rights, prosecute opposition parties, or do not respect the outcome of democratic elections.

Aid conditionality has been hotly debated. It is not the principle as such that is at stake. Although officials in recipient countries often complain about donors not trusting them enough and being overly paternalistic, it is at the same time generally accepted that donors couldn’t just transfer large sums of money into the bank account of the government. It is also appreciated that most conditionalities are well intended. For a variety of reasons however, conditionalities end up doing more harm than good. Applying this to debt relief in the framework of HIPC, the question is whether it is possible to agree on a set of conditionalities that satisfy the legitimate concerns of the donors, leave the recipient government in charge, and most importantly, contribute to the development objectives pursued. Conditionalities are an important issue in the context of HIPC for at least two reasons. First, there is widespread dissatisfaction, on both sides of the bargaining table, with the conditionalities of the past, and a willingness to experiment with new modalities for delivering aid. And secondly, debt relief is different from other forms of aid in that it targets the recurrent budget of the recipient. We turn to the discussion of HIPC conditionalities in a further section of the paper.

2.3. Some Basic Facts about Aid

Some data on the macroeconomic aggregates discussed in section 2.1 are reproduced in table 1 for a selected number of HIPC countries and Guatemala.
Table 1: Macroeconomic aggregates for selected countries

*all data for 1998, and expressed as % GDP*

<table>
<thead>
<tr>
<th>Country</th>
<th>I</th>
<th>S</th>
<th>M</th>
<th>E</th>
<th>ODA</th>
<th>DS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethiopia</td>
<td>18.2</td>
<td>6.3</td>
<td>27.7</td>
<td>15.8</td>
<td>9.9</td>
<td>1.8</td>
</tr>
<tr>
<td>Ghana</td>
<td>22.9</td>
<td>13.2</td>
<td>36.4</td>
<td>26.7</td>
<td>9.2</td>
<td>7.6</td>
</tr>
<tr>
<td>Kenya</td>
<td>14.4</td>
<td>6.7</td>
<td>32.3</td>
<td>24.6</td>
<td>4.1</td>
<td>4.7</td>
</tr>
<tr>
<td>Zambia</td>
<td>14.3</td>
<td>5.3</td>
<td>38.4</td>
<td>29.4</td>
<td>10.3</td>
<td>6.0</td>
</tr>
<tr>
<td>Guatemala</td>
<td>16.0</td>
<td>7.7</td>
<td>26.9</td>
<td>18.6</td>
<td>18.4</td>
<td>2.1</td>
</tr>
<tr>
<td>Honduras</td>
<td>29.6</td>
<td>23.4</td>
<td>52.1</td>
<td>45.8</td>
<td>5.9</td>
<td>9.4</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>33.4</td>
<td>1.1</td>
<td>71.5</td>
<td>39.1</td>
<td>28.0</td>
<td>12.4</td>
</tr>
<tr>
<td>Bolivia</td>
<td>20.0</td>
<td>10.8</td>
<td>28.9</td>
<td>19.7</td>
<td>7.4</td>
<td>5.5</td>
</tr>
<tr>
<td>HIPC average  (a)</td>
<td>19.4</td>
<td>8.5</td>
<td>39.1</td>
<td>28.2</td>
<td>13.6</td>
<td>5.2</td>
</tr>
</tbody>
</table>

(a) : unweighted average for HIPCs for which data are available
I : gross domestic investment
S : gross domestic saving
M : imports of goods and services
E : exports of goods and services
ODA : Official Development Assistance
DS : foreign debt service payments by the public sector


As table 1 reveals, the savings gap stands at more than 10% of GDP in 199812. Domestic saving is particularly disappointing at well below 10% of GDP. In the same year HIPC governments paid more than 5% of GDP abroad to service their debt. These data reveal macroeconomic imbalances for which an inflow of ODA resource flows of almost 14% of GDP provides partial redress. Debt cancellation under the HIPC-2 initiative will bring further relief, but other measures are needed if those countries are to achieve GDP growth rates of more than 5% a year which are necessary to reduce poverty significantly within a reasonable time horizon.

The debt crisis arose notwithstanding general favorable borrowing conditions, as table 2 illustrates. The HIPCs were able to borrow at more favorable than market conditions from multilateral institutions and donor countries. Taking the average for all creditors (public and private) in the bottom part of the table reveals that those countries were borrowing at low interest rates (between 1.5 and 4.8% in the years considered) with long maturities (between 22 and 35 years) and grace periods (between 6 and 9 years). This translates in high grant elements of loans, typically well over 50%. To this one must add considerable amounts of grant aid, not shown in this table. And yet these countries accumulated an unsustainable debt, which by itself is a striking illustration of internal policy failure and ineffective aid from the international community. Table 2 also reveals that borrowing conditions were far from stable. They were generally favorable in the early 1970s, but the situation had

12 As the data for the first four columns of the table are taken from national accounts, the foreign exchange gap has by definition the same size as the savings gap, following equation (1) above.
turned around by 1980. By 1990 HIPCs were again able to borrow from public creditors at conditions that were comparable to those of the 1970s. The situation improved during the 1990s when creditors eased their conditions still further and bilateral donors shifted increasingly from loans to grants.

Table 2: Average borrowing conditions for HIPCs

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>OFFICIAL CREDITORS</td>
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<td></td>
</tr>
<tr>
<td>Average interest (%)</td>
<td>2.6</td>
<td>3.6</td>
<td>2.5</td>
<td>1.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Average grant element (%)</td>
<td>58</td>
<td>47</td>
<td>59</td>
<td>66</td>
<td>73</td>
</tr>
<tr>
<td>maximum</td>
<td>83</td>
<td>91</td>
<td>83</td>
<td>81</td>
<td>83</td>
</tr>
<tr>
<td>minimum</td>
<td>23</td>
<td>11</td>
<td>20</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Average maturity (years)</td>
<td>31</td>
<td>26</td>
<td>31</td>
<td>33</td>
<td>37</td>
</tr>
<tr>
<td>Average grace period (years)</td>
<td>9</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>ALL CREDITORS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average interest (%)</td>
<td>3.5</td>
<td>4.8</td>
<td>2.9</td>
<td>2.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Average grant element (%)</td>
<td>49</td>
<td>38</td>
<td>56</td>
<td>63</td>
<td>69</td>
</tr>
<tr>
<td>maximum</td>
<td>83</td>
<td>91</td>
<td>83</td>
<td>81</td>
<td>83</td>
</tr>
<tr>
<td>minimum</td>
<td>14</td>
<td>-6</td>
<td>14</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Average maturity (years)</td>
<td>27</td>
<td>22</td>
<td>29</td>
<td>31</td>
<td>35</td>
</tr>
<tr>
<td>Average grace period (years)</td>
<td>7</td>
<td>6</td>
<td>8</td>
<td>8</td>
<td>9</td>
</tr>
</tbody>
</table>

source: Global Development Finance 2001, World Bank

Let us now look more closely at the composition of total net flows and net transfers for HIPC countries over different types of instruments and different types of donors and creditors as well as their evolution during the last decade. An overview of total net transfers to HIPCs for 1980 and the 1991-1999 period is presented in table 3 and figure 1. Net transfers are defined as gross flows net of all repayment of loans (and disinvestment) and interest charges (and dividends). Note that ODA is defined as part of net resource flows, meaning that that reimbursement of loan principals is deducted, but not interest charges. Figure 1a shows annual average net total transfers (excluding Foreign Investment, both direct FDI and portfolio equity investment, but including technical assistance and IMF flows) for three sub-periods: 1977-1987, 1988-1995 and 1996-1999, in nominal terms. The figure also provides a breakdown for different creditor categories, namely official transfers as a sum of multilateral (World Bank, IMF and other multilaterals) and bilateral transfers on debt, grants (including technical cooperation grants) and private transfers on debt (including both guaranteed as well as non-guaranteed public debt). Figures 1b and 1c provide a decomposition of these net transfers into disbursements and debt service, using the same breakdown.

Table 3 shows that total net transfers are structurally positive, remain at a relatively high level, but are overwhelmingly official transfers. Net private transfers on debt are structurally negative; foreign investment flows are
modest compared to levels for other types of developing countries, but on the increase in recent years.

Let us first look more closely at the periodic trend figures as in figure 1. First focus on the two first sub-periods. The figure shows that total net transfers (excluding FDI) increase in nominal terms from period one to period two, from about 10.5 to about 15 billion US$. Expressed in GNP terms however, they remain at about the same level for the two periods: about 11% of GNP overall. However, this status quo masks different profound changes over time, with respect to the relative importance in total net transfers of different types of donor/creditors, and with respect to the underlying new inflows (disbursements) versus outflows (debt service).

With respect to the relative importance in total net transfers of different types of donor/creditors, multilaterals (exclusive of the IMF) substantially increase their relative share, while bilateralas shift from loans to grants, making grants the main type of net transfers to HIPCs. There is also a shift from non-concessional to concessional loans (as e.g. witnessed by the shift from IBRD to IDA loans). Private net transfers become negative in the second period.

With respect to the decomposition in disbursements and debt service, it becomes clear from figures 1b and 1c that the net status quo hides an increase of both disbursements and debt service. Increased disbursements, from an average of about 15 to 22 billion US$, come mainly from multilaterals (exclusive of IMF) and from increased grants (overcompensating the decrease in bilateral loan disbursements due to their shift to grant financing). Increased debt service, from about 5 to about 6 billion US$ on average, is quite evenly spread over different types of creditors.

The most recent sub-period 1996-1999 witnesses a substantial decrease in overall net transfers, whose level almost falls back to the period 1 average in nominal terms to about 11.5 billion US$. Net transfers from bilateralas become negative due to a substantial increase in debt service payments, while bilateral disbursements continue to fall and also new grants are in decline; also net private transfers become more negative, mainly due to increased debt service payments.
### Net transfers to HIPC countries (including FDI) Millions $

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Long-term official debt</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New loans</td>
<td>723.4</td>
<td>5329.0</td>
<td>7773.2</td>
<td>6640.5</td>
<td>7181.0</td>
<td>6194.4</td>
<td>6429.6</td>
<td>6186.4</td>
<td>6153.4</td>
<td>6379.1</td>
<td>5734.4</td>
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<td>Principal reimbursement</td>
<td>-167.0</td>
<td>-727.1</td>
<td>-2107.8</td>
<td>-2421.0</td>
<td>-1927.7</td>
<td>-2081.2</td>
<td>-2509.4</td>
<td>-2998.2</td>
<td>-3100.2</td>
<td>-2744.4</td>
<td>-2601.1</td>
<td>-2733.0</td>
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<td>Interests</td>
<td>-102.5</td>
<td>-738.4</td>
<td>-1565.9</td>
<td>-1954.4</td>
<td>-1406.1</td>
<td>-1619.8</td>
<td>-1986.6</td>
<td>-1860.8</td>
<td>-2133.5</td>
<td>-1894.6</td>
<td>-1929.7</td>
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<tr>
<td>Net transfers</td>
<td>453.9</td>
<td>3863.5</td>
<td>4099.5</td>
<td>2265.1</td>
<td>3847.2</td>
<td>2493.4</td>
<td>1933.6</td>
<td>1327.4</td>
<td>919.7</td>
<td>1740.1</td>
<td>1203.6</td>
<td>729.4</td>
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<tr>
<td><strong>Grants</strong></td>
<td>299.2</td>
<td>3129.0</td>
<td>10341.8</td>
<td>10992.2</td>
<td>9541.7</td>
<td>8519.0</td>
<td>10261.3</td>
<td>9444.3</td>
<td>8392.2</td>
<td>7401.6</td>
<td>8130.5</td>
<td>7967.5</td>
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<tr>
<td><strong>Technical assistance</strong></td>
<td>441.1</td>
<td>2015.7</td>
<td>3616.7</td>
<td>3742.2</td>
<td>4099.4</td>
<td>3999.6</td>
<td>3511.7</td>
<td>4052.0</td>
<td>3786.1</td>
<td>3350.2</td>
<td>3003.8</td>
<td>2930.2</td>
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<tr>
<td><strong>IMF net transfers</strong></td>
<td>-37.4</td>
<td>809.1</td>
<td>-525.5</td>
<td>-182.1</td>
<td>-256.6</td>
<td>-382.2</td>
<td>402.5</td>
<td>99.9</td>
<td>-108.4</td>
<td>158.0</td>
<td>156.1</td>
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<tr>
<td><strong>Total Official Net Transfers</strong></td>
<td>1156.8</td>
<td>9817.3</td>
<td>17532.5</td>
<td>16817.3</td>
<td>17231.6</td>
<td>14629.8</td>
<td>16109.1</td>
<td>14923.6</td>
<td>13325.1</td>
<td>12383.5</td>
<td>12495.9</td>
<td>11783.2</td>
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<td><strong>Long-term private debt</strong></td>
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<tr>
<td>New loans</td>
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<td>5009.6</td>
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<td>1576.5</td>
<td>1730.6</td>
<td>1963.2</td>
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<td>-3093.5</td>
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<tr>
<td>Interests</td>
<td>-74.7</td>
<td>-1323.0</td>
<td>-777.7</td>
<td>-647.6</td>
<td>-536.0</td>
<td>-433.8</td>
<td>-537.5</td>
<td>-530.6</td>
<td>-675.5</td>
<td>-709.5</td>
<td>-899.4</td>
<td>-778.1</td>
</tr>
<tr>
<td>Net transfers</td>
<td>302.5</td>
<td>1812.8</td>
<td>-186.8</td>
<td>-441.1</td>
<td>83.2</td>
<td>543.6</td>
<td>-936.5</td>
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<td>-313.4</td>
<td>-1678.5</td>
<td>-2118.5</td>
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</tr>
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<td><strong>Foreign investment</strong></td>
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<td></td>
<td></td>
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<tr>
<td>Net flows</td>
<td>-156.9</td>
<td>693.1</td>
<td>154.0</td>
<td>2071.9</td>
<td>1900.4</td>
<td>3125.3</td>
<td>4242.0</td>
<td>5076.4</td>
<td>5644.5</td>
<td>6239.7</td>
<td>6798.4</td>
<td>8097.7</td>
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<tr>
<td>Dividends</td>
<td>-363.3</td>
<td>-949.4</td>
<td>-946.6</td>
<td>-772.3</td>
<td>-933.7</td>
<td>-959.0</td>
<td>-977.0</td>
<td>-995.0</td>
<td>-1074.0</td>
<td>-1191.0</td>
<td>-1271.5</td>
<td>-1546.0</td>
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<tr>
<td>Net transfers</td>
<td>-520.2</td>
<td>-256.3</td>
<td>-792.6</td>
<td>1299.6</td>
<td>966.7</td>
<td>2166.3</td>
<td>3265.0</td>
<td>4081.4</td>
<td>4570.5</td>
<td>5048.7</td>
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<tr>
<td><strong>Total Private Net Transfers</strong></td>
<td>-217.7</td>
<td>1556.5</td>
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<td>1049.9</td>
<td>2709.9</td>
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<td>3848.4</td>
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<tr>
<td><strong>Total Net Transfers</strong></td>
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<td>11373.8</td>
<td>16553.1</td>
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<td>18437.6</td>
<td>18615.2</td>
<td>17582.2</td>
<td>17180.9</td>
<td>16344.3</td>
<td>16216.4</td>
</tr>
</tbody>
</table>

Source: Global Development Finance 2001
Figure 1a

Annual Net Transfers to HIPC by category of creditors

Source: Global Development Finance, 2001

Figure 1b

Annual Disbursement to HIPC by category of creditors

Source: Global Development Finance, 2001
Some general information on ODA is presented in table 4. The table present aid as an outflow from DAC countries and not as an inflow to recipient countries. Consequently no breakdown for recipient categories such as HIPCs is available here. ODA is broken down into three categories: bilateral grants and grant-like flows, bilateral loans, and contributions to multilateral institutions. The table illustrates the shift from bilateral loans to grants: the share of bilateral loans in total ODA decreased gradually from 15.7% in 1983-84 to a minimum of 2.4% in 1997, and then again slightly increased to 4.6% in 1999. The table provides also information on the relative importance in total flows of technical assistance, food aid and emergency relief as well as debt forgiveness.

The DAC provides further details on the use of flows, among others a breakdown of programme assistance and other, mainly project-type of interventions. However, these categories do not provide much insight since they are not used consistently by donors. Unfortunately there is no breakdown of those funds that enter into the budget and those that are situated outside the budget of recipient governments.
2.3.4. More Facts about Debt Relief

Debt relief is defined as any reduction in its (net) present value of debt, i.e. the sum of all future scheduled payments on this debt, discounted at the appropriate discount rate\(^{13}\). Debt reduction can take several forms. It may be rescheduled at concessional terms, or, more radically, be cancelled. Debt cancellation, in the current debate more important than rescheduling, may in turn relate to the whole debt stock, or just to debt service during a given period of time. Furthermore, several types of debt liabilities may be involved: bilateral public debt, most of which will be concessional in the case of low-income countries, multilateral debt owed to International Financial Institutions (IFIs), debt to (semi-)public export credit agencies (ECAs), and debt owed to private sector operators. In all but exceptional cases, debt relief will involve a cost to the relief-granting agency. This may involve a direct budgetary outlay, as when private sector debt is bought on the secondary market or directly from an ECA in view of its cancellation, or when a contribution is paid towards some IFI debt relief fund. Or it may take the form of income forgone, as when the cancellation of bilateral public debt leads to future debt service payments no longer being due to the creditor.

In the seventies and a large part of the eighties, most of the debt servicing problems, both with respect to bilateral debt (mainly in the Paris Club) and debt owed to private creditors (in the London Club), were met through debt restructuring, or ‘rescheduling’, operations of part of debt service due, first only of repayment of capital, later also of interest payments. It is important to note that to the extent that debt claims are rescheduled at market interest rates, they do not include an element of debt reduction. Such rescheduling merely provides liquidity

\(^{13}\) See section 3.2.1 of the text for a more elaborated discussion of this concept.
relief, and contributes to the buildup of debt stocks. Only rescheduling at concessional terms implies debt reduction in a NPV sense.

Debt reduction with respect to debt owed to private actors took off from the mid-eighties on through small-scale ('marginal') and stand-alone so-called market-based debt reduction operations such as buybacks, debt-equity swaps or other debt exchanges. These operations could be engineered thanks to the existence of a secondary market for value-impaired debt, whose prices could be used as a yardstick for determining a market price for debt transactions. Since transactions involved, sometimes, huge discounts of nominal value, they promised a substantial degree of implied debt reduction.

These practices which started as corollaria in conventional rescheduling operations became the center stage in the so-called Brady deals in the beginning of the nineties, whereby mostly middle-income countries with a lot of bank debt managed to regain access to international capital markets by striking a concerted debt reduction deal with their private creditors. An innovative technique was used whereby all old debt claims were transformed into new debt through a menu of both debt reduction and new money options. The debt reduction options included buybacks as well as exchanges of old debt for new (bond) debt at concessional interest rates, or reduced principal, some of which with value enhancements, such as collateralized principal and even (some) interest payments as well as recapture clauses. The new money, or refinancing, exchanged old for new debt of the same conditions, but required creditors that chose this option to provide new loans as a certain percentage of old debt tendered under this option (a ‘new money’ tax). The deals were carefully engineered so as to make options equivalent. Creditors who chose this option took a loss, comparable to the debt reduction provided by those preferring the debt reduction options, because the value of the debt claims on the secondary market was below-par, even after the debt reduction deal.

As most low-income countries did not have a lot of private debt, they were never much involved in these debt operations. Some donors or debtor governments did use funds to retrieve debt through secondary market based buybacks. The only noteworthy transactions are those through the IDA Debt Reduction Facility. In these operations, the small amount of still remaining (tail end) private debt was completely bought out through a donor-financed buyback or menu-operation, organised through IDA, at tail-end prices\footnote{In the 1989-1999 period, IDA Debt Reduction Operations were executed for 17 countries, of which 16 HIPCs involving buybacks and debt exchanges at an average price of 15 cents on the dollar. Funds came almost exclusively from bilateral donor contributions.}.

Bilateral debt reduction initiatives remained sporadic and scattered, until the Paris Club introduced common terms for debt reduction operations from 1988 on. These involved long-term rescheduling at highly-concessional terms of (already highly concessional) ODA debt, but also, more importantly, a menu of options for rescheduling non-ODA, mainly ECA, debt, which is generally non-concessional debt. The menu consists of three ‘comparable’ options of which two entail debt reduction: a rescheduling at concessional interest rates or a rescheduling at non-concessional interest rates but with a reduction of principal. The third (so-called B) option involved the conventional rescheduling at non-concessional terms and as
such did not include debt reduction. It was added to prevent creditors that did not
wish to give debt reduction from blocking others that wanted to do so.

The amount of debt reduction in these two concessional debt reduction options for
non-ODA debt gradually increased from one-third (1988 Toronto) over one-half
(1991 London) to two-thirds (1995 Naples). All these terms dealt with debt service
relief, as they applied to debt service due during a limited consolidation period.
Debt reduction involving the full stock of debt is on the table from 1995 on (Naples
terms on stock). From 1996 on, within the HIPC-Initiative framework, terms were
enlarged to 80% (Lyon), later even to 90% or more under the enhanced HIPC-
Initiative (1999 Cologne terms).

Multilateral creditors successfully resisted the granting debt reduction on their
claims prior to the HIPC-Initiative. One of the major breakthroughs achieved
through the HIPC-Initiative was that multilateral donors accepted to take part in the
collective effort of debt reduction, with their contribution partly being financed by
bilateral contributions in HIPC trust funds.

It is difficult to assess how much debt relief took taking place before the HIPC-
Initiative. The Debtor Reporting database used to produce the World Bank’s
“Global Development Finance” data has entries only for debt forgiveness or
reduction, and interest forgiven, and it does not take into account debt
rescheduled at concessional interest rates. Taking the latter into account to
calculate the overall debt reduction in NPV terms therefore necessitates some
heroic assumptions. An IMF study (Daseking and Powell 1999) included one-third
of the total amount of debt rescheduled\(^\text{15}\). Applying this methodology, the study
estimates total pre-HIPC debt reduction (covering the 1987-1997 period) for HIPC
countries to be about US$ 72 billion (at end-1998 prices), as shown in more detail
in table 5.

Table 5: Debt reduction under pre-HIPC (traditional) mechanisms

<table>
<thead>
<tr>
<th>Country (a)</th>
<th>PV of debt reduction (Mln 1998 US$)</th>
<th>In percent of 1987 PV of debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia</td>
<td>5909</td>
<td>57.3</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>702</td>
<td>5.9</td>
</tr>
<tr>
<td>Honduras</td>
<td>1718</td>
<td>26.6</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>11035</td>
<td>67.1</td>
</tr>
<tr>
<td>Zambia</td>
<td>3756</td>
<td>28.2</td>
</tr>
<tr>
<td>Total HIPC</td>
<td>72260</td>
<td>...</td>
</tr>
</tbody>
</table>

(a): Ghana and Kenya have never received concessional Paris Club reschedulings. Guatemala is non-HIPC and was not included in the calculations.


How much debt reduction is hypothetically on the table through the enhanced
HIPC-Initiative, and related efforts such as the preceding full use of so-called
traditional debt reduction, i.e. a Paris Club debt stock reduction deal at Naples
terms and comparable action of other creditors? Of the 42 countries, IMF and

\(^{15}\) Discounting uses the average commercial interest reference rate (CIRR) of the US$. A more
complex calculation is made to come to the final ‘one-third’ part (Daseking & Powell [1999, p.16].
World Bank expect 34 countries to receive assistance. As of September 2002, 26 countries have reached their decision point under the enhanced HIPC Initiative, and six of them (Bolivia, Burkina Faso, Mauritania, Mozambique, Tanzania and Uganda) have reached their completion point. Table 6 gives an overview of the amounts projected. The estimated total enhanced HIPC debt relief is divided roughly evenly between bilateral and multilateral creditors. Overall committed debt relief in NPV terms for these 26 countries is some US$ 25.1 billion, of which US$ 7.5 billion is for the six completion point countries.

Table 6: Stock of debt before and after Enhanced HIPC-assistance (in bn US$)

<table>
<thead>
<tr>
<th></th>
<th>34 countries expected to receive assistance</th>
<th>26 decision countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal debt stock</td>
<td>124</td>
<td>87</td>
</tr>
<tr>
<td>Present Value (PV) of debt (1997)</td>
<td>93</td>
<td>62</td>
</tr>
<tr>
<td>PV of debt after traditional debt reduction</td>
<td>74</td>
<td>52</td>
</tr>
<tr>
<td>Less PV of HIPC debt reduction</td>
<td>36</td>
<td>25</td>
</tr>
<tr>
<td>= PV of debt after HIPC assistance</td>
<td>38</td>
<td>27</td>
</tr>
<tr>
<td>Less estimated PV of additional bilateral relief</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>= Remaining PV of Debt</td>
<td>30</td>
<td>22</td>
</tr>
</tbody>
</table>


In the following section, we will try to assess what the impact is of scheduled debt relief on resources available for poverty reduction.
3. The HIPC-Initiative, Fiscal Ownership and the Quality of Aid

3.1. The Quantitative and Qualitative impact of the HIPC-Initiative

So far, we have applied a macro-economic framework that enabled us to track down the important conceptual issues surrounding fiscal sector implications of donor interventions and gave some history on the level and type of interventions and the type of donor-implied incentives and rules that have come with it.

Let us now try to assess what will be the impact of the HIPC process in particular on public resources and policy targeted on basic human development and poverty alleviation. Especially for heavily indebted countries, and HIPCs that will benefit from debt reduction under the Enhanced HIPC-Initiative in particular, debt relief will be in the center of operations.

The link with fiscal policies is that debt relief frees budgetary resources no longer needed to service debt. Although debt relief does not constitute fresh donor money, it has the same effect on the budget. It delivers virtual, rather than fresh resources. Even so there is an important qualification: provided the debt would have been serviced in the absence of the debt relief operation. For if the debt would not have been serviced in the absence of debt relief, debt relief has not even a virtual impact on the budget. It provides neither fresh nor virtual resources in this case, but only illusory resources.

In this section, we first try to assess to what extent these virtual resources will transform into real resources available to the public sector for poverty alleviation, i.e. the so-called ‘debt reduction dividend’. Furthermore, we assess to what extent more resources can become available because debt reduction removes potentially-important disincentive effects for additional lending and investment by other (private) actors, both domestic as well as foreign, and assess to what extent debt reduction can lead to long-term debt sustainability (both from a fiscal as well as from a human development point of view). This is what we call the more ‘quantitative’ aspects of HIPC process.

However, this quantitative effect of increased availability of resources might not be the most important element of HIPC. The impact of increased resource availability will crucially depend on the extent to which they can be used more ‘productively’ than before. There is currently a lot of debate among the donor and research community on trying to improve quality of interventions by increased effectiveness and selectivity, policy issues that have gained prominence exactly through the HIPC process and the attached PRSP framework. We will try to make an initial assessment of the impact of this ongoing debate.
3.2. Impact on Resource Flows: the Debt Reduction Dividend

3.2.1. Measuring the amount of virtual resources

What is the direct fiscal advantage of debt reduction to the beneficiary country? The obvious answer is debt service (interest and principal repayments no longer due). This advantage will be a function a number of parameters, linked to the characteristics of the debt contract.

The advantage will clearly be a function of the nominal value of the loan outstanding, but also the interest rate it carries. The higher the nominal debt forgiven, but also the higher the interest rate, the more the debtor wins. In this sense it is better to forgive hard, commercial debt, than concessional debt. In order to translate this into a concept that can be compared to any other type of aid, it is necessary to compute debt reduction in Net Present Value (NPV) terms, i.e. discount all future contractual debt service payments at a discount rate reflecting the market conditions facing the country in question.

Debt relief affects both immediate and future debt servicing. The exact time pattern depends on the maturity of the loans involved, on the type of action undertaken, e.g. cancellation of stock or debt service, on cut-off periods considered, etc. Typically debt relief is more backloaded in time than other instruments of development aid: the effects on the recipient economy are spread out over a large number of years. This however depends on the loan being forgiven, and the type of relief offered. If only immediate debt service is being cancelled for instance, debt relief is in fact as expedient as quick disbursing balance of payments support. If the aim is to make resources immediately available for development, it is better to front-load debt relief, i.e. with a large component of immediate debt service relief.

Debt relief should measure what the debtor would have effectively paid, i.e. actual budgetary savings. In the following, we will call this the debt reduction dividend. The considerations can be brought together in a simple formula:

$$DRD = \sum_{t=0}^{n} \frac{S_t \cdot (1-d)}{(1+i)^t}$$

Where:
- **DRD**: debt reduction dividend;
- **S_t**: contractual debt service in year t (present = year 0, final year of reimbursement = year n) related to the debt relieved in the operation;
- **d**: percentage of future non-payment in the absence of the debt relief operation, i.e. the percentage of defaulting by the debtor that would have taken place in the absence of the present debt relief;
- **i**: the appropriate discount rate from the debtor country’s perspective.\(^\text{16}\)

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\(^{16}\) The DAC and the World Bank (GDF) use interest rates on world financial markets to calculate the net present value of debt. To measure the debt reduction from the point of view of recipients, it would be more appropriate to use a country specific discount rate that reflects the conditions under which developing countries can actually borrow. Typically this would include a risk premium above world capital market levels.
What does HIPC offer in terms of net budget savings that may be used for poverty reduction, i.e. the debt reduction dividend? Table 7 provides some exemplary estimates for four countries that have reached the decision point of the enhanced HIPC-Initiative. Instead of measuring debt reduction in NPV terms, estimates shown here are in annual average terms, for the 2001-03 period. It measures the debt reduction dividend as the difference between average annual debt service effectively paid before HIPC (as estimated by the average of 1998) and debt service after HIPC debt reduction (including also traditional debt relief that precedes HIPC debt relief), as estimated by the average of 2001-03 period. Results are presented both in absolute values as well as in percentage of exports, GDP and government revenues.

Table 7: Measuring the debt reduction dividend (in million US$)

|                      | Bolivia | Honduras | Nicaragua | Zambia | 22 HIPC
|----------------------|---------|----------|-----------|--------|---------
| **Debt Service**     |         |          |           |        |         |
| Paid 1998            | 388     | 311      | 198       | 147    | 2991    |
| In % of exports      | 29      | 13       | ..        | 16     | 18      |
| In % of Fiscal Revenues | 19     | 32       | ..        | 24     | 28      |
| **Debt Service after HIPC** |         |          |           |        |         |
| Average 2001-2003    | 211     | 207      | 153       | 152    | 1902    |
| In % of exports      | 12.1    | 5.8      | 13.4      | 11.1   | 8.2     |
| In % of GDP          | 2.2     | 3.1      | 5.2       | 4.1    | 2.1     |
| In % of Fiscal Revenues | 9      | 13.3     | 19.1      | 22.3   | 11.9    |
| **Debt Reduction (DR)** |         |          |           |        |         |
| In Present Value (HIPC only) | 1302 | 556      | 3267      | 2499   | 20491   |
| Average 2001-2003    | 194     | 134      | 235       | 435    | 2400    |
| Traditional          | 91      | 54       | 109       | 168    | 999     |
| Enhanced HIPC        | 103     | 80       | 126       | 267    | 1651    |
| **Annual Debt Reduction Dividend (DRD)** |         |          |           |        |         |
| Average 2001-2003    | 178     | 104      | 45        | -5     | 1089    |
| **Debt Reduction ratio’s** (Average 2001-03) |         |          |           |        |         |
| DR / Exports         | 11.1    | 3.8      | 20.6      | 31.7   | 10.3    |
| DR / GDP             | 2.0     | 2.0      | 8.0       | 11.7   | 2.6     |
| DR / Fiscal Revenues | 8.3     | 8.6      | 29.4      | 63.7   | 15      |
| DRD/ Exports         | 10.2    | 2.9      | 4.0       | -0.4   | 4.7     |
| DRD / GDP            | 1.8     | 1.6      | 1.5       | -0.1   | 1.2     |
| DRD / Fiscal Revenues | 7.6    | 6.7      | 5.7       | -0.8   | 6.8     |
| ODA / GDP            | 7.4     | 5.9      | 28.0      | 10.3   | 13.6*   |
| DRD / ODA            | 25      | 27       | 6         | -1     | 9       |

* Unweighted average for all HIPC.


On average, the 22 decision point countries considered here paid about 18% of exports and 28% of fiscal revenues in 1998, in debt service before HIPC and
accompanying tradtional debt relief. After HIPC relief, debt service due will amount to about 1.9 billion US$ on average over the 2001-03 period, which implies debt relief of about 2.4 billion US$ in contractual terms, which will amount to about 10% of (average 2001-03 estimated) exports, 2.6% of GDP and 15% of fiscal revenues. The debt reduction dividend (as measured by the difference with actually paid debt service in 1998), however, will only be half of the contractual debt relief figures: it will amount to about 1.1 billion US$, or about 4.7% of (average 2001-03 estimated) exports, 1.2% of GDP and 6.8% of fiscal revenues.

Furthermore, it is interesting to compare the debt reduction dividend (on debt), as calculated in the table with current donor interventions, measured by current ODA, as in the last line of table 7. The ratio DRD/ODA gives some indication on what percentage decrease of conventional ODA would full wipe out the actual cash flow savings of debt relief, i.e. in the absence of full additionality, for the country as a whole. For the 22 HIPC's involved here, this would on average amount to about 10%.

Before treating this issue of additionality in the following section, we highlight one more feature: what would debt relief mean for ‘pro-poor’ spending assuming that debt relief savings would indeed be channeled into this ‘pro-poor’ spending? Some preliminary estimates based on the 23 countries that reached the decision point of the enhanced HIPC-Initiative as of May 2001 shed some tentative light on the issue17.

Table 8: The impact of HIPC on annual social spending (million US$ and %)

<table>
<thead>
<tr>
<th></th>
<th>Bolivia</th>
<th>Honduras</th>
<th>Nicaragua</th>
<th>Zambia</th>
<th>23 HIPC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annual Social Spending</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before HIPC (1999)</td>
<td>1041</td>
<td>442</td>
<td>267</td>
<td>167</td>
<td>4278</td>
</tr>
<tr>
<td>After HIPC (2002)</td>
<td>1210</td>
<td>844</td>
<td>594</td>
<td>263</td>
<td>6626</td>
</tr>
<tr>
<td><strong>As % of GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before HIPC (1999)</td>
<td>12</td>
<td>8</td>
<td>12</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>After HIPC (2002)</td>
<td>13</td>
<td>13</td>
<td>20</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td><strong>As % of Revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before HIPC (1999)</td>
<td>53</td>
<td>42</td>
<td>47</td>
<td>30</td>
<td>35</td>
</tr>
<tr>
<td>After HIPC (2002)</td>
<td>52</td>
<td>55</td>
<td>83</td>
<td>38</td>
<td>41</td>
</tr>
</tbody>
</table>


3.2.2 Additionality

Advocates of debt relief emphasize that the HIPC initiative should provide additional resources to developing countries. By this is meant that donors should grant debt relief on top of the traditional aid programs they are already funding and should continue to fund. Some of the international financial institutions, in

17 It is important to note that the WB document obtains these figures typically from the HIPC decision or completion documents, and that actual achievements may differ. For this, in-depth country case studies are needed.
particular the World Bank and the IMF, can contribute to the effort by drawing on their accumulated profits and reserves, yet the major effort to provide additional funds for debt relief will have to come from bilateral donors. But how likely is this to happen? Our starting point is a rational donor who allocates his budget over different instruments so that the marginal contribution to his chosen objective function of each instrument is equalized. The objective function includes growth and poverty reduction in developing countries, but presumably also the economic self-interest of the donor, his geopolitical ambitions and the like.

More resources will be devoted to debt relief when a donor feels he has underrated the contribution it makes to his objective function. Such a change of mind may be triggered off by the debt crisis starting to have negative effects on its own economy. In the case of the HIPCs this is however unlikely. The debt crisis in the poor highly indebted countries does not pose a threat to the world financial markets or the western economies. It would be different if we were dealing with a debt crisis in more advanced countries, like Brazil, Mexico, or Russia, which may well have major repercussion on donor economies. Another external factor is the pressure from multilateral organizations, the research community and the impressive mobilization of western public opinion (Jubilee 2000 is reported to have canvassed 25 million signatures) in favor of debt cancellation. To this the donors have responded with the present HIPC initiative. The crucial question is whether additional resources will be made available or whether the HIPC-initiative will be at the cost of other aid. If there is some real growth in western economies in the years to come and if the fraction of total government spending devoted to aid remains constant or goes up, then we may expect western governments to provide additional debt relief. Otherwise the outcome is more difficult to predict.

Whether or not debt relief is additional is also influenced by DAC/OECD rules for recording ODA. ODA volume targets are being used by many western governments, and even if more often than not they fail to attain them, such targets play an important role in national debates on foreign policy. If debt relief was not counted as part of ODA, and the donor community had agreed on a separate target for debt relief in the framework of HIPC, additionality would be favored. If, as is actually the case, debt relief efforts are included in ODA without volume targets for aid being revised upwards, substitution is tacitly condoned.

Does the past experience offer any guidance of how western governments might act? Some information on ODA and debt relief since 1960 is provided in figures 2 and 3. We use aid statistics published by the DAC/OECD in Paris. As figure 2 shows, the use of ODA for debt relief is a recent phenomenon, which becomes important in the 1990s only. During this recent period, debt relief constituted slightly more than 6% of overall ODA. Note that HIPCs were not the only countries benefiting from debt relief. In the second half of the 1990s two thirds of ODA debt

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18 This undoubtedly explains why the debt crisis of the middle-income countries was addressed earlier and more vigorously than that of the low-income countries.
19 Substitution even pays, as donors who shift from other instruments into debt relief can keep up the same level of ODA with a lower effort. This is so because the recording of debt relief as ODA is excessively generous: it does not take into account that much of the debt forgiven, especially debt owed by ECAs, would not be paid back in the absence of debt relief.
forgiveness went to HIPCs. In the beginning of the 1990s the percentage was much smaller.

Figure 3 shows that ODA as a part of donor GNP remained fairly constant during the 1970s and 1980s. In volume terms this translated in a gradual rise of ODA, as figure 2 illustrates. If during the 1990s ODA inclusive of debt relief had remained at the level obtained at the end of the 1980s, this would have provided prima facie evidence of zero additionality. Likewise, if ODA exclusive of debt relief had remained at the level of the end of the 1980s, this would have suggested full additionality. Inspection of figure 2 and 3 shows that neither of these two happened. Around 1992 the upward trend in ODA was halted and sharply reversed, whether we measure ODA inclusive or exclusive of debt relief. And donor countries devoted smaller and smaller shares of their GNP to ODA. Taking together this information seems to provide strong evidence of negative additionality, at least at the level of recipients taken as a whole: debt relief in the 1990s did not come on top of continued aid efforts using other instruments. In fact it occurred against the background of diminishing overall ODA flows. The suggestion is not that there is a causal link between debt relief and falling ODA levels. Other factors, in particular the end of the Cold War, fiscal restraint in some western countries and the disillusionment with aid in the face of the many man-made disasters in low-income countries are undoubtedly more to blame. It is therefore possible that had it not been for debt relief, ODA flows would have been even lower. But that is of little comfort.

Figure 2: ODA from DAC countries (billion US$ - 1998 prices)

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20 In figure 1 this means that the line measuring ODA inclusive of debt relief would be flat from 1989 onwards.

21 In figure 1 the line measuring ODA net of debt forgiveness (the lower of the two lines) would become flat from 1989 onwards. Note that although the upper line will be upward sloping in this scenario, it need not necessarily keep up with the historical upward trend of the 1970s and 1980s to satisfy the additionality condition.
But maybe DAC countries channeled more of their ODA towards the HIPCs, so as to ensure additionality for this group of countries, even if ODA to LDCs taken together declined? The available data from the DAC, visualized in figure 4, does not suggest that debt relief was additional to what HIPCs were already getting. On the contrary, ODA (measured in real terms) went down twice as fast for the HIPCs (a decrease of 3.4% per year) than for LDCs as a whole (a decrease of 1.7% per year).

It is worth remembering that ODA debt relief in the 1990s was pre-HIPC, and that the historical tendencies we have just described need not be a good guide to the
future. The HIPC-initiative has been rightly hailed as an important breakthrough. It is maybe justified to hope that donor behavior will indeed be different once the HIPC debt relief program gets in full swing.

There is a final comment we wish to make at this juncture. Donor compensation of debt relief within the aid budget (non-additionality) may be likened to the so-called fungibility on the part of recipients. In fact, if the major purpose of the advocates of debt relief is to increase net transfers to recipient countries, it is appropriate to use the label “donor fungibility”, as the following table illustrates.

| fungibility caused by evasive action on behalf of the aid recipient (in the case of project aid) | Fungibility caused by evasive action on behalf of the aid donor (in the case of debt relief) |
| Pressure from donor, in form of project conditionality | International public opinion, in the form of moral exhortation |
| Purpose of pressure implement the project, with a view of increasing investment in the sector concerned | Grant debt relief, with a view of increasing net transfers |
| Defensive tactic accept project, reduce own effort in same sector | Accept to provide debt relief, reduce aid effort elsewhere |
| Outcome what you see is not what you get: the project is there, but the intended sector impact is missing | What you see is not what you get: debt relief has been granted, but without an increase in net transfers |

In both cases the end result is that the efforts of the party exerting pressure have been thwarted, although on the face of it its demand has been heeded.

3.2.3. Debt overhang

Apart from the direct effect of debt relief on the economy in terms of foreign exchange and the budget, there may be indirect beneficial effects which are specific to this form of aid, and may make it especially attractive. This is when an ‘excessive’ debt stock introduces negative externalities in the economy beyond the transfer of resources. This is generally described as the debt overhang hypothesis. The link between debt overhang and fiscal issues is straightforward: high (current and) future debt transfers lead to anticipations by investors (both domestic and foreign) of future higher taxes and increased uncertainty, which both create a disincentive effect on the present investment (sensu stricto) or adjustment decisions (‘investment’ sensu lato) of an indebted country.

23 The notion of investment has to be viewed broadly here. It refers to accumulation in human capital—through spending on education and health—as well as in physical capital such as
First, it depresses the willingness of debtor governments to execute adjustment programmes because a (possibly large) part of the benefits of adjustment will go to foreign creditors as increased debt service transfers and does not stay in the country as increased consumption or additional investment capacity.

Moreover, it depresses private investment (by both domestic as well as foreign investors). The argument runs as follows. Since it is the public sector that has to service the debt, either public spending will have to be reduced or internal transfers will have to be operated from the private sector, or, most probably, both. As a consequence, not only public investment, but also private (domestic and foreign) investment gets depressed as expected external transfers are transmitted throughout the economy in the form of higher uncertainty and large expected taxes of different kinds. These effects reduce perceived future net after-tax returns on investment as well as increase the risk premium on investment. Additionally, the public sector may be tempted to use taxes on financial intermediation, such as the inflation tax. This negative incentive effect can be expected to be particularly pronounced in the sectors most likely to be tapped for public financing, be it the monetary and financial systems, the manufacturing sector or trade activities (Claessens and Diwan 1989).

Apart from the investment disincentive effect, debt overhang will also scare off new foreign lenders. In the absence of seniority, new loans enter the same pool as old loans and instantly metamorphose into as poor a financial claim as the old loans. Furthermore, as long as the old claims stand undiminished, the new lenders will have to share the fruits of any improved creditworthiness with the old lenders. This depresses the return to the potential new lenders, and keeps them from doing business with the debtor countries. As a consequence these countries are shunned in international credit markets and cannot borrow as they otherwise could. Some high-yielding investments, which investors would undertake notwithstanding the disincentive effect described earlier, may thus go unexploited because of a lack of finance.

Debt overhang therefore acts as a brake on the economy in a way, which goes beyond the siphoning off of public resources for debt service. For the same reason, it is claimed that debt reduction has a more beneficial effect than an equivalent amount of aid, which is injected in a debt-ridden economy. The difference resides in the stimulating effect on the private sector stemming from debt relief, made possible by the reduced foreign claim on future gains. By selecting debt relief, the donor ensures that the proceeds of economic growth remain within the economy. Political features are also important: debt relief also increases domestic acceptance of austerity, as the burden of reforms is now perceived to be shared with creditors.

machinery and infrastructure. It also captures many types of policy reform, including structural reform and macro-economic stabilization, whose long-term benefits may come at the expense of short-term costs. As such, it is best captured by the term ‘adjustment’. 24\footnote{The negative effect of increased uncertainty on investment is central in the so-called real option approach to investment (Dixit & Pindyck 1994). Empirical analysis provides general support for this hypothesis, especially in developing countries (Serven 1997, Pindyck and Solimano 1993).}
The debt overhang hypothesis gives rise to the concept of a Debt Laffer curve (Krugman, 1988) showing that expected payments to creditors might even start to decrease with higher debt at high debt ratios due to this debt overhang effect. This hypothesis was then turned into argument in favour of debt relief: for high levels of debt, it might be in the self-interest of creditors to grant some debt relief because it would lead to higher expected payments.

Empirical studies do not unambiguously confirm a strong disincentive effect of a large debt on investment; this may be largely due to depressed investment being explained by the general dismal state of the economy in some countries, of which a large debt overhang is just another reflection. Moreover, it is shown that the ‘marginal tax’ effect of debt transfers on GDP is too low to matter much (Eaton 1990, Diwan and Rodrik 1991, Claessens et alii 1997).

Will HIPC have a substantial impact on debt overhang in its broad sense, i.e. on the disincentive effect with respect to adjustment, and additional inflows from new creditor-types? In the beginning of the 1990s, Brady-type debt reduction operations managed to lift debt overhang from the involved middle-income developing countries, mainly by removing uncertainty associated with continual ongoing debt reschedulings and by bolstering the confidence in the process of policy reform (Claessens et alii 1997). But this study along with others also stresses that the situation of the HIPCs is not a replica of the Brady countries.

- HIPCs will not immediately regain access to the international (private) capital markets, contrary to what was witnessed for Brady countries, and as such, a big increase of new additional resource inflows will not be forthcoming, with the notable exception maybe of foreign direct investment (FDI) flows, for particular countries.
- Since conventional tax/GDP rates are relatively low in HIPC-countries, the impact on future after-tax return on investment tax argument was never very credible for these countries;
- To the extent that high uncertainty and bad governance in both public and private sectors was a main channel to explain low investment rates and ‘waiting to invest’ behaviour, it remains to be seen whether debt relief accompanied by the economic reform as laid down in the PRSP, will increase expected returns and depress uncertainty so as to make investors change their waiting behaviour. Moreover, it might be that investors have already taken into account the possible benefits of debt relief so that further increases in (private) investment rates are unlikely to be large in the short run.

The more important effect will be on public investment, where additional and conditional debt reduction will free up resources for investment in human development. It may also provide an opportunity to reduce or eliminate remaining highly distortionary public finance mechanisms (such as inflation taxes) for countries where there is a relaxation of the recurrent fiscal gap.

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25 Empirical studies, using predominantly information from the secondary market of value-impaired debt (such as Claessens, 1990, Cohen 1991) do seem to validate the existence of the debt Laffer curve and the position of some countries at the the ‘wrong side’ of the curve, where creditors an collectively benefit from granting debt relief. This methodology can also be used to try to determine the threshold value of sustainable debt (see 3.2.4).
3.2.4. Debt Sustainability

Sustainable debt is a central notion in the HIPC initiative. However, sustainability can be interpreted and measured in several ways. For instance, the savings, trade, and fiscal gap discussed in section 2.1 each translate in a different measure of sustainable debt. Let us illustrate this with the fiscal gap. At a given point in time the increase in foreign debt can then be defined as:

\[
\frac{dD}{dt} = iD + (T + A_{gb} - I_s - C^* - g) \cdot \Delta M + \Delta L = iD + (b - m - l) Y
\]

where:
- \(D\): the stock of foreign debt
- \(i\): interest on foreign debt
- \(T\): domestic government revenue, consisting mainly of taxes
- \(A_{gb}\): foreign aid flowing to the government budget
- \(C^*\): government recurrent spending exclusive of interest payment on public debt, or:
  \[C_g = C^* + iD\]
- \(\Delta M\): the increase in base money or seignoriage
- \(\Delta L\): the increase in public borrowing from the domestic private sector
- \(b\): ratio of the primary fiscal deficit (including budget aid) to GDP
- \(m\): ratio of seignoriage to GDP
- \(l\): ratio of domestic borrowing to GDP

Equation (10) states that a fiscal deficit which is not financed by domestic borrowing or money creation (inflation tax) will automatically feed into foreign debt. Conversely, fiscal surpluses allow to service foreign debt. Sustainability is simply defined as a stable international debt/GDP ratio:

\[
\frac{dD}{dt} = \frac{dD}{dt} Y - g \cdot \frac{D}{Y} = 0
\]

with

\[
g = \frac{dY}{dt} \cdot \frac{1}{Y}
\]

using (10) in (11) we obtain the familiar steady-state equilibrium condition (see e.g. Branson and Jayarajah 1995)

\[
\frac{D}{Y} = \frac{(b - m - l)}{(g - i)}
\]

If the rate of growth of GDP exceeds the average rate of interest on foreign debt then a fiscal deficit is compatible with a sustainable debt to GDP ratio. If on the other hand the growth rate of GDP falls short of the average rate of interest on foreign debt, as is the case for some HICPs, a fiscal surplus will have to be maintained indefinitely in
order to sustain a constant the debt to GDP ratio. If this is not possible, the country faces an exploding debt.

The HIPC-Initiative uses a concept of sustainability that is different from the ‘fiscal’ approach just described, and seems more inspired by the trade gap. Debt sustainability is in fact determined in terms of export receipts, irrespective of a poor country’s relative income position within the group of IDA eligible countries. More precisely, the enhanced HIPC-Initiative has determined a fixed sustainability ratio of the present value of debt over exports of 150%, down from 200-250% under the original HIPC-Initiative. Somewhat strangely, most of the empirical work tends to concentrate favors debt to exports indicators (e.g. Cohen 1996). What has not been considered in all this is that not all low-income countries are equally poor. Ceteris paribus the poorest countries deserve more debt relief than those at the higher end of the human development range. Lumping all poor countries in the same basket has prevented from addressing this intra-group equity issue.

It is clear that debt relief alone will not automatically lead to long-term sustainability of post HIPC debt. A recent joint IMF/World Bank Board paper (IDA & IMF2001b) explicitly discusses long-term sustainability of post HIPC debt for the 22 countries having reached at least decision point status under the enhanced Initiative. It shows the three requirements for maintaining long-term debt sustainability in the HIPC countries: first, output growth must double from 3 % in the past decade to 6 % in the coming decade; secondly, annual export growth must more than double, from 4 to 9 %, and thirdly, the grant component in new borrowing also needs to double from 28 to 57% in the same period. Those requirements are very demanding in view of the past experience and the likely impact of HIV/AIDS on future economic growth. But each assumption is useful in reminding us that much more than debt relief is needed to achieve long term debt sustainability.

All the above calculations are based on some arbitrary ceilings for sustainability. What is missing is a normative view on sustainability based on the essential functions of the developmental state. In this view, external debt is sustainable if servicing debt does not prevent the government from attending to the basic human needs of the population. As such, it focuses on the fiscal policies, in terms of public investment and recurrent spending and in terms of tax exemptions for the poor, needed to meet these goals and derives from these the necessary savings, both domestic and foreign, and also the necessary fiscal resources. This ‘human development’ approach to sustainability will differ from the conventional fiscal notion of sustainability to the extent that the steady state equilibrium level under fiscal sustainability where (external) debt can continue to be serviced in the future

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26. Apart from a focus on the trade gap, another reason might be that data on exports are more reliable than GDP data.
27. For the first 22 Enhanced HIPC decision point cases, despite a common after-HIPC present value of debt to exports ratio around 150%, the corresponding present value of debt to GDP ratio ranges between 14.5% and 75%. There is no correlation with GDP per capita. Malawi, Niger and Guinea-Bissau, the three poorest countries in the sample with a GDP per capita below 200 US$ per year are considered capable of servicing an external debt that in terms of GDP is equal or larger than what is sustainable for Bolivia (namely 25.5%), with a GDP per capita of 1010 US$. 

39
might be situated at a level where it still crowds out the needed public expenditures in support of human development.\(^{28}\)

The need of supporting developing countries in meeting their basic human needs has recently been made operational at the international level by the acceptance of a number of International Development Goals for the year 2015\(^{29}\); this effort is officially supported by the international donor community, as witnessed first e.g. by the OECD in its ‘Shaping the 21st Century: the Contribution of Development Cooperation’ (1996) report and the joint ‘Paris21’ initiative of OECD, UN, World Bank, IMF and WTO. More recently, this approach has moved to the center stage of debate following the UN Millennium Summit, the UN Conference on Financing for Development in Monterrey of March 2002 and the Millennium Development Goals (MDGs) that resulted from this and that have now been subscribed unanimously by the international community as the common framework to guide and assess human development up to 2015\(^{30}\).

In trying to achieve these ambitious goals, one has to also make the difficult exercise of figuring out not only how to make aid more effective, but also how much is needed in terms of (additional) resources to finance the needed development and recurrent spending, and through which mechanisms the western world will contribute\(^{31}\). Increasing conventional aid would of course be a natural candidate.

But debt relief could also contribute. Clearly, the enhanced HIPC mechanism was never set up to generate the necessary resources to meet these MDGs. But donors could decide to use the instrument of debt relief as one of their aid interventions to go beyond enhanced HIPC debt relief (which is what some bilateral donors are already doing), especially after the Monterrey Conference. From the viewpoint of public spending in recipient countries, the human development approach to debt sustainability would imply that meeting basic needs is so prior in the allocation of public sector resources that it is optimal to cancel any debt service that crowds out (public) spending needed to realise a minimum level of basic human development. To the extent that needed resources fully exhaust the available budget, it might be optimal from a human development point of view, through an appropriate mechanism and with appropriate conditionality, to grant that country complete debt cancellation\(^{32}\).

### 3.3. Impact on Poverty Reduction and Aid Effectiveness

The overall impact of the HIPC-initiative could be much more important than just the quantitative effect it may have on the recipient economy. Donors and

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\(^{28}\) For analysis that take this approach, see e.g. the CAFOD (Nothover et alii1998) and PAIR (Berlage et alii 2000) proposals. See also Eurodad (2002) and Birdsall and Williamson (2002) for alternative approaches to debt sustainability and debt relief.

\(^{29}\) Such as to reduce by half the number of persons with an income less than one US$ (PPP value) per day; to make primary education universal and to reduce infant mortality by two thirds.

\(^{30}\) See UN(2000, 2001, 2002) and [www.developmentgoals.org](http://www.developmentgoals.org) for a detailed overview of the MDGs.

\(^{31}\) See especially the Zedillo report (UN, 2001) and Devarajan et alii. (2002) for estimates.

\(^{32}\) Crude and very preliminary estimates, as in Nothover et.alii. (1998), Berlage et alii. (2000) and Eurodad (2002) tend to indicate that this might indeed be the case for some low-income countries.
recipients alike are frustrated with the failure of aid. If all aid that has been provided to low-income countries since the 1960s had been only moderately effective, then the debt situation would not have arisen, and poor countries would have seen dramatically better off then they are at present. But if aid does not seem to have any long-term effect on recipient countries in terms of growth and equity, why bother to provide more? But the picture is not that gloomy. A new consensus seems to have emerged on how to make aid more effective. And the enhanced HIPC initiative seems to have exactly the right ingredients. Among them aid delivery modalities that stress recipient ownership, support to the budget, and a new conditionality.

3.3.1. Channeling Debt Relief into Pro-poor Spending

Minimal conditionality attached to the enhanced HIPC-Initiative is to recycle debt savings into poverty-related public spending. Three broad alternatives on which mechanism to use in order to track recycling are available: institutional poverty funds, accounting-only (‘virtual’) poverty funds, or comprehensive budget tracking.

Institutional poverty funds refer here to revenues set aside in a separate account, with expenditures occurring outside country’s normal budget execution and reporting system, subject to different reporting and accountability standards, and frequently with dedicated local staff hired and paid outside normal civil service systems. There is now widespread consensus that the use of separate institutional funds is inadvisable mainly because of fungibility, but mainly because they would generally set the clock back and undermine the significant progress already achieved in most HIPCs in providing comprehensive budgets.

A more appropriate short-term alternative is to use an accounting-only or “virtual” poverty fund, whereby appropriately coded budget line items are “tagged” as part of the virtual poverty fund, and this spending is tracked by the ministry of finance as part of overall budget execution. By using the existing budget processes, this approach avoids the pitfalls of a separate institutional mechanism and at the same time enables tracking of all poverty-related programs. About half the HIPCs have such virtual funds at this time.

The medium term goal would however be to move towards a system of comprehensive expenditure tracking, using a public expenditure management (PEM) system linked to a MTEF mechanism, where tracking of spending is largely replaced by output monitoring. However, most HIPCs lack the necessary budgeting and financial management systems to fully track budget allocations and execution, and strengthening their capacity in these areas will become a priority of donors due to HIPC.

33 IMF/IDA (2001,2002) report synthesis results of a preliminary assessment of the quality of central government PEM systems in the 25 countries that had reached, or were expected to reach, the decision point under the HIPC Initiative within the next few months. Fewer than 10 percent of the HIPCs will be able to carry out satisfactory tracking and reporting within one year, with little or no upgrading of their present systems; a further 25 percent will require some upgrading to achieve the same objective over 1–2 years; and the remaining 65 percent of HIPCs have PEM systems with significant weaknesses, that are unlikely to be fully resolved in the near term.
3.3.2. New Conditionality and New Hopes

Recently there has been much soul-searching in the donor community about aid effectiveness. This has culminated in a number of interesting publications, including the World Bank’s “Assessing Aid” (World Bank 1998) and “Can Africa Claim the 21st Century?” (World Bank, 2000). The starting point is the admission that aid has not lived up to its expectations. This is especially so in the countries that are the poorest and that have been receiving heavy doses of aid as a fraction of their GNP. Most of the HIPCs belong to this category. These countries have been the target of massive project aid since the 1960s and ambitious structural adjustment efforts from the 1980s onwards. Yet in terms of rates of economic growth or in terms of social indicators, the situation in most of these aid-dependent countries is dismal. In per capita terms they have progressed little, if at all, since 1960. How comes that 40 years of intensive development aid has not produced better results? The answer is complex, and the literature imparts the blame on both recipients and donors. The policy failures on the recipient side are well known, and the analysis in this respect has not changed much over the years. What is really new is the frankness with which the errors on the donor side are being admitted, and more importantly, the solution being offered. Four principles underly the proposed new approach (World Bank 2000 p. 247): more selectivity by donors in choosing aid recipients increased beneficiary participation, recipient capacity strengthening, and recipient ownership.

The new conventional wisdom, expounded in “Assessing Aid”, starts from the claim that neither micro conditionality nor macro conditionality has been effective. As far as micro conditionality is concerned, the argument refers to the failure of projects. Administering concentrated project efforts in a political and economic environment, which is not conducive to development, did not prove workable. Many projects failed, if not during donor intervention, then shortly afterwards. If agricultural price policies for instance are inappropriate, it does not help to fund agricultural development projects, for in the end farmers have insufficient incentives to produce for the market.

Secondly, large doses of project aid by many different donors are very difficult to manage on the recipient side. It is very difficult, if not impossible, for the country to be in control of its development process, with most of public investment, and sometimes a significant part of recurrent spending, subject to a myriad of donor-imposed management procedures, accounting and reporting rules, hiring and grading systems for local experts, while being mainly outside public budgetary procedures. The national process of planning, budgeting, implementing and monitoring is by-passed and institutionally weakened in the process.

A third and in a way more deadly blow comes in the form of fungibility, since long known and debated in the literature, but brought to the center of the stage in “Assessing Aid”. Fungibility fundamentally challenges the wisdom of putting much effort in micro conditionality. If the recipient can cancel a donor’s effort, say, to invest more in favor of small-scale farming, by reducing its own support to the sector, thus freeing public resources to be used by the recipient at will, then donor
impact is thwarted. It is now believed that fungibility has taken place on a massive scale. Note that as presented here, fungibility is a problem for the donor, not for the recipient. The assumption in “Assessing Aid” is that the donor and recipient have different perceptions on what are the appropriate priorities, and that those of the donor are the right ones. It is only then that the escape from donor-imposed conditionalities through fungibility is unequivocally bad. The thesis of the prevalence of fungibility is based on both theoretical and empirical arguments.

“Assessing Aid” is equally skeptical about traditional macro conditionality in the form of structural adjustment policies. The reason is not that the policy reforms advocated were mistaken. Better policies are still important, although the definition of “good” policies has evolved, with increasing attention being put on equity and poverty eradication, and on governance issues. A central theme of the book, supported by empirical evidence, is that aid works in the right policy environment; the latter defined in the Bretton Woods sense. Another claim is that such policy reforms cannot be ‘bought’ through structural adjustment lending. The inevitable conclusion is that donors must resort more to ex post conditionality, or selectivity. Rather than negotiate appropriate policies with the government, and provide up-front financing on the basis of promises, the solution advocated is to reward governments only after they have convincingly shown they are following the right policies. Yet another important conclusion of recent research, from the perspective of the present paper, is that in a good policy environment, aid should not be in the form of projects, for all the reasons mentioned above, but rather a general support to the budget.

Many other donors have been drawn into this debate and share its most important recommendations. A number of them, among them some of the Nordic countries, the Netherlands, the United Kingdom, Canada, and the European Union, have been questioning the heavy emphasis on project funding and its debilitating effect on recipient institutions and ownership. The discussions in the framework of the SPA, the Strategic Partnership with Africa (until 1999 known as the Special Program of Assistance for Africa) have proved very stimulating. The question is how donors, including the smaller ones, can provide budget support while at the same time satisfying their own desire for accountability. Using much the same arguments that have been detailed above, these donors are trying to move away from project funding and to develop appropriate procedures for budget support. The major ingredients are a sector policy dialogue involving all the donors, under the responsibility of the recipient government, technical assistance for capacity building, budget support, and procedures of joint monitoring through public

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34 Econometric evidence in favor of the fungibility thesis is presented in Feyzioglu et al. (1998), but these results have been questioned by McGillivray and Morrissey (2000) and Beynon (2001). To add a further critical note, it is difficult to see how governments can actually invoke the fungibility escape mechanism in countries where almost the whole of the development budget is funded by donors. Note further that even if there is full fungibility at sector level, the project modality may still make sense in terms of knowledge transfer, for instance by funding pilot schemes whose successful features may later be repeated elsewhere.

35 The thesis that aid works better in a better policy environment and that at the same time the latter cannot be “bought” by donor imposed conditionalities, is shared by the research community. See for instance Collier et alii (1997). A related conclusion of the report, that aid does not have a significant effect in the absence of good policies, has however been challenged (Hansen and Tarp 2000).

36 see for instance Jones and Lawson (2000).
expenditure reviews. These are first elements of moving towards a kind of ‘common pool’ approach (Kanbur et alii. 1999).

Why is the above discussion so relevant for debt relief in the context of HIPC? Essentially it is because these reflections fit in very well with the modalities of debt relief. In a way the emerging consensus just described paves the way for the acceptance by donors of a new type of conditionality related to debt relief, but also to other forms of budget support. Rather than being just a temporary, ad hoc modality of aid delivery, the (enhanced) HIPC-initiative is set to become a major testcase for a renewed relationship between donors and recipients, and for the attainment of adequate levels of aid effectiveness which have largely eluded the world community for the past 40 years.

37 see Foster (2000) and White (1999) for documents commissioned by donors which tackle these issues.
Conclusion

The HIPC-initiative has raised high expectations among the millions worldwide that fought for substantial debt relief for the poorest countries. It certainly holds the promise of substantial gains for the countries concerned as billions of dollars will be freed to be spent on social priority needs and on investment in long-term development, as put forward e.g. by the MDGs. Some also regard it as a hallmark in the relations between donor and recipient countries. Concluded at the end of the 1990s, in a period of fast declining development aid and donor fatigue, it seems to offer a way out of several deadlocks, and provides some hopes for more and more effective international aid in the 21st century.

There are indeed many things that (enhanced) HIPC is meant to achieve. We explicitly mention some of the more crucial ones:

- address the fiscal constraint, and especially the recurrent fiscal constraint in low-income countries where governments have not able to adequately play their role in the development process
- lift the negative externalities associated with debt overhang
- direct the attention of donors and recipient governments towards poverty reduction and human needs
- restore ownership to recipient governments over aid to the public sector, which has been eroded through excessive and badly conceived conditionalities
- address the many issues of poor governance and inadequate policies in the recipient countries which contribute to low levels of economic development
- improve donor co-ordination, moving towards a ‘common pool’ approach on interventions
- improve selectivity on the use of different instruments of intervention, such as project versus program aid, and debt relief
- improve selectivity by donors of aid recipients, with interventions based on determinants such as the level of human development, the supporting of good reform policies and away from interventions that are motivated by donor self-interest or backing up historical interventions that have failed (defensive lending).

All this is certainly very ambitious. The experience with debt relief measures during the pre-HIPC 1990s is very mixed. For instance, the resource flow effect of debt relief was more than cancelled by the fall in other aid. It will be crucial that the HIPC-initiative resources are made truly additional to more conventional aid interventions. But that is very difficult to monitor, and donors have been making many promises over the decades, which they have not lived up to.

Equally if not more important are the qualitative improvements which are pursued through the HIPC-initiative. On that score there is room for cautious optimism, as donors and the research community seem to be moving towards a new consensus
on aid delivery mechanisms and the selection of aid recipients. The element of caution here refers e.g. to the intrinsic conflict between selectivity and quality of the poverty reduction strategy, with high country ownership, on the one hand, and the need to execute debt relief on the other hand. In any case, either implicitly or explicitly, donors will wish to gradually increase selectivity, especially once the current debt overhang problem is solved. At that moment, they will want to effectively sanction blatant policy failures. With the new system also comes good governance of public expenditures and well-functioning PEM-systems. Currently, most HIPC's seem to lack the necessary budgeting and financial management systems to fully track budget allocations and execution, and strengthening their capacity in these areas will become a priority of donors as a direct effect of the HIPC-initiative.

Another element of caution refers to the uncertainties that still surround the new modalities by which (more of total) aid will be delivered, and that will be more budgetized and controlled by the recipient public sector. This will force donors to achieve greater coherence and coordination on what sectors of the economy to support, what exactly does one want to achieve by conditionality and policy dialogue, how to interpret results of monitoring and evaluation, etc... In this field, donors have as yet little experience, the exception being coordination needed in the structural adjustment framework, and special initiatives such and the SPA in the case of African countries. Moving towards such a ‘common pool’ approach will also imply a better division of labour between the bilateral and multilateral donors, increasing leverage for bilaterals to become more engaged in policy discussions that surround aid interventions.

It will take a while before we can fully judge whether proposed changes also materialize in practice. But clearly, by (again) more explicitly referring to the prime objective of the promotion of human development and poverty reduction, both the entire donor community as well as governments of recipient countries have (re) adhered to the right priorities.
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