

HIPC DEBT RELIEF, THE DEBT SERVICE BURDEN AND POVERTY REDUCTION

With a Special Reference to
Uganda's Experience

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**HIPC DEBT RELIEF, THE DEBT SERVICE
BURDEN AND POVERTY REDUCTION
With a Special Reference to Uganda's Experience**

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December 2006

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Abstract

This paper offers a review of the theories behind the architecture of the Heavily Indebted Poor Countries (HIPC) initiative and the literature concerning its link to the formulation and implementation of Poverty Reduction Strategy Papers (PRSPs), to speculate on the appropriateness of this link and its possible effects on poverty reduction. Special emphasis is placed on reviewing the literature on aid conditionality and ownership, these debates being highly relevant to the HIPC framework and its poverty reduction association. To see the advancement of the HIPC initiative, the paper offers an overview of one of the World Bank's showcase passages through the HIPC initiatives; Uganda and its implementation of the PRSP. The paper concludes that the HIPC initiative is an important step in the right direction to foster sustainable growth in low-income countries and to integrate debt relief into a global poverty reduction strategy, but it emphasises that it is only a step. The focus on poverty reduction and participatory linkage is considered appropriate and welcome, but some possible tensions between these explicit twin objectives are highlighted.

In recent years, the academic and policymaking circles have witnessed an intense discussion about poverty, inequality and pro-poor growth. The persistence of poverty at high levels, the slow rate of poverty reduction and the high external indebtedness of developing countries pose major challenges for world leaders, policy makers and governments and have received increased attention as one of the main factors contributing to limiting the development of numerous poor countries. Various recent policy and research documents have identified pro-poor growth as the most important ingredient in achieving sustainable poverty reduction, and debt relief as critical to improving macro stability, reducing the drain on scarce resources and allowing for investments in priority sectors, such as health and education.

In theory, debt relief reduces poverty through three distinct channels. First, debt relief may increase economic growth. The idea is that debt relief stimulates private (foreign or domestic) investments and possibly international credit ratings. Second, relief of government debt releases resources that the government can use for increased spending on social sectors, which is likely to have an impact on non-income poverty. Third, debt relief may be used to change policies. In particular, donors (or creditors) may buy reforms with debt relief, making the economic environment more conducive to growth and private initiative. Debt write-off seems an obvious response to the plight of low income, and especially sub-Saharan African, economies where growth has been extremely slow, and often negative over the last two decades. It is also an eminently campaignable issue, as Jubilee 2000 and other NGO movements have shown.

External debt burden is not new to the Low-Income Countries (LICs), but it has increased significantly since the 1970s. In 1996, after almost two decades of repeated attempts to relieve many LICs of their external debt burdens, international organizations as well as bilateral creditors added to traditional debt relief mechanisms by implementing the Heavily Indebted Poor Countries (HIPC) Initiative. This initiative provides conditional

assistance to countries that meet specific policy and performance criteria and aims to reduce, within a reasonable time, the external debt burden of qualifying countries to sustainable levels. The initiative was then enhanced in 1999, in response to intense pressure to make debt relief broader, faster, and deeper, and poverty reduction emerged as a key element in the programme. The poverty reduction approach results in a comprehensive country-based strategy for poverty reduction. It aims to provide a link between national public actions, donor support, and the development outcomes needed to meet the United Nations' Millennium Development Goals (MDGs), one of which is centred on halving poverty between 1990 and 2015. The enhanced HIPC scheme (or HIPC II) is based on conditionality, linking debt relief to policies for poverty reduction. Stated briefly, countries are required to establish a good record of implementing economic and social policy reform and prepare a Poverty Reduction Strategy Paper (PRSP) indicating how they will tackle poverty reduction, giving voice to the poor. Countries are then expected to use the surplus to meet social expenditure and other objectives for poverty reduction. The IMF and the World Bank must endorse and assess the PRSP and then agree with the government on a policy reform and macroeconomic management programme to be followed during the HIPC period.

The HIPC initiative was, among other things, a consequence of the apparently successful experience of the Brady Plan in the late 1980s, in reactivating Latin American economies as private capital returned to the region once the debt burden seemed sustainable. The debt problems of the HIPCs, though, differ in many dimensions from those of the middle-income countries. Apart from the obvious difference in income per capita, the composition of debt between private and official creditors is different, as the HIPC debt is mainly to official creditors. Another important difference is that the HIPCs are characterised not only by high debt, but also by relatively poor economic performance and slow economic policy reform. The links between high debt and the implementation of policy reform are thus central.

Given the short time since the HIPC initiative was launched, its economic and social outcomes will not be known with any certainty for some years. Thus, the objective of this paper cannot be the evaluation of the success or failure of the HIPC poverty reduction linkage. The paper therefore offers a quick review of the theories behind the architecture of the HIPC initiative and the literature concerning its link to the formulation and implementation of PRSPs, to speculate on the appropriateness of this link and its possible effects on poverty reduction. Special emphasis is put on reviewing the literature on aid conditionality and ownership, these debates being highly relevant to the HIPC framework and its poverty reduction association. To see the advancement of the HIPC initiative the paper offers an overview of one of the World Bank's showcase passages through the HIPC initiatives: Uganda and its PRSP implementation. Uganda was the first country to qualify for debt relief under both the initial and, with Bolivia, the enhanced HIPC initiative. As such, it has served as a valuable learning ground for the HIPC program. Uganda has recovered in a remarkable way from the economic devastation brought by Idi Amin. Over the last decade, Uganda's progress in implementing a market-oriented development strategy and its commitment to poverty reduction have attracted a considerable amount of financial inflows, including Official Development Aid (ODA), and notable results: the percentage of the population living in poverty fell dramatically from 56 per cent in 1992 to 35 per cent in 2000; furthermore Uganda has recently achieved universal primary education.

The first section provides a selective review of the literature on the debt impact on economic performance, the debates behind the design of the enhanced HIPC initiative and an outline of debt relief history. Section 2 discusses the current HIPC initiative, comparing it to the original framework, and its link to poverty reduction. Section 3 illustrates Uganda's use of HIPC funds and achievements in poverty reduction. Thus the paper offers an overview of the theories behind the HIPC initiative structure and the literature concerning its link to the formulation and implementation of

PRSPs to conclude that the HIPC initiative is an important step in the right direction to foster sustainable growth in low-income countries and to integrate debt relief into a global poverty reduction strategy, but it emphasises that it is only a step. The focus on poverty reduction and participatory linkage is considered appropriate and welcome, but some possible tensions between explicit twin objectives are highlighted.

1. The background of the HIPC initiative: debates and theories

Debt impact on economic performance

An important part of the motivation for debt relief to heavily indebted poor countries comes from the presumption that an adverse interaction exists between heavy debt burden, economic growth, and human development. Growth is important for two reasons. First, as growth rates of HIPC countries have been disappointingly low, the tax base has stagnated or declined in many cases, and low or declining public revenues have contributed to the underfunding of development spending, including pro-poor spending. Second, growth can reduce income poverty by enhancing livelihood opportunities for the poor. Growth acceleration could be the key benefit of the HIPC initiative, although growth is no panacea for deep development problems – and must be undertaken in ways that ensure environmental sustainability.

The debt overhang hypothesis

It is now generally accepted that a large debt stock can impair development, but there is less agreement on how this impact might occur (OED, 2003). Theoretical analysis yields a number of hypotheses on the impact of debt on economic performance. One of special importance is the

harmful effects of a country's *debt overhang*, the accumulation of a stock of debt so large as to threaten the country's ability to repay its past loans, which in turn scares off potential lenders and investors. This hypothesis, which originally emerged in response to the middle-income countries' debt crisis in the 1980s, has been the main theoretical argument in support of explicit debt reduction, as opposed to continued flow rescheduling (Dijkstra and Hermes, 2001) and was the basic strategic rationale for the HIPC initiative as originally conceived and operationalized. The theory is based on the premise that, if a country's debt level is expected to exceed the country's repayment ability with some probability in the future, expected debt service is likely to be an increasing function of the country's output level. Therefore, some of the returns from investing in the domestic economy are effectively "taxed away" by existing foreign creditors, and investment by domestic and foreign investors is discouraged (Claessens *et al.*, 1997). The implication would be that large debt stocks lower growth through the channel of reduced investment, and therefore a reduction in the face value of future debt obligations will reduce the distortion due to the implicit tax, and this will increase investment. Since debt reduction leads to increased investment and repayment capacity, the portion of the debt that remains outstanding becomes more likely to be repaid.

If the negative effect is strong enough, the debtor is said to be on the "wrong side" side of the debt Laffer curve¹, and debt reduction may benefit the creditors as well as the debtor. While initially the expected value of payments equals the nominal value of the debt, if the debt increases, the expected payments will be less than the nominal value. If the debt grows even further, the expected value of repayments may even decline. The country then finds itself in the downward section of the debt Laffer curve.

1. For detailed information about debt overhang and the debt Laffer curve, see Claessens (1990).

As the stock of public sector debt rises, investors may worry that the government will finance its debt-service obligations through distortion measures, such as inflationary financing and/or precipitate a currency depreciation/devaluation. Such uncertainty generates in possible investors a tendency to remain on the sideline, or to invest in projects with quick returns rather than in projects that enhance growth on a sustainable basis over the long term (Clements *et al.*, 2003)

In its original formulation, the debt overhang theory focused on the adverse effects of debt on investment in physical capital. The scope of the theory, however, is quite broad. To the extent that foreign creditors are expected to appropriate some of the benefits of future growth, any activity that involves incurring costs up front for the sake of increased output in the future will be discouraged. Such activities may include investment in human capital and in technology acquisition. Furthermore, disincentives for the government to implement economic reforms (trade liberalization, privatization, fiscal reform) and invest in productive activities increase with higher debt service. This comes as the returns on such activities will be used to repay outstanding debt instead of directly improving the economic welfare of residents, leading to an immediate, political as well as economic, cost (Clements *et al.*, 2003). If policy makers expect foreign creditors to appropriate most of the gains from policy reform through larger debt service payments, then the presence of a debt overhang may be a strong obstacle to economic reform. With government postponing much needed economic reforms and good policies, private investors become even more cautious before taking new investment decisions (Dijkstra and Hermes, 2001). This deterrent to reform would exist in any country with a heavy external debt burden, but it is of special concern in the HIPC's, where structural reforms are essential to sustaining higher growth (Clements *et al.*, 2003). So, the channel for the debt overhang's effect on growth may not only be through volume of investment but also through a poorer macroeconomic policy environment, which is likely to affect the efficiency of investment, and uncertainty (Patillo *et al.*, 2002).

Few studies have been able to determine how large the stock of external debt has to be, relative to gross domestic product (GDP), for the debt overhang to have an effect (Clements *et al.*, 2003). A 2002 study by Patillo, Poirson and Ricci of 93 developing countries between 1969 and 1988 did, however, find strong support for the debt overhang hypothesis (Patillo *et al.*, 2002). Their study argues that external debt begins to have a negative affect on growth when its net present value exceeds 35-40 percent of GDP and 160-170 percent of exports. The authors' simulations suggest that doubling the average stock of external debt in these countries would slow down annual per capita growth by between a half and a full percentage point. In a follow-up study in 2004, the same authors conclude that large debt stocks negatively affect growth by dampening both physical capital accumulation and total factor productivity growth (Patillo *et al.*, 2004). Along similar lines, another IMF working paper (Clements *et al.*, 2003) finds that external debt slows growth after its face value reaches a threshold level estimated to be about 50 percent of GDP (in net present value terms, 20–25 percent of GDP) and that external debt also affects growth through its effect on public investment.

Although conceptually appealing, there are strong and contrasting views on whether the debt overhang argument is applicable to the HIPC countries. The middle-income countries' debt crisis in the 1980s was thought to demonstrate that an excessive debt stock could create disincentives for investment, for undertaking or sustaining politically costly reforms, and for achieving growth and poverty reduction. But the situation of the middle-income countries was quite different from that of the HIPCs. For example, the former group dealt with problems in servicing their commercial debt, while HIPC countries deal with a debt problem that is largely one of bilateral and multilateral debt. Furthermore, the current HIPCs are not only characterized by high debt but also by poor economic performance, poor policies, weak government and institutions, slow reforms, deficient infrastructures, and limited administrative and managerial capacity (OED, 2003). The economic evidence of the negative

impact of a high debt stock, particularly of the debt overhang effect, on investment and growth is suggestive and shows in general a negative correlation between high debt stocks and growth. Still, there has not emerged a clear consensus on whether the accumulation of debt is caused by the slow growth, a result of low savings and investment and a weak policy environment, or if it is debt that is really discouraging investment and good policies and hence deterring growth (see Claessens *et al.*, 1997; Dijkstra and Hermes, 2001; Easterly, 2001 and Patillo *et. al* 2002 for different perspectives and empirical evidence).

Birdsall, Claessens and Diwan (2004) question the relevance of the debt overhang theory for the HIPC's, as net transfers to most of them are positive (averaging 12 per cent of GDP in Africa) and consequently there is no fear of a 'debt tax' – unlike Latin America in the 1980s, when net transfers turned sharply negative and the debt overhang concept entered the debate. Though acknowledging this, the World Bank's Operation Evaluation Department (OED, 2003) emphasises that despite the large positive net transfers, the fiscal space of HIPC's might simply be too small to simultaneously accommodate large debt service obligations and fund the necessary infrastructure and social investment for broad-based, equitable growth and poverty reduction. This could partly reflect the inefficiency of existing aid processes such as project finance and tied procurement, but also insufficient efforts to increase budgetary revenues, inefficient management of public expenditure, or both. To effectively reduce the fiscal strain would therefore require not only debt reduction (to lower debt service obligations) but also concurrent actions on the policy front by donors and recipients alike (OED, 2003).

Berthélemy (2004) responds to Birdsall, Claessens and Diwan, arguing that as the positive transfers to the HIPC's are due to new aid flows corresponding to projects by donor agencies, thus what counts is not the total aggregate resources that a country receives but the amount of resources that the government can discretionarily allocate. The central issue to Berthélemy is whether projects financed by the donors are truly

owned by the debtor government, i.e. whether this government would have decided on such expenditures in the absence of aid flow². Recent debates on the necessity to improve the ownership of reforms and development policies by governments in developing countries suggest that project aid does not always add resources to the budget that a debtor government can discretionarily allocate. This implies that, notwithstanding project aid flows which have reversed net transfers in favour of HIPCs, their debt service obligation may have actually created a taxation effect as assumed above (Berthélemy, 2004). Moreover, these positive net transfers have been maintained through a complex and inefficient restructuring and negotiation process. This uncertainty surrounding the process and the general inefficiency associated with high debt stocks can have a negative influence on both level of investment and the effective use of existing capacity³.

Other effects of debt on economic performance

Debt overhang is not the only avenue through which heavy debt burden is thought to affect economic performance. A strong case has been made for the *crowding out* effect, a link between growth and debt burden mediated through the fiscal account. High debt service payments crowd out high-priority public expenditures, so the smaller the debt service more resources are available to finance investment without reducing public investment expenditure. Reduced public investment can ultimately lead to lower growth rates through a reduction of:

2. See Cohen (2000), who also finds evidence for the debt overhang effect in HIPCs.
3. The literature on investment under uncertainty stresses that in highly uncertain environments, even if fundamentals are improving, investors continue to exercise their option of waiting, see Patillo *et al.* (2002).

- total investment (since public investment in LICs is often a significant proportion of gross domestic investment),
- private investment (as some private investment is complementary to public investment),
- investment productivity because of lost externalities for certain types of public investment, e.g. physical infrastructure⁴.

Heavy debt burden may also reduce growth output through its effect on human capital development, crowding out social investment spending leading to reduced investment in human capital and, ultimately, to a slower rate of increase in physical capital and growth (Serieux and Samy, 2001). Debt burden can, furthermore, affect growth through the external account, or the *import compression* effect (Serieux and Samy, 2001). For countries with non-traded currencies, as is the case for most LICs, external debt-service payments require the purchase of foreign currency that must be earned from exports or capital inflows, or from drawing down reserves. The increased demand for limited foreign currency causes a direct fall in output by reducing imported inputs or indirectly by reducing imported capital goods and, therefore investment. Furthermore, most low-income economies are creditrationed, that is, they do not access international capital markets and face significant human capital constraints (Claessens *et al.*, 1997). These two features most likely make the effect of a heavy foreign debt burden on these countries significantly different from its effect on other, less constrained, economies (Serieux and Samy, 2001).

4. The crowding out theory does not support the strategy of debt reduction over ongoing rescheduling combined with new resources in the same clear way as the debt overhang theory does, as an identical increase in investment could be obtained by giving the country a new loan instead of reducing current debt service, since a new loan would be just as effective at “crowding in” investment.

There are, thus, various ways that debt relief can be useful to raise growth. To summarize, there are three main channels. First, by reducing the debt overhang effect on private investment and economic policies. Second, by reductions in debt service payments, which, in turn, makes additional resources available for growth-enhancing (and poverty-reducing) public investment. Finally, investment and growth might be spurred by reducing uncertainty regarding debt payments and aid flows, where such uncertainty has disruptive macroeconomic effects.

Aid efficiency debates with reference to the HIPC initiative: a review

The design of the HIPC initiative takes stock of previous developments in debt relief and growth literature, acknowledging that unsustainable debt and debt service are counter-productive. It aspires to embody the emerging empirical aid studies and lessons of experience on the link between aid effectiveness and policy environment, conditionality and ownership, social impact of macroeconomic policy and public expenditure reforms, and aid coordination (OED, 2003).

The debate on the importance of the quality of policies for aid effectiveness

One of the significant conclusions of the aid-effectiveness literature has been that aid is more effective when the recipient country's policy and institutional environment satisfies some minimal criteria, and aid should thus be allocated selectively on the basis of the quality (however defined) of prospective recipients' economic and social policies (World Bank, 1998). In terms of the pure economic debt theories mentioned above, one may, however, question if poor policy performance is a cause or a consequence of external debt. The debt overhang theory and the more general concerns of debt distorting incentives of the borrowing countries to reform imply that

poor policy performance could be an outcome caused by external debt, at least in some of the HIPC countries, especially in the short run, as governments have much less incentive to absorb reform costs if they primarily produce income for foreign creditors. Hansen (2001) suggests that through a joint analysis of aid and debt, one might consider external debt, rather than poor policy performance, to have a negative influence on the impact of foreign aid on growth.

In the initial debt overhang literature, it was assumed that the government's objective was to maximize the nation's welfare. Within this framework, only the debt overhang disincentives can prevent implementation of the right economic policies. If the government, however, has different objectives (e.g., protecting vested interests), the policies it implements might be the wrong ones, whatever its debt obligations. This suggests that the impact of HIPC debt relief programmes cannot be assessed independently of the quality of economic governance in the debtor countries (Birdsall, Claessens and Diwan, 2004).

Origins of debt and HIPC debt relief: with a special reference to the experience of Sub-Saharan Africa

Following a decade of good growth in the 1960s, after independence for a large number of African states, the economic shocks of the early 1970s combined with serious economic, social, and structural constraints to rapid and broad-based growth, resulted in a long and persistent economic decline that lasted until the early 1990s (OED, 2003). Between 1980 and 1990, the low-income countries' total stock of external debt grew rapidly from US\$125 billion in 1980 to US\$419 billion in 1990. In contrast, gross national product increased only from US\$0.9 trillion to US\$1.3 trillion in the same period. In other words, the debt-to-GNP ratio increased from less than 14% in 1980 to over 31% in 1990 (Gunter, 2002). This growth of foreign debt in the 1970s and 1980s can be traced to diverse and interrelated causes, a combination of internal and external factors. These factors include, but are not limited to:

- Exogenous factors, such as adverse terms of trade shocks;
- The absence of sustained adjustment policies, particularly when facing exogenous shocks, which gave rise to sizable financing needs and failed to strengthen the capacity to service debt; including inadequate progress in most cases with structural reform that would promote sustainable growth of output and exports;
- The lending and refinancing policies of creditors, particularly lending on commercial terms with short repayment periods by many creditors in the late 1970s and early 1980s and non-concessional, mostly multilateral rescheduling terms for most of the 1980s;
- Lack of careful management of the currency composition of debt;
- The lack of prudent debt management by debtor countries, driven in part by excessive optimism on the part of creditors and debtors about the prospects for increasing export earnings and thereby building debt-servicing capacity and;
- Political factors, such as civil war and conflict (Brooks *et al.*, 1998).

Mechanisms for restructuring or rescheduling debt have been around for a long time: the most important is the Paris Club which, since the mid-1950s, has been a framework for rescheduling sovereign debt, mainly with Organisation for Economic Co-operation and Development (OECD) creditor governments. From the late 1980s onwards, Paris Club creditors granted relief on bilateral official debts on increasingly generous terms as it became clear that the mounting debt burdens of poor countries reflected a deep solvency problem that required not only a temporary reduction in debt service, but also a reduction in the level of debt. In late 1988 the Paris club members began to grant such debt reduction in the form of concessional flow rescheduling for low-income countries under the so-called “Toronto terms”, which involved a debt reduction of about one-third of the eligible amounts. The level of debt forgiveness was then raised in two steps: London terms in late 1991 (50 per cent debt reduction), and Naples terms (two-thirds debt reduction) at the end of 1994. Some bilateral donors gave additional, separate, relief by retrospectively converting loans

into grants. The grant element of new flows under bilateral aid programmes also increased. As a result, the payment profiles on restructured debt became increasingly longer and lower. Paris Club rescheduling was complemented by initiatives to forgive bilateral Official Development Aid (ODA) claims. Donor governments also gave some debt reduction through debt swaps, and began to provide more and more of bilateral development assistance in the form of grants (Abrego and Ross, 2001)⁵.

Nevertheless, these mechanisms proved inadequate to the task, especially in the context of the continuing poor economic performance of the indebted countries and the widespread view that the adjustment programmes of the 1980s (which contributed to the build-up of multilateral debt as concessional loans were given to support adjustment) had, at best, delivered only modest gains in growth and poverty reduction. These mechanisms reduced bilateral and commercial debt, but not multilateral debt, and the debt burdens of many low-income countries continued to grow, particularly in sub-Saharan Africa (OED, 2003). The continuing support of multilateral institutions to the policy adjustment efforts of low income countries through, mostly concessional, loans was reflected in an increasing share of multilateral debt in the total debt of low-income countries. Thus, approaches that had proven successful in resolving the earlier commercial debt crises of the 1980s, in particular the Brady Plan, were by and large not applicable to HIPC countries because their debt composition being overwhelmingly multilateral. To mitigate this, a number of bilateral creditors provided grants to help some countries to service their multilateral debts, e.g.

5. Bilateral creditors not participating in the Paris Club – mainly oil exporters in the Middle East, but also China, Taiwan and a number of development countries, including some of the HIPC countries, provided more limited debt restructurings than other creditors, but in turn often saw their claims increasingly falling into arrears.

Uganda (Abrego and Ross, 2001). This led some bilateral donors to question why they were effectively compensating multilateral donors for bad lending decisions, thereby facilitating a transfer of the lending risk from the multilateral agencies to their bilateral cousins (Addison *et al.*, 2004).

The unsatisfactory situation led to increasing calls, by debtor countries themselves as well as the NGO community, for more thorough action. The growing influence of civil society, with NGO networks at its core, transformed the international debt regime through political reach into the higher levels of international governance, especially with the G-7 governments and the Development and Interim Committees of the Bretton Woods Institutions (OED, 2003). Eventually the IMF and the World Bank launched the Highly Indebted Poor Countries initiative in September 1996. The initiative aimed to reduce debt servicing to a sustainable level, defined in terms of targets for the ratios of debt to export earnings and public revenues and marked a distinct break with the traditional debt relief mechanisms being the first comprehensive attempt to deal with the debt crisis and involving multilateral debt, which became eligible for relief for the first time (Gunter, 2002)⁶. The original HIPC (HIPC I) framework had a straightforward focus on the key issue that the initiative was created to address: to reduce the debt stock of publicly guaranteed disbursed and outstanding debt. The strategic rationales were that it would remove the disincentive effects on private investment of the debt overhang and allow progress toward the underlying development goal of economic growth and poverty reduction (OED, 2003). At the same time, the “savings” from reduced debt, to the extent that they were actually

6. Given that less than 4% of HIPC's total external debt was private non-guaranteed (PNG) debt, the architects of the HIPC framework decided to exclude this debt (Gunter, 2002).

realized⁷, would generate the much-needed fiscal space in the HIPC governments' budget to pursue economic growth. To qualify for the HIPC I debt relief framework, a country would have to be an "IDA-only" country⁸, face an unsustainable debt situation after the full application of current debt relief mechanisms, and demonstrate an appropriate track record of adjustment and reform through IMF- and World Bank-supported programs. On the basis of these criteria, forty-one countries were eligible for debt relief⁹.

Three years after launching the HIPC initiative, it was clear that the original HIPC framework was not sufficient to provide the HIPCs with a permanent exit from repeated debt rescheduling, and partly due to strong public pressure and the NGO community led by Jubilee 2000, the IMF and World Bank formally agreed in September 1999 to enhance the framework. In a nutshell, the original scheme was thought to offer too little to too few and too late (Dagdeviren and Weeks, 2001; OED, 2003). The

7. Debt principal relief does not necessarily imply debt service relief. Although a reduction in the debt stock should translate roughly into a proportional cut in the service payments, it is not so for the HIPCs. Much of the debt service is not being paid anyway, so there is a point up to which debt forgiveness will not reduce interest payments.
8. That is, they rely on financial resources from the World Bank's International Development Association (IDA). To become an "IDA-only" country, the per capita income level is required to be \$900 or lower. Originally Nigeria and Equatorial Guinea were considered to be HIPCs, but were dropped from the list of HIPCs as they were later considered to be no longer IDA-only countries. Likewise, other countries have been added to the list once they satisfied that requirement. For the current list of HIPCs and a more detailed description of the HIPC initiative, see the World Bank's HIPC website: www.worldbank.org/hipc.
9. Overall 33 African, 4 Latin American and 4 Asian countries. See: worldbank.org/hipc.

fundamental causes were thought to be the criteria for debt sustainability and the conditionality accompanying the debt relief. High debt sustainability thresholds were denounced for limiting the size of debt relief, as well as restricting the number of countries that might qualify. The prolonged negotiations among multilateral and bilateral donors, the efforts to create an integrated debt-reduction mechanism and the emphasis on policy conditionality were thought to severely delay delivery of debt relief (Killick, 2004). The initiative was thought to lack resources to fulfil its promises, and harshly criticised for missing an explicit linkage with human development and poverty reduction (Dagdeviren and Weeks, 2001). The key slogan of the initiative had been *sustainable development requires sustainable debt*, and thus the creation of mechanisms to direct resources released by debt relief into social expenditure, especially poverty reduction, was seen as vital for the effectiveness of debt relief (Gunter, 2002).

The enhancement certainly came as a result of strong public pressure, but the apparent slow pace of debt relief¹⁰ and the high administrative burden associated with implementing the initiative also contributed to the enhancement (OED, 2003). Debt relief is an eminently campaignable issue (as various NGO initiatives, the Jubilee 2000 campaign, Live8, etc., have shown). Yet like with other highly campaignable and popular movements there is a danger that an oversimplified solution is advocated and then adopted, possibly in a way that does not respond to the real problems of the economies in difficulties (Ranis and Steward, 2001). This is relevant to the design of the initiative, as the PRSP emphasis on social expenditure was, by some means, the result of powerful NGO campaigning.

10. From 1996 to 1999 only seven countries became eligible for debt relief and although eligibility criteria was handled with some flexibility, only four countries reached the Completion Point under the HIPC I: Uganda and Bolivia in 1998; and Guyana and Mozambique in 1999.

2. The Enhanced Initiative and its Poverty Reduction Link: a review

The enhancement of the initiative was an attempt to improve the original framework's defects. While the original goal of promoting growth by removing the debt overhang was retained, the transformation from the original framework to the enhanced one took place in two dimensions: a shift in focus of the original objective related to debt service; and the addition of an explicit twin objective, linking debt relief to policies for poverty reduction with participatory PRSPs. To be eligible for the enhanced HIPC (HIPC II) debt relief, a country has to comply with a set of conditions. Two generic requirements are (a) staying on track with the IMF's Poverty Reduction Growth Facility macroeconomic stabilization and reform program as before, and (b) the development and implementation (for at least one year) of a participatory PRSP. In addition, the World Bank, the IMF and the bilateral donors, with the government, identify key structural and social development actions or reforms that would promote progress toward sustainable development. Beyond the two generic requirements, the design allows for the triggers to be tailored, suiting the particular circumstances of a country, and expects them to be designed in full consultation with its government (OED, 2003).

While some of the major criticism of the HIPC I was on its excessive reliance on the conditionality aspect of the initiative, supported by some of the arguments of the aid efficiency-conditionality debate, the enhancement initiative pursued high conditionality, found in the moral hazard and good governance literature. The enhanced initiative clearly states that the public resources released thanks to the HIPC Initiative are to be used to reduce poverty, and it requires debtor countries to elaborate a participatory poverty reduction strategy after an extensive process of domestic consultation and participation. The participatory part is important, as it is the initiative's attempt to develop a strong ownership of the program (OED, 2003), responding to an important defect of conditionality. Linking the enhanced HIPC initiative to the making of a PRSP is seen by many as an important

step forward; what began as a limited debt reduction scheme increasingly took on the role of a poverty-reduction programme, placing debt relief within an overall framework of poverty reduction (Dagdeviren and Weeks, 2001). However this linkage possibly involves some problems. A strong argument, based on experience of the initiative, is that the PRSP requirement either delays enhanced HIPC assistance or leads to a lower level/quality of country ownership and civil society participation (Gunter, 2002).

The Enhanced HIPC initiative: novelties and comparison to the original framework

Alongside the new emphasis on poverty reduction with the Poverty Reduction Strategy Papers, HIPC II aimed to provide deeper, broader and faster debt relief. Deeper, by lowering the ratios considered to provide debt sustainability (together with a lowering of the minimum threshold to qualify for the openness/fiscal criteria). Moreover, the sustainability analysis on reaching the decision point would no longer be based on a projection of exports and government income for the coming three years, but on an average of actual data for the preceding three years. Faster, by the provision of interim relief from some creditors between the decision point and the completion point (see Table 1 and Flowchart 1). Furthermore the concept of a floating completion point (reached by the successful provision of so-called “triggers for the floating completion point”) would replace the, in principle, fixed three-year period between decision and completion point. Finally, HIPC II aimed to be a broader initiative than its predecessor, by allowing more debtor countries to be considered for the initiative’s facilities (Gunter, 2004). This results automatically from the reduction of access thresholds.

Like the original HIPC framework, HIPC II involves two stages. The first stage is a three-year period during which the HIPC works in coordination with the support of the World Bank and the IMF to establish a record of good economic policies. At the end of this three-year period, the IMF and

the World Bank determine whether a country's debt level is sustainable. For those countries whose debt burden remains unsustainable after full use of traditional debt relief mechanisms, a package of debt relief is identified. This is known as the enhance Decision Point (eDP), at which some creditors may start with the provisioning of HIPC debt relief. The decision to provide HIPC debt relief is irrevocably taken once the conditions identified at the eDP are satisfied, which is then known as the enhanced Completion Point. The amount of debt relief is determined in Net Present Value (NPV) terms, and the NPV debt-to-export ratio should be 150 percent at the eD.¹¹ To reach the eDP countries draw up a PRSP in which stakeholders are meant to participate. After the Decision Point, HIPCs would then have immediate access to debt relief by multilateral institutions (interim relief), which should be used for implementing the PRSP. The duration of the period between Decision Point and Completion Point would be flexible, as the latter is no longer fixed in advance but floats: the country must at least implement a number of tangible reforms and start to implement a PRSP, to be certified by a Progress Report. On reaching the Completion Point, the interim relief would be continued but would now be fixed for the next 15 to 20 years, and bilateral creditors would forgive the greater part of their debt stocks. In short, HIPC I conditionality was restricted to evaluating (ex post) the track record of past performance, while HIPC II set conditions in advance (ex ante) again. Moreover, HIPC II signified that demands were set on the use of debt relief. Table 1 compares the original initiative with the enhanced one, and Flowchart 1 describes the process of the HIPC II initiative.

11. The actual ratio of the years following the eDP may be quite different. For example, it was expected at Rwanda's enhanced decision point that the NPV debt-to-export ratio at end-2003 would be 193 percent. However, based on the analysis at the Completion Point in April 2004, it turned out to be 326 percent (Hussain and Gunter, 2005).

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

EITHER

EXIT

(Country is not eligible for HIPC)

OR

DECISION POINT

(World Bank and IMF boards determine eligibility)

All creditors (multilateral, bilateral, 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 the latest available data at the decision point.

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

"FLOATING" COMPLETION POINT

* Paris Club goes beyond the Naples terms to provide more concessional debt reduction of up to 90 percent in NPV terms (and, if needed, higher) on eligible debt so as to achieve an exit from unsustainable debt.

Table 1. The Original and Enhanced HIPC frameworks in a nutshell

ELEMENT	ORIGINAL
Stated objectives	To bring the country's debt down to sustainable levels, subject to satisfactory policy performance. New measures will be built, as much as possible, on existing mechanisms. The initiative was seen as one element of an overall strategy to achieve debt sustainability for the HIPCs
Qualification criteria	(i) IDA-only country, (ii) Unsustainable level of debt after full use of traditional mechanisms, (iii) Strong record of policy performance. 41 countries eligible, 29 expected to qualify
Debt sustainability	<i>Guiding principle:</i> Target overall debt sustainability to provide a durable exit strategy from the rescheduling process.
Indicators: Targets	Target range for main indicator: NPV debt-to-exports: 200-250% NPV debt-to-revenues: 280% with export/GDP: e40%; revenue/GDP: e20%. Debt service-to-export: 20-25%
Calculation of relief	Fixed at completion point, based on projections of debt indicator for completion point.
Time of relief delivery	Completion point, irrevocable commitment.
Forward-looking assessments	Debt sustainability analysis to project profile of key debt indicators.
Performance criteria	<i>Guiding principle:</i> Action only after the debtor has shown, through its track record, the ability to put to good use whatever relief is provided.
For decision point	3-year track record of macroeconomic stability and policy reform.
For completion point	Further 3-year track record of macroeconomic stability and policy reform.
Interim period	3 years
Creditor participation	<i>Guiding principle:</i> Comprehensive debt relief action: coordinated among all creditors involved with broad and equitable participation. New external finance to be on appropriately concessional terms.
Other guiding principles and principles of change	(i) Actions by the multilateral creditors will preserve their financial integrity and preferred creditor status, (ii) new external finance for the countries concerned will be on appropriately concessional terms.

Author's compilation from OED (2003) and www.worldbank.com/hipc

ENHANCED

Maintains original focus to remove debt overhang and provide a permanent exit from rescheduling. Puts a stronger emphasis on freeing up resources for higher social spending aimed at poverty reduction to the extent that cash debt-service payments are reduced. Debt relief should reinforce wider tools of the international community to promote sustainable development and poverty reduction.

Same. Applied retroactively to include countries already past decision or completion points under the original framework. 41 eligible countries, of which 38 expected to qualify.

Principle for change: Provide a clear exit from unsustainable debt burden to remove debt overhang and provide an appropriate cushion against exogenous shocks.

Uniform application of single target:

NPV debt-to-exports: 150%

NPV debt-to-revenues: 250% with export/GDP: e30%; revenue/GDP: e15%.

Debt service-to-export: 10-15%

Fixed at decision point, using actual data on NPV debt for year prior to decision point and 3-year average for exports.

Decision point: on an annual basis, interim relief is bulk of anticipated post-completion point relief, it is irrevocable.

Same

Principle for change: To strengthen the incentives for debtor countries to adopt strong programs of adjustment and reform.

Same plus interim of full PRSP.

Maintenance of macroeconomic stability, completion of PRSP plus one-year PRSP implementation. Performance benchmarks for structural and social reforms.

Flexible, with the introduction of floating completion point.

Principle for change: Same plus debt relief should be additional to reinforce the wider tools of the international community to promote sustainable development and poverty reduction.

(i) Accompanied by proposals for financing the cost to multilateral institutions, (ii) debt relief should focus on the poorest member countries, (iii) provided in a simplified framework

The Enhanced HIPC Initiative's poverty reduction link

The announcement of the PRSP by the World Bank and the IMF reflects the institutions' willingness to put poverty reduction at the center of their work in low income countries. The HIPCs would be the first countries in which PRSP would be adopted, but the strategy would in the end be a key to World Bank and IMF concessional lending facilities, i.e. IDA and the Poverty Reduction Growth Facility (OED, 2003). With the explicit poverty reduction link, the HIPC initiative acknowledges that though economic growth is the basis for increasing national income, it does not necessarily result in better distribution or poverty reduction (Klasen, 2004).

The debate on Pro-Poor Growth: a review

Surrounding the initiative's poverty-reduction effect is a quite controversial debate. Although relief itself will not affect poverty, if allocated to pro-poor expenditures, the funds associated with debt relief should reduce poverty. Pro-poor growth has been broadly defined as growth that leads to significant reductions in poverty (United Nations, 2000) and it considers both average income growth and changes in income inequality. Ideally, pro-poor growth combines high growth of average income with inequality reduction (income, asset, and gender inequality) in order to have a maximum impact on poverty¹². While

12. Empirical evidence suggests that growth is the primary driver of the rate of pro-poor growth, but changes in inequality can either enhance or reduce the pro-poor growth rate. So, accelerating the rate of pro-poor growth will require not only faster growth but also efforts to enhance the capabilities of poor households to take advantage of the opportunities growth generates. With its focus on accelerating the rate of poverty reduction, this definition is consistent with the international community's commitment to the first MDG of reducing the proportion of people living on less than a \$1 a day by half between 1990 and 2015 (Klasen, 2004).

everyone would agree that this case is the first-best-option, there is some debate as to whether (or to what extent) growth is still “pro poor” when it is only accompanied by one of the two conditions, high growth or inequality reduction (Klasen, 2004). Pro-poor growth thus aims at combining growth and social policies to achieve poverty reduction, as policies that merely concentrate on growth may only be looking at part of the development problem.

Pro-poor policies aim to promote the necessary conditions for pro-poor growth (macroeconomic stability, competitiveness, and an enabling institutional framework that will attract private investment and generate employment) and may benefit the poor directly or indirectly (Robb and Scott, 2001; Klasen, 2004). Growth that favours the sectors and regions where the poor are (or are likely to move to) and uses the factors of production that the poor possess (or are able to acquire) is a pattern of growth that would immediately raise the incomes of the poor (Klasen, 2004). While this being probably the most sustainable way of ensuring the poor benefit disproportionately from economic growth, it carries the risk that they will also suffer (possibly disproportionately) from economic contractions and high volatility (Klasen, 2004). A more indirect avenue, however, operates through public redistributive policies (especially via taxes, transfers, and other government spending). High growth could in principle be made pro-poor if it involved progressive taxation, targeted government spending on the poor and if it created jobs for the poor (Kappel *et al.*, 2005). The government spending on the poor could either try to promote their inclusion in economic growth and thus improve the direct linkage between growth and poverty reduction, or provide transfer payments to the poor through a basic safety net that could become even more generous with the increase in economic growth (Klasen, 2004).

Since the poor are not spread evenly throughout the economy, the distribution of growth is a critical ingredient to poverty reduction/pro-poor growth. It is useful to differentiate between general politics,

sectoral/cross-sectoral ones, and targeted policies. General policies are those with economy-wide effects, and are designed to influence the general economic and institutional environment in order to promote growth from which the poor will benefit (e.g., macroeconomic policies and structural reforms). Sectoral and cross-sectoral policies are more specific in focus, and benefit both the poor and the non-poor (e.g. universal access to primary education). Targeted policies refer to specific targeted programs, such as social safety nets (Robb and Scott, 2001). Sectoral or cross-sectoral programs (e.g. HIV/AIDS) may be oriented to the general population, including the poor. Such programs are not confined to the social sectors (health and education) but also include, for example, rural development, land reform, small enterprise development and judicial reform.

HIPC's Poverty Reduction Strategy Paper: some considerations

Support for a deeper pro-poor emphasis and a more holistic and participatory approach to development was emerging in its own right at the time of the HIPC review in 1999 (OED, 2003). The PRSP embodied such an approach and incorporated lessons from experience from past development efforts, emphasizing the need for ownership and participation.

The general evolution of PRSP is difficult, as there are great variations in the policies chosen to achieve the goals of growth and poverty reduction among countries. But in general, and related to the above discussion, the PRSPs involve 2 sets of policies: (i) directly related to poverty reduction and (ii) covering the macro and meso policy levels (OED, 2003). The macroeconomic framework repeats many standard policies found in stabilisation and structural adjustment programs. Commitment to low inflation and fiscal deficit reduction as well as the familiar “reforms” of privatisation, trade liberalisation, capital liberalism, and public sector

“restructuring” are common to almost all PRSPs (in some, target rates are set for each of these components)¹³.

The policies directly linked to poverty reduction are of 3 types. First of all, those policies fostering rural development, as the vast majority of the poor are in rural areas, a majority depend directly or indirectly on agriculture for their livelihood, and the factor of production the poor possess and pursue most is labour, sometimes land, and even more rarely human capital (Klasen, 2004). Rural development policies are expected to have direct or indirect effects on agricultural productivity that would foster economic growth and poverty reducing efforts. In second place, so-called institutional capacity building and public expenditure policies (reforms that allegedly increase efficiency and improve management of public spending and debt, transparency and fiscal accountability, and reduce corruption). Last, but not least, all PRSPs define social spending as poverty reducing, that is, expenditure on: health, education and infrastructure (access to clean water, sanitation facilities, rural access roads, etc.). So-called prioritising is always emphasized. As mentioned above, policies that promote economic growth are generally good for the poor on aggregate, and desirable for that reason (Morrissey, 2004). Specific groups, however, will suffer; these are likely to be the relatively poor, implying a need for additional, compensatory policies targeted at those groups. Broadly liberal economic policy reforms and poverty reduction objectives can thus go together (Morrissey, 2004). The PRSPs thus are meant to include pro-poor complementary policies and compensatory expenditures.

13. Some countries have identified specific sectors such as agriculture and tourism as drivers of growth and have expressed an intention to focus on these sectors to achieve their targets. Goals like increasing investment and public savings are also encountered among other growth promoting channels

A clear-cut merit of the PRSPs is that they force governments to think in a structured manner about the impacts of economic policies on the poor, and to identify policy areas requiring actions that are pro-poor (OED, 2003). There are, however, some problems in linking HIPC debt relief to poverty reduction strategies. In analytical terms, the poverty reduction conditionality is not much different from a condition on good economic policy-making, and the same critique goes for one type of conditionality as the other.

The debate on the Poverty Reduction Strategy Papers and ownership

“Development cannot be imposed. It can only be facilitated. It requires ownership, participation and empowerment, not harangues and dictates.”

Mkapa, President of Tanzania

With the incorporation of the PRSPs, the HIPC initiative acknowledges the literature of country ownership, discussed above, as it is explicitly stated that the PRSP process should include consultation with civil society and other interested parties. The intention of the broad-based participation requirement is to ensure a large degree of ownership; in other words, that the people consider the strategy to be ‘theirs’ (Morrissey, 2004). By putting the government in the driver’s seat and including conditionality that called for the participation of a wide cross-section of stakeholders, the PRSPs aimed to improve ownership, transparency, accountability and focus on results (OED, 2003). The initiative envisages the conditionality to emerge from the PRSP process, with broad participation from civil society in defining and supporting the adjustment program for attaining macroeconomic stability and a sound policy framework. HIPC programmes may thus, particularly through the preparation of PRSPs, have a positive institutional development impact.

In several countries, the PRSP has created the first opportunity for dialogue between the government and citizens on development objectives (Gunter, 2002). They may also facilitate time-consistent efforts towards development objectives, insofar as they represent irreversible long-term aid commitments, and stronger ownership of the development policies by debtor governments. They also play a useful role in capacity building. In some cases, the budgetary procedures set up to allocate debt service relief proceeds have a positive influence on a government's fiscal rules and procedures. Another example of capacity-building content of the HIPC programmes is that preparing the PRSP has, in many instances, led to new incentives to launch poverty surveys, which had been overlooked for a long time (Berthélemy, 2004). To sum up, the HIPC initiative is not simply a comprehensive debt relief programme, it also creates new development policy commitments and, occasionally, new budgetary rules for beneficiary governments. The HIPC initiative in combination with the PRSPs embraces the idea of higher degree of ownership, programmatic aid and donor coordination (World Bank, 2001).

Ownership and participation can, however, only be of limited significance if the strategy requires the International Finance Institutions' (IFI) approval (Killick, 2004). The IMF and the World Bank must endorse and assess the PRSP and then agree with the government on a policy reform and macroeconomic management programme to be followed during the HIPC period. Consequently, there will be some degree of cross-conditionality. While commendable *prima facie*, involving affected parties in the design of poverty-reduction strategies is a highly demanding condition. The poorest countries, almost by definition countries with weak policy making and implementation capacity, are being required to design and implement a sophisticated programme of linked policies. This is likely to stretch political capacity and may undermine commitment. On the one hand there is no clear consensus on what actually constitutes a 'pro-poor growth strategy' while the impact of economic policies on poverty is not well understood. On the other hand, 'consultation with civil society' is a

politically sensitive topic (Morrissey, 2004). The dominance of multilateral institutions is criticised for limiting the influence that the participatory meetings might have had and also the degree of ownership. The weak capacity of many countries to carry out complex consultations and strategy formulations might result in either a delay in the delivery of HIPC relief or provide an incentive for countries to rush the PRSP to secure the debt relief.

The HIPC II linkage has thus been criticised for seriously degrading quality by inducing governments to rush the PRSP process in order to secure the irrevocable relief that is granted on reaching the completion point. Some critiques even go so far as to state that there is an unacceptable tension between the urgent need for debt relief and the time required to build a genuinely participatory PRSP process (US GAO, 2000)¹⁴. To ease this divergence between debt relief urgency and ownership of PRSP, an interim PRSP (I-PRSP), essentially a statement of intent and a roadmap to carry out a full PRSP, was determined to be a compromise criterion for decision point qualification. To reach the completion point, a full PRSP, with satisfactory implementation for one full year, was retained as a requirement for the completion point.

In theory, the HIPC II substitutes untied programme aid for tied donor projects, and this, too, should have beneficial effects on both transaction costs and local ownership, and in its greater concern for the social content of agreed upon policy programmes (OED, 2003). However, it is by no means clear that the move into PRSPs has actually marked a retreat from World Bank and IMF defined policy conditions. HIPC governments now have to concern themselves with further conditionality arising from the

14. As with so many aspects of the HIPC initiative debate and in general the aid efficiency debates there are divided opinions on the subject. Some authors argue that PRSPs do not go far enough in incorporating an analysis of the ethnic, religious, and social tensions confronting the lives of most Africans (Gunter, 2002).

World Bank's Country Assistance Strategy Papers, as well as that specific to the HIPC Completion-Point arrangements. A question that remains to be answered is whether this PRSP process strengthens or threatens governance in countries where political participation is a relatively new phenomenon.

The debate on Poverty Reduction Strategy Papers and conditionality

The initial debt overhang literature assumed that the government objective was to maximise the nation's welfare. The HIPC initiative departs from the assertion that not all debtor governments are initially committed to good economic governance. If for this reason only, the architects of the HIPC initiative argue that pure debt relief is far from being the panacea for the countries concerned. Therefore the framework combines debt relief with conditionality on poverty reduction policies. The modifications to the track record requirements in the HIPC II are consistent with a key lesson from the Middle Income Countries' debt crisis in the 1980s: the need to focus on countries with convincing policy track records, but once that is accomplished, the process should not delay the delivery of debt relief (Cline, 1997).

The HIPC initiative has been criticised heavily for the excessive conditionality link, and the central aim of campaigns such as the Jubilee 2000 was one-off cancellation of debts¹⁵. Campaigners in favour of the cancellation have argued that donors use conditionality to avoid granting the promised relief. If the conditions for macroeconomic stability and policy reform are demanding, it will be difficult for debtor countries to qualify for relief. Gunter (2002), however, states that it is crucial to integrate debt relief into a global poverty reduction strategy and not to suggest an unconditional

15. See www.jubilee2000.uk.org

write-off of all HIPC debt. An unconditional write-off will neither foster growth nor help the poor, since no country will achieve sustainable growth without internal and external peace, progress towards which can only be made by improved governance, covering a broad range of policies that aim at enhancement of the rule of law, the establishment of property rights, less corruption, and improvement in the overall legal system, and an uncorrupted public leadership. In cases where a country is serious about reducing poverty but has not reached the completion point triggers because of exogenous factors (such as a flood), reaching the enhanced completion point should not be based on checking off completion-point triggers (Gunter, 2002). Here we have entered again into the classical aid conditionality debate, where the good policy and moral hazard arguments are up against the failure of conditionality efficiency ones.

An inherent dilemma within the current HIPC arrangements is that conditions on pro-growth reforms determine eligibility for the initiative, whereas the specific pro-poor policies and expenditures only come into effect once the PRSP is accepted and resources are released (Killick, 2004). Pro-poor policies under the PRSP in HIPC II are not part of the eligibility criteria, and thus have implicitly been subject to softer conditionality based on performance indicators rather than the implementation record. Pro-poor expenditures are in a sense an add-on, being activities that support implementation of pro-poor policies, as the pro-poor element does not really come into effect until after compliance with liberal economic reforms. This delays the implementation of pro-poor policies that do not require comprehensive economic policy reform and the disbursement of pro-poor expenditures in general (Morrissey, 2004). Although the PRSP allows the debtors to set the performance indicators for the PRSP (pro-poor policies and expenditures), the IFIs, in effect, set the tighter pro-growth conditions for eligibility. Thus, tighter conditions (with greater likelihood of unsatisfactory compliance) are applied to pro-growth policies than apply to pro-poor policies. By implication, countries that could implement pro-poor policies, especially expenditures, are being at least constrained, if not

prevented, from doing so by being denied eligibility (Morrissey, 2004). Reversing these implicit priorities could enhance the provision and effectiveness of debt relief.

It is important to note that these two 'roles' of conditionality may conflict. Typically, the extent of reform the donor wants to encourage will be broader and deeper than the degree of reform required to maintain aid flows. In other words, the level of reform required to continue receiving aid is less than the level of reform required to be eligible for debt relief. This conflict lies at the heart of the problem of the ineffectiveness of conditionality, as it gives rise to a signalling problem. Recipients want to signal a commitment to reform in order to be eligible for debt relief. Whatever the level of genuine reform they wish to implement, recipients will only see a need to meet the minimum requirements. If the compliance conditions are set too high, even recipients that are genuinely trying to reform may be denied relief (as mentioned before, there are many reasons other than intentional behaviour to explain failures in implementing reforms). Alternatively, if the conditions are set too low, insufficient reform is encouraged. Donors do not know how much reform a recipient really wants to implement and therefore may set the conditions at the wrong level. A general resolution to this problem is to allow the recipients to set the target level of reform, and donors can decide whether this is acceptable. This is implicit in the spirit of HIPC selection criteria, but it is not so evident in the application (Morrissey, 2004). To facilitate future fiscal and debt sustainability, donors/creditors are justified in desiring pro-growth reforms; hence such reforms have been the basis for eligibility.

OIB's¹⁶ (2003) evaluation of debt relief points out another problem of the preconditions set on debt relief. As past experience has taught us,

16. Policy and Operations Evaluation Department (OIB) of the Ministry of Foreign Affairs, Netherlands.

countries will do only what they had already planned to do (Berthélemy, 2004). In addition, ownership and participation can only be limited because a PRSP's prime objective is to ensure debt relief, and plans are thus discussed principally with IFI representatives (OIB, 2003). As long as countries are heavily indebted to the multilateral institutions, the report argues, the latter will continue to provide loans for that reason alone, and bilateral donors for that reason alone (i.e. because of the high debt itself, and because of the need for those countries to repay the institutions), will continue to give large amounts of aid. Sanctions on the non-compliance with conditions (e.g. drawing-up a good PRSP) will thus not be effective. Moreover, as long as debt relief remains tied to policy conditions, it is unlikely that donors will apply greater selectivity. As countries are highly indebted, the cycle of debt relief, aid and new loans will continue. Debt relief is, in itself, so necessary and inevitable that even countries where corruption is rife, those with poor policies, and those where genuine participation does not exist, have received it or will eventually do so.

Highly indebted countries will also continue to receive more aid than others. Such adverse selection will only be reduced if debt relief is no longer tied to conditions. Donors could then start to be really selective in the allocation of new foreign aid. A preoccupying aspect is that although many heavily indebted poor countries have received sizeable debt relief, they still seem to need more. From this, two contradictory conclusions can be drawn. Some argue that the international community has done far too little in alleviating the debt burden of these poor countries. They have been given just sufficient relief to enable them to pay their primary creditors, but not enough to allow their economies to grow, let alone to reduce poverty¹⁷. Others conclude

17. See for example, Sachs (2002).

that too much relief has already been given. For example, some empirical studies show that the greatest relief has gone to countries with bad policies (Easterly, 2002) or without good governance (Neumayer, 2002), and that it has not yet been used for poverty reduction (Allen & Weinhold, 2000).

Given that the HIPC framework requires that eligible HIPCs adopt poverty reduction strategy, an implicit condition for HIPC debt relief has been that debt service savings due to the HIPC initiative were spent on pro-poor social sector spending, mostly targeting primary education and health services for the poor. This increase in social sector spending is expected to reduce poverty and to stimulate growth, at least in the long term, though critics have pointed out that a much broader development strategy is needed to reduce poverty and to stimulate growth in a more sustainable way (Hussain and Gunter, 2005). The initiative set performance benchmarks for public expenditures with an emphasis on social sectors, particularly health and education. This is evident both in the conditions attached to the use of HIPC resources and on input- and expenditure-related targets for public expenditures as completion point triggers. In principle, the beneficiary countries track overall government spending for poverty reduction. In practice, most countries focus on social expenditures, primarily in the form of health and education expenditures (Hussain and Gunter, 2005).

The implementation of a PRSP can thus be at the expense of regular and useful public expenditure, particularly if debt relief does not make additional resources available. Even apart from that, it is not certain that implementation of a PRSP will promote economic growth and help to reduce poverty. The OED (2003) HIPC evaluation report concludes that the HIPC II approach to the task of reducing poverty is particular and narrow (that is, the expansion of spending on social services to the neglect of wider growth and development priorities). For the 13 countries for which data were available when the OED made its evaluation, 65% of all resources released by HIPC II debt relief were to be devoted to social

services, with 7% on infrastructure, 4% on governance and just 1% on structural reforms. This has been associated with a sharp rise in the share of total aid in these countries devoted to the social sectors with an almost corresponding decline in the share of aid for production services (Killick, 2004). The impact of these inputs is likely to be limited by absorptive capacity constraints, as substantial aid resources are already targeted at social sectors, and the uniform application of conditions across countries – even where funding may not be the core constraint to achieving social sector outcomes (Hussain and Gunter, 2005). HIPC progress reports indicate that over half of government revenues will be earmarked for social spending in future years. The inefficient use of resources in the targeted sectors and the lack of focus on other growth-enhancing and poverty-reducing expenditures are likely to limit the achievement of the HIPC objectives.

Inadequate access to education and health is certainly a powerful influence on poverty. But poverty has many other causes as well, notably the effects of past economic stagnation or decline, inadequate access of the poor to various forms of capital, large and growing inequalities, high demographic dependency rates, gender biases, and various forms of disempowerment of state failure (White *et al.*, 2001). That is, a multitude of factors contribute to poverty, only a few of which have much to do with neglect of social spending induced by the necessity to service external debt. Thus the initiative's strong focus on social service might risk diverting attention from other fundamental causes of poverty (Killick, 2004). OED (2003) draws attention to the pervasiveness of low efficiency, poor service quality, capacity shortfalls and low utilisation within poor countries' social services. Although many of the completion point triggers do address relevant sectoral constraints, increased budgetary allocations in most cases have been superimposed on weak institutions, which is likely to limit the effective use of HIPC resources. So far, there is little evidence on outcomes or results to determine what the increased expenditures are achieving, although cross-country

evidence suggests that expenditure levels have little influence on educational outcomes, although comparable tests for health provide more mixed results (OED, 2003).

There are some exceptions to this, Uganda being one example. Surveys are being undertaken there to track access to and quality of public services, and the outcomes from Uganda show a marked improvement in service delivery, but also highlight the need for improving the efficiency of social expenditures. A similar survey for Ghana reveals substantial leakage of funds allocated to primary health and education facilities (OED, 2003)¹⁸. The IFIs have answered this criticism, stating that the PRSPs should tackle all these weaknesses as a part of the anti-poverty effort (OED, 2003. Annex K). The attention bias seems to be real though; not everything can be done at once (Killick, 2004). Emphasis is being put on raising the quantity and quality of social service provisions, and this is liable to further increase total consumption relative to savings, even though savings and investment are already too low. Most recipient and creditor countries consider the focus of the initiative to be excessive on social sectors, and too little on growth and “wealth creation” (OED, 2003. Annexes G and H). Furthermore inflexibility in the use of HIPC resources for building essential infrastructure and for economic services, even when there are known absorptive capacity constraints in the social sectors, is viewed by debtor representatives as an inefficient use of scarce resources. The conditions attached to the HIPC Initiative are viewed as inadequately attuned to the holistic development goals of the HIPC governments or to enhancing the “post-HIPC prospects” to ensure debt sustainability and poverty reduction (OED, 2003. Annex G). Thus, the HIPC initiative’s focus on poverty

18. The Ghana Public Expenditure Tracking Survey found that only two-thirds of the funds for recurrent expenditures reach their intended destinations (primary schools and primary health care clinics).

reduction is appropriate and welcome, but growth, securing entry to labour market and wealth creation warrant more attention.

Failure of the additionality principle

With the enhancement, the HIPC Initiative has acquired multiple objectives, while the instruments at its disposal have remained the same (OED, 2003). The objectives were expanded in the HIPC II to explicitly target the resources released by debt relief toward higher social expenditures aimed at poverty reduction. The achievement of this objective rests on the key assumption that the debt relief provided will be additional to other aid transfers. This is necessary to free up resources for increased poverty reducing social spending. The design of the initiative, however, has no means to ensure that this will in fact happen. Debt forgiveness by itself does not guarantee additionality (Gunter, 2002). Without additional resources, it is unclear how the fiscal space is to be created and, in the absence of additionality, what the implied tradeoffs are among priority actions for poverty reduction.

Past debt relief efforts have not been additional. ODA has been falling generally, including to the poorest countries, in recent years and is likely to be reduced even further as a result of HIPC (Ranis and Steward, 2001). In theory, there is broad agreement that debt relief should be additional to existing traditional development assistance and that this cannot be achieved without increases in overall development budgets. However, the evidence so far seems to indicate that HIPC debt relief has been deduced from traditional development assistance. This means that in part HIPC might simply be taking away with one hand what it is giving with the other (Hansen, 2001). With limited aid resources, the poverty reduction and debt sustainability objectives may conflict with each other. The decline in loans is good for debt sustainability, but it may reduce the availability of overall resources for poverty reduction and growth (Killick, 2004). Replacing loans with grants would help avoid this conflict

between the need for increased real resources and debt sustainability, but the prospects for this happening in the near future are limited (Ranis and Steward, 2001).

The extra resources provided by HIPC might not generate anything like proportionate additions to the foreign exchange transfers of recipient countries. One reason is that many donor countries are likely to reduce their aid resources simultaneously. Another reason is that the HIPC countries are currently not paying their full debt service because of their severe foreign exchange problems. The market value of their debt is far less than the face value. Putting these two factors together, it is likely that the actual additionality of resource flows will be just a fraction of the nominal relief, and could even be negative (Killick, 2004). By the same token, the cost to donors will be very small¹⁹. The OED report criticises the objectives of the initiative for being overambitious and states that it is not clear how the limitations can be overcome by design improvements. The design would have been more appropriate for a more modest objective, that of delivering debt relief to some of the poorest countries (OED, 2003). With non-increasing development budgets, the only possibility of increasing the total assistance to the HIPCs would be to cut assistance levels to non-HIPCs (Gunter, 2002). In view of the fact that past aid has flowed to countries that were not committed to poverty reduction, some reallocation of aid may be justified in line with the recent efforts to improve aid effectiveness. However, considering that some of these non-HIPCs are actually poorer than the average HIPC (though less indebted), this could hamper the achievement of the international development goals (Dagdeviren and Weeks, 2001; Gunter, 2002).

19. Krugman (1990) estimated that the general debt relief for developing countries would cost US tax payers less than one twentieth of the costs of the US savings and loan bail out.

Long-term debt sustainability requires the development and institutionalization of a credible growth strategy to generate the levels of income, job creation, and revenues necessary to attain fiscal sustainability and repayment capacity. A key element of this strategy is stabilizing export earnings by diversifying the export base and gaining market access, with worsening terms of trade and an inequitable international trade regime remaining a significant source of risk. To meet their development challenges, these countries may continue to need to borrow, and the key challenge is to ensure that all resources are used productively and efficiently. The recent progress on increased availability of grants will help in financing development in a sustainable manner, but the amounts of grant aid are still limited and far short of the financing needs of the HIPC. Beyond official finance, the HIPC need to create a hospitable environment for private investment through continued and substantial policy and structural reforms, including providing the necessary infrastructure and other services (OED, 2003). Thus, while the initiative is relevant to the circumstances of the HIPC, its design might not be totally consistent with the stated objectives (Killick, 2004).

In general, the debt sustainability analyses carried out for the HIPC initiative show that debt is likely to increase strongly in the coming two decades. However, since it is assumed that exports will grow rapidly and that new debts will be concessional, the indicators for sustainability improve in the prognoses. These predictions are at odds with the analyses of longer-term debt sustainability, which show that if trade deficits continue unchanged, countries will remain so dependent on new loans that they will quickly have an unsustainable debt burden once again (Patillo *et al.*, 2004). Moreover, the domestic debt situation is worsening rapidly in many countries and the growth elements of the HIPC debt relief strategy are weak (OED, 2003). This finding is consistent with the reviews of PRSPs by the World Bank and external partners, which indicate that although growth is universally accorded high priority in the PRSPs, a common weakness is the lack of focus on how the anticipated levels of growth are to be realized and

on the prioritization of actions necessary to achieve the key objectives of the strategy (OED, 2003). The US GAO (2000) points out that the growth assumptions used in the country-specific debt sustainability analysis might be rather over-optimistic.

Over-optimistic growth rates affect debt sustainability in two ways: they imply over-optimistic growth rates for the country's exports and; they underestimate the country's future financing needs. Given that the HIPC framework defines debt sustainability largely by a debt-to-export ratio, overestimations of exports (which are in the denominator of the ratio) result in unrealistically low future debt-to-exports ratios, which then indicate unrealistic long-term debt sustainability. As the GAO report points out, if Tanzania's exports grow at an annual 6.5% (instead of the 9% projected by the IMF and World Bank), Tanzania's debt-to-export ratio could be more than twice what the joint IMF/World Bank's forecast predicts for the projection period. An analysis provided by Gunter (2001) of capital flows, structural transformation, investment and savings rates of HIPCs shows that there is little macroeconomic foundation for the high growth projections of HIPC debt sustainability analyses. Recognizing this major challenge and the possibility that the HIPC initiative may not achieve debt sustainability, the IMF and the World Bank have issued a paper on the challenge of maintaining long-term debt sustainability, in which they acknowledge that the net present value debt-to-export ratio is projected to remain above 150% for at least 5 HIPCs (IMF and the World Bank, 2001).

There is also a widespread criticism that the HIPC initiative uses inappropriate debt sustainability criteria. Gunter (2002) has shown that the HIPC initiative neglects standard debt-to-GDP ratios and is far too restrictive in the application of the fiscal indicator. As a 2001 World Bank evaluation report on the financial impact of the HIPC initiative points out, maintenance of debt sustainability depends on countries achieving a higher growth path, which itself requires overcoming lack of diversification in exports and production, dependency on capital imports, declining terms of

trade and protectionism in the North. For Honduras, Bolivia, Nicaragua, Uganda and Zambia, debt service due in 2005 after HIPC relief would be higher than what was paid in 1999 (World Bank, 2001). Some countries will pay more in the short term than they did previously even with the full application of HIPC.

3. Poverty reduction and debt relief in Uganda

Given its deep indebtedness, relatively strong macroeconomic performance and commitment towards poverty reduction, extreme vulnerability to external shocks, being a receiver of Paris Club relief, eligible for the IMF's Extended Structural Adjustment Facility, and an IDA-only country, Uganda became the first country to qualify for debt relief under both the initial and, with Bolivia, enhanced HIPC initiative. As such, it has served as a valuable learning ground for the HIPC program. The country was quick to commit itself to linking debt relief to poverty reduction under the original HIPC program, and first among LICs to successfully formulate a national poverty reduction strategy. Uganda's poverty reduction strategy, known as the Poverty Eradication Action Plan (PEAP), was formulated in 1997 following an 18-month-long consultation involving stakeholders that included central and local governments, NGOs, donors, academia and civil society. These successes have strongly influenced the World Bank's and International Monetary Fund's (IMF) design of the enhanced initiative, and Uganda's PEAP has become a model for the PRSPs. Uganda has recovered from the economic devastation brought by Idi Amin in a remarkable way and today Uganda is regarded as one of the successful turnaround states in sub-Saharan Africa. The country has experienced sustained improvement in rates of economic growth and poverty reduction, recently it achieved the goal of universal primary education and has managed to bring peace to many parts of the country

after years of political instability and civil strife. Low levels of life expectancy, continuing problems of rural poverty, a high HIV/AIDS infection rate and a persistent conflict in the North, however, offset these achievements.

Uganda: economic settings and recent development

Since gaining political independence from Britain in 1962 Uganda has experienced numerous political regime changes with far-reaching socioeconomic implications. Increasingly authoritarian civilian rule under President Milton Obote gave way to military dictatorship under Idi Amin in the 1970s, who ruled by decree up to 1979, when a combined force of Tanzanian and Ugandan forces pushed him out of power through armed struggle (Okidi *et al.*, 2004). Following the predations of Idi Amin and three other transient presidents accompanied by civil war, mass murder, and mass emigration of skilled workers, the economy recovered quickly after the National Resistance Movement (NRM), led by Yoweri Museveni, took power in 1986. Since 1986, various armed groups have though continued to fight President Yoweri Museveni's government with the aim of overthrowing it (Okidi *et al.*, 2004), and the country's long-running conflict in the north and north-east of its territory shows no signs of easing (DAC, 2005).

The NRM government came to power in January 1986 with a clearly stated commitment to its Ten-Point Programme, which was developed during the armed struggle. Its key premises included state-led economic development, the elimination of corruption, decentralisation of power, and democracy (Robinson, 2005). Uganda held presidential and parliamentary elections in 1986 and 2001, and the country is moving towards general and presidential elections in 2006. The so-called "Movement system", under which traditional political parties are banned, continues to dominate the political process. In the Movement system of politics, political parties are tightly regulated and prohibited from contending in elections. The

intention was that the no-party system would be a transitional arrangement to contain the ethnic and religious rivalries that had been the principal cause of violent conflict in earlier years. All members of parliament represent the Movement and elections are contested on individual merit. While the Movement system is not conducive to political competition, many observers concede that reasonable freedom of association and expression is tolerated by the government, with regular national and local elections on a no-party basis, an active civil society and relatively free media. More critical observers claim that the Movement system is increasingly assuming the character of a one-party state dominated by a political and ethnic elite with its power base in Southwest Uganda (Mugaju and Oloka-Onyango, 2000). With this in mind, it is interesting to see the government's commitment to involving civil society in the formulation and implementation of Uganda's PRSP, to be discussed later on. Ugandans are expressing a growing desire for greater pluralism in the political process, and many opposition party candidates were successful in the 2002 local elections (DAC, 2005).

By 1986, Uganda had become one of the poorest countries in the world. Per capita incomes, which had averaged US\$ 800 in the 1970's, hovered just over US\$ 200 in 1986, spawning widespread poverty (Collier and Reinikka, 2001). The education and health systems had collapsed, the physical infrastructure crumbled, and low wages and poor morale had destroyed the civil service. Furthermore, the economy was highly regulated, with state intervention in nearly all sectors. Real gross domestic product (GDP) per capita was 42 percent below its level in 1970; the public revenue base had collapsed; and government expenditure, exports (primarily coffee, which constituted 95 percent of total exports) and investment had all fallen to below 10 percent of GDP (Okidi *et al.*, 2004). Annual inflation rate rose to three digits mainly because of Government financing of the fiscal deficit through borrowing from the domestic market (Robinson, 2005).

Following the restoration of relative political and economic order in most parts of the country in the second half of the 1980s, coupled with strong

leadership commitment to reform, Uganda embarked on implementation of economic reforms in 1987 with a view to correcting macroeconomic imbalances and removing inefficiencies in production and distribution of goods and services so as to register high rates of economic growth. When an early *dirigiste* approach to reform failed, the Government of Uganda announced a market-oriented Economic Recovery Program (ERP) to promote rehabilitation and growth, improve internal balances to reduce inflation, increase the volume and diversity of exports to limit external account imbalances, and strengthen the institutional framework. IDA, IMF, and numerous multilateral and bilateral donors supported the ERP (OED, 2001)²⁰. The initiative was immediately followed by a sequence of Structural Adjustment Programs (SAP). An important aspect of the reform strategy was trade liberalization through extensive reduction of non-tariff barriers, competitive tendering for government purchasing and a switch from export taxation to import taxation (OED, 2001). Significant gains were realized from trade liberalization²¹.

In the early 1990s, the government decided to embark on a series of ambitious and potentially contentious structural and institutional reforms. The principal results of the reform process were quite positive: lowering of the annual inflation rate from 190 percent to 28 percent by

20. The ERP was primarily aimed at realizing economic rehabilitation, growth, domestic financial stability, and low inflation rates.
21. For example, the 1991/92 abolition of the coffee export tax together with overall coffee marketing liberalization increased competition among exporters, resulting in producer prices received by coffee growers as a share of border prices increasing sharply from 30% to more than 80% (Collier and Reinikka, 2001). Successful implementation of privatization of non-performing state enterprises further induced efficiency and boosted the growth of the private sector in the industrial, commercial, agricultural, and hotel sectors (Okidi *et al.*, 2004).

the end of 1991; revival of the GDP growth rate from negative figures to an average of 6.3 percent per year over 1988-2000; inflation was curbed by fiscal year 1994 and there was a gradual recovery of exports and public and private investment rates (Hölmgren *et al.*, 2001; Kappel *et al.*, 2005; OED, 2003). Political commitment and the support of aid donors were the critical ingredients for the early phase of reform. Financial aid was decisive for stimulating public investment in infrastructure and balance of payments support to restore financial stability (Robinson, 2005)²². Technical assistance from aid donors also played a role in sustaining the reform process. Government officials went on donor-funded study tours to Ghana to learn from its successful adjustment reforms. Foreign economists were placed in key ministries to serve as advisors and train Ugandan counterparts (Hölmgren *et al.*, 2001). Political opposition was gradually sidelined as pragmatic arguments in favour of economic reform became ascendant in policy debate. The experience of the first year of the NRM in office, with its emphasis on price controls and government intervention and advice from technocrats and aid donors, gradually convinced the president of the need for reform and that alternative approaches would not work (Robinson, 2005). The legitimacy acquired from the Movement's success in bringing an end to conflict in many parts of the country strengthened the hand of the president, giving him the confidence to depart from interventionist approach (Morrissey, 2004).

22. Over a five period from 1987 to 1992, the World Bank provided more than US\$ 1 billion in quick-disbursing policy-based credits, supported by highly concessional bilateral grant financing for adjustment operations. Loan conditions ensured government adherence to reform prescriptions and strengthened the hand of reform-oriented technocrats. The government commissioned reports from independent experts paid by donors (Robinson, 2005).

Although absolute poverty (measured by headcount)²³ fell by 21 percent between fiscal year 1992 and fiscal year 1998, 44 percent of the population remained poor (Appleton, 2001), poverty being overwhelmingly rural²⁴. The government's initial strategy for reducing poverty was to promote growth and improve the availability of social services. Concerns about the likely poverty impact of the reforms prompted the preparation and implementation of two projects to address the social impact of adjustment and the needs of Uganda's war-torn northern districts (OED, 2003)²⁵. In 1993, the government committed itself to decentralization in order to strengthen local decision-making and popular control over services. By 1995, the government realized that economic growth had not been sufficiently broad-based to address mass poverty and improve Uganda's

23. Using a national survey on household expenditure (which has been conducted in most years since 1992), statisticians calculate the real household expenditure per adult equivalent. This measure includes home-produced food as well as goods purchased from the market, and adjusts household size for the number of people of different ages, to give an accurate reflection of the relation between the household's total expenditure and its members' consumption needs. It also corrects for inflation. Households whose real expenditure per adult equivalent falls below a given level (the poverty line) are considered poor. The poverty line used in Uganda is an absolute, not a relative one; it measures the level of expenditure needed to secure basic food consumption needs (taking into account regional variations in food prices) and a corresponding level of non-food consumption. Poverty can be measured by the headcount – the proportion of people below the poverty line – or by the poverty gap and depth of poverty, which also take into account the distance below the poverty line.
24. Ninety-five percent of the poor are in rural areas and are concentrated among food crop farmers, women, and the country's northern and eastern regions.
25. The two projects were the Program for Alleviation of Poverty and Social Costs Adjustment (PAPSCA) and the Northern Uganda Reconstruction Programme (NURP).

human development indicators²⁶. It therefore adopted a Poverty Eradication Action Plan (PEAP), which turned out to be the country's holistic development framework, covering economic management, governance and security, increasing the incomes of the poor, and improving delivery of social services²⁷. In 1997, the government adopted universal primary education as a national goal, which now has been achieved.

Uganda's legacy of debt inherited from previous regimes and the financial assistance it received for rehabilitation and reform left it with a large, unsustainable debt burden in the 1990s. With domestic savings lagging, and due to its narrow revenue base and excessive need of economic rehabilitation in order to revive its productive capacity and improve the government's ability to manage the economy, the country relied heavily on external assistance in order to implement its economic reforms (Nannyonjo, 2001). Total official development assistance more than tripled between 1986 and 1996 (OED, 2003). At that point, Uganda's debt-to-export ratio exceeded 1,400 percent and its debt-service ratio

26. This concern emanated in part from the criticism levied by NGOs, which argued that poverty levels were not significantly affected by the economic reforms of the previous decade. Bilateral donors increasingly drew attention to the questionable impact of reforms on the poor. Another focus of non-governmental advocacy efforts was the growing level of debt that resulted from the large-scale financing of the economic reform programme by multilateral lenders. The growing burden of debt diverted resources from public expenditure on public services, which were coming under increasing pressure from the growing HIV/AIDS crisis (Robinson, 2005).
27. The key elements of the PEAP are to maintain growth-promoting macroeconomic policies; encourage broad-based growth sufficiently to increase economic opportunities for the poor (especially in agriculture); provide social infrastructure; create a capacity for quick response to shocks; build a secure, just, and tolerant social order; and promote balanced regional development.

exceeded 60 percent (Hölmgren *et al.*, 2001), IDA and the IMF being Uganda's largest creditors. On the basis of its strong adjustment record, Uganda became eligible for debt relief under the Highly Indebted Poor Countries (HIPC) Initiative in April 1997. In 1998, the government established the Poverty Action Fund (PAF) as an instrument for achieving PEAP objectives, and after committing to creating and protecting the Poverty Action Fund, Uganda became the first country to benefit from the World Bank's and the IMF's original framework of the HIPC initiative (Okidi *et al.*, 2004). The PAF ring-fenced the savings from HIPC to ensure that they were used transparently and that they were truly additional to budget resources that would have been committed to poverty reduction in the absence of HIPC.

Debt reduction operations in Uganda

In the early 1990s, external loan repayment accounted for about a third of Ugandan government's recurrent expenditure. This was generally much higher than amounts committed to health, community and social services, public order and safety, and education until the introduction of the Universal Primary Education (UPE) policy (Nannyonjo, 2001)²⁸. Uganda had gone through a number of negotiations and agreements related to reducing the burden of debt servicing since the early 1980s. This was after the creditors appreciated the constraints the country was experiencing in its bid to try to retire debt falling together with arrears and, at the same time, attain some progress on its development goals (Muwanga-Zake and Ndhaye, 2001).

28. A weak revenue base combined with internal security problems also meant that sectors like defence would receive a higher share of the recurrent budget than social sectors (Nannyonjo, 2001).

Debt reduction operations have varied depending on creditor category and the nature of the debt involved. Debt relief negotiations with the Paris Club gradually expanded to multi-year rescheduling agreement and debt stock reduction. Uganda has, over the years, also benefited from debt-buy-backs and debt-to-equity conversions. Despite the relief efforts, debt continued to rise in the 1990s, though at a slower rate than in the second half of the 1980s (Muwanga-Zake and Ndhaye, 2001). By the end of June 1996, Uganda remained heavily indebted with a stock of external debt of US\$ 3.5 billion (Nannyonjo, 2001). This constituted 63 per cent of GDP, of which 75.5 per cent constituted multilateral debt (Muwanga-Zake and Ndhaye, 2001). Regarding sustainability targets, Uganda's NPV of debt was approximately US\$ 1.7 billion (after implementing Paris Club rescheduling and stock reduction), or 233 per cent of exports of goods and non-factor services – a clear indication that Uganda could not achieve debt sustainability within a reasonable period even with good performance (Muwanga-Zake and Ndhaye, 2001).

The government of Uganda embraced the HIPC initiative with much optimism and anticipation, and committed itself to promoting rapid economic growth with equity. In recognition of its track record of a decade of adjustment, the country lobbied hard to persuade the IFIs and the G7 that it should receive both the decision and completion points early in 1997. However, several G7 governments opposed this idea and the completion point was fixed at April 1998 (Muwanga-Zake and Ndhaye, 2001). Estimates suggest that the decision to delay the completion point for Uganda to April 1998 denied the country US\$ 193 million in debt relief, or 56 per cent of the amount that was eventually granted.

Uganda thus formally entered the HIPC debt relief process in April 1997 and reached completion point in April of the following year. The original HIPC framework proposed to lower Uganda's debt-to-exports ratio to 202 percent in NPV by completion point. At this point, the

country achieved debt relief equivalent to US\$ 347 million NPV terms²⁹ (or US\$ 650 million of relief on debt service over the next 30 years), which signified a reduction of approximately 20 per cent of the NPV of the total debt stock. IDA debt relief³⁰ was contingent on satisfactory structural and social reforms under ESAF, IDA's Third Structural Adjustment Credit, and new or ongoing IDA health and education projects. All performance criteria were met (OED, 2001). However, substantial decline in export proceeds and a projected increase in the NPV of debt arising from old and new loans meant that, at the end of June 1999, the NPV of external debt had increased to US\$ 1,806 million against the projected US\$ 1,608 million at the completion point of April 1998 and the ratio of NPV of debt-to-exports increased to 248 per cent, compared with the projected 201 per cent (Muwanga-Zake and Ndhaye, 2001). This indicated that Uganda could not sustain its debt.

Uganda's passage through the enhanced initiative

Having qualified for the original HIPC, Uganda met the requirements for the enhanced version with little difficulty. In line with the revised sustainability indicators of the enhanced HIPC initiative, the World Bank and IMF estimated the total amount of relief to be received at US\$ 656 million in NPV terms (US\$ 1.3 billion in nominal terms) over a 20-year period (Muwanga-Zake and Ndhaye, 2001)³¹. Uganda's NPV of the debt-to-export ratio was expected to reach 150

29. US\$ 274 million in multilateral contributions and US\$ 73 million in bilateral contributions.

30. IDA's debt relief share, US\$ 160 million in NPV terms, was funded by grants and the HIPC Trust Fund.

31. The multilateral creditors' share estimated being about 83 percent.

percent by completion. In accordance with the closer tie between debt relief and poverty reduction, to make progress towards the international development targets, Uganda submitted a PRSP, which drew on experiences from the already prepared and implemented PEAP since 1997. The PRSP was endorsed by the Board of IDA and the IMF, as part of Uganda's requirements under the HIPC II Initiative before completion point in April 2000 (Muwanga-Zake and Ndhaye, 2001). The resources saved from HIPC debt relief were purposively channelled to the PAF and allowed Uganda to increase the budget for the most critical areas, such as primary education, primary health care, rural roads, safe water and sanitation, and agriculture (MFPED, 2004). The PEAP/PRSP in Uganda is largely acknowledged as having put poverty eradication in addition to economic growth, macro-economic stability and private sector development at the centre of policy design, formulation and implementation (Gariyo, 2003) and to specifically address the problems of the HIV/AIDS virus.

Uganda's use of HIPC funds and achievements in poverty reduction

Qualification for debt relief was important for Uganda. The ratio of debt interest payments to exports fell from 35% in 1997/8 to 10% in 2000/1, while the ratio of debt payments to tax revenue fell from 22% to 11%. HIPC savings were equivalent to 13% of tax revenue and 23% of export earnings in 2000/01 (MFPED, 2004). These savings have been channelled to spending on social sectors (particularly primary education and health care, and, especially, to making progress in AIDS awareness and reducing the incidence of the disease) and partly institutionalized through the PAF structure. Though a good innovation, aimed at protecting expenditures with direct impacts on poverty reduction, the PAF structure tended to focus budget cuts on

activities which were complementary as far as growth was concerned (Okidi *et al.*, 2004). The implication is that pro-poor spending may not have been holistic in implementation since it lacked counterpart funding of other related activities.

The implementation of poverty reduction programmes has enhanced access to services by the population despite some shortcomings (MFPED, 2004). The immediate outputs of most of these policies have been commendable, as attendance of both schools and hospitals have increased following the introduction of UPE in the mid-1990s and the removal of user fees in 2001. Access to health care has improved following the abolition of cost-sharing. Under the Health Sector Strategic Plan, some headway has been made in the provision of minimum health care delivery, including new health centres and the upgrading of others. Yet, life expectancy was only 43 years in 2003, and child and maternal mortality are high. In 2003, the mortality rate for children under five was 140 per 100,000 births. In 2000, the most recent year for which adjusted WHO/Unicef data is available, the maternal mortality rate was 880 per 100,000 live births (DAC, 2005).

There is quite a bit of evidence that in education and health, the quality of services has been sacrificed for an increase in quantity (Okidi *et al.*, 2004). The quality of services is a challenge, as the system continues to suffer under the weight of non-availability of drugs, absence of qualified health staff, lack of preventive primary health care, poor sanitation diseases and HIV/AIDS (DAC, 2005). Low quality can seriously inhibit the effectiveness of public spending, which may then fail to improve the living standards of the poor and increase their human capital. Incidents of corruption at the local government level make the abiding problem of low funding and scarce financial resources even worse (MFPED, 2004). Kappel *et. al* (2005) acknowledge that the government is successfully targeting its spending in both sectors and reaching the intended group, but they point out that even if the poor have access to primary schools

and primary health facilities, this does not necessarily lead to a long-term reduction in poverty. As a consequence, people who can afford to pay for education and health services prefer private or NGO-run facilities over public ones.

Trends in the human development index for Uganda show steady improvement over a period of fifteen years, from 0.402 in 1985 to 0.489 in 2001, comparing favourably with economically more advanced countries like Kenya and Zimbabwe, which displayed a declining trend over the same period (Robinson, 2005). During the 1990s, income poverty fell dramatically. The proportion of Ugandans whose expenditures fell below the poverty line (poverty headcount) fell from 56% in 1992 to 44% in 1997/8 and even faster to 34% in 2000. These changes were driven mainly by increases in average income, rather than by redistribution, as the government has little room for manoeuvring regarding the tax base. However, since 2000, the situation in Uganda appears to be taking a turn for the worse. Inequality was basically unchanged from 1992 to 1997 but increased thereafter; the Gini coefficient was between 0.37 and 0.35 until 1997, but rose to 0.39 in 2000 (MFPED, 2004). Income poverty increased from 34% to 38% between 2000 and 2003, the number of poor rising from approximately 7 million to 9 million (Kappel *et al.*, 2005). Inequality as measured by the Gini coefficient rose markedly from 0.39 to 0.43. Notably, nevertheless, poverty remains well below the 44 per cent level of 1996/1997 when the PEAP began (Robinson, 2005). This setback certainly reduces Uganda's chances to achieve its goal of reaching a poverty level of 10 percent or less by 2017.

Among reasons for the decline in poverty reduction is that agriculture, where the bulk of the population is, has grown very slowly (at a rate much lower than the overall growth rate). The main agricultural tradable, coffee, suffered significant price falls after the boom of the mid-1990s, prompting systematic efforts to increase the

export shares of other commodities such as fish and flowers (Okidi *et al.*, 2004). Although the effort has paid off, the poverty effects are very limited given that they engage only a small segment of the population, unlike the coffee sector. Bevan *et al.* (2003) underscore the importance of agriculture and the significance of raising its productivity for achieving rapid overall growth by increasing aggregate output and by releasing labour for other sectors that have to expand in line with the pattern of structural transformation that some middle-income countries went through. The share of agriculture in Uganda's public expenditure has remained very low (Okidi *et al.*, 2004). Although the proportion of donor assistance going into general budget support is increasing, the share of agriculture in the total budget has been, and is projected to be, below 4%. It is projected that the national budget will grow by at least 3% between 2003/2004 and 2004/2005 but agriculture and accountability budgets are the only ones to experience a decline in nominal terms.

Effects of the Enhanced HIPC Initiative on debt sustainability

Despite a certain success in debt reduction through the HIPC initiative, Uganda remains highly dependent on aid flows to sustain the government budget. The country's current dependence on donor funds has implications for the sustainability of its external debt burden, as external loans currently account for approximately 40% of donor inflows in any given year (DAC, 2005). Uganda has borrowed \$1.5bn from multilateral donors since the HIPC Completion point, and although these loans have been on highly concessional terms, their impact on the debt stock, combined with lower export growth as a result of the fall in coffee prices and low prevailing world market interest rates, has been to raise Uganda's NPV of debt to export ratio to 305%, which is more than double the HIPC threshold (IMF, 2005).

Another reason for the current debt sustainability problem, apart from the inability of export earnings to rise substantially, is the non-delivery of HIPC debt relief by some non-Paris Club creditors and the litigations won by commercial creditors against the government, recovering claims of \$40 million (DAC, 2005). Furthermore, low global interest rates have increased the present value of Uganda's debt and reduced the concessionality of IDA lending terms (Kuteesa and Nabbumba, 2004)³².

It is broadly agreed that the fiscal deficit should be reduced to give the private sector space and a favourable environment to develop. However, reduced public sector spending could adversely affect the quantity and quality of social services delivered by the public sector (Kappel *et al.*, 2005). Regarding inefficiency in the use of public financial resources, the government has taken several measures to reduce corruption, such as putting in place an institutional framework for curbing vice. However, corruption and inefficiency in the use of public resources at all levels of government is still enormous. According to the latest HIPC unit projections, Uganda is expected to borrow on average well over US\$ 300 million annually through the end of this decade (DAC, 2005), and thus the country is not expected to reach sustainable debt levels by the end of the decade.

32. In a way, Uganda has been penalised by virtue of the fact that it was the first country to access the HIPC initiative (Kuteesa and Nabbumba, 2004). Errors made in the calculation of HIPC debt relief to Uganda have been corrected for subsequent countries. Subsequent countries accessing the initiative have had their exports valued at the prevailing lower global commodity prices, which means they have been given relatively more relief to enable them to arrive at the same NPV debt-to-export ratio.

Uganda's relative success within the HIPC initiative: the role of aid conditionality and political commitment

“Planning is not an accident nor is it a stroke of luck. It is a result of deliberate, planned effort by the government and its development partners.”

Government of Uganda (1999)

Aid donors played a central role in Uganda's turnaround, offering significant and growing levels of financial aid combined with technical assistance that was used to considerable effect by the government (Robinson, 2005). The ideas and influence of aid donors contributed to policy choice and helped to ensure continued government adherence to policy commitments through the use of conditionality. Growing levels of ownership helped to sustain the momentum of reforms and create a receptive environment for increasing levels of aid (Hölmgren *et al.*, 2001, Collier and Reinnika, 2001). The significance of foreign assistance is confirmed by the high levels of aid flows from the late 1980s, reaching a quarter of national income in 1992, and ranging between 10-15 percent thereafter. Aid provides accounts for a significant government expenditure aid, equivalent to 52 percent of the government budget in 2004 (Robinson, 2005). The aggregate impact of aid on economic growth and poverty reduction has been significant. According to estimates furnished by Collier and Reinnika (2001), aid contributed 31 percent of the 5.5 percent average growth rate and 29 percent of the decline in poverty levels in the period 1992 to 1997.

Political commitment and the support of aid donors were the critical ingredients for the early phases of reform (Robinson, 2005). The Ugandan government clearly held a strong commitment to economic liberalisation throughout the 1990s, and to implementing pro-poor policies from the mid-1990s (Morrissey, 2004). Commitment to reforms does not, however, necessarily mean ownership of reforms. The Ugandan

government did not design its liberalisation strategy but largely followed donor, especially World Bank, advice and conditionality³³. Donors certainly influenced preferences, and their continued support reinforced political capacity (Morrissey, 2004). Interest in stronger government ownership of the reform programme was, however, manifested in a number of areas. The president displayed active commitment to various reform initiatives. Decisions to embark on more challenging structural reforms were often initiated in the absence of donor support or conditionality but attracted financial assistance once commitment was evident in the preparatory and design work (Robinson, 2005).

One of the central features of the PRSP is the requirement that civil society should participate, and here Uganda has been a leader in the process of innovation in participatory poverty reduction strategy formulation and implementation (OED, 2003). The formulation of Uganda's PRSP coincided with the desire of the government to revise the PEAP, and, as mentioned above, the revised PEAP served as Uganda's PRSP. The PEAP was first developed in 1997 following an 18-month-long consultation involving stakeholders that included central and local governments, NGOs, Civil Society Organisations (CSOs), donors, and academia. The case of the PEAP/PRSP process in Uganda is thought to show how Civil Society Organisations (CSOs) can influence policy planning at the macro level (Gariyo, 2002).

This successful involvement of the CSOs did not come out of the blue. This was not the first time CSOs were included in influencing policies, although it was the first time that they were being deliberately

33. In many respects, the timing was fortuitous. Liberalisation of coffee marketing in the early 1990s, for example, coincided with a boom in world coffee prices over 1994-96. The positive effect on growth and sustained inflows of aid added impetus to the reform process that was seen as benefiting the economy and the majority of the population (Dijkstra and van Donge, 2001).

included in policy design, planning and formulation (Robb and Scott, 2001). The decision by the officials of the government of Uganda to open up to the involvement of CSOs came in an important part as a result of increased pressure and demands by donors and the international aid agencies (Gariyo, 2002). These experiences have played a central role in getting CSOs to be accepted by the government as key actors in influencing policy processes. Many of Uganda's CSOs are now involved in building the capacity of the grassroots to participate in policy formulation processes at the local government level and monitor the implementation of pro-poor programmes, including public expenditure management, accountability, transparency and in participatory poverty assessments (Gariyo, 2002). This coincides with Ugandans' growing desire for greater pluralism in the political process (DAC, 2005) and the preparation of multiparty elections scheduled for 2006. Thus, CSOs in Uganda were already, more or less, prepared to participate in the revision of the Poverty Eradication Action and the formulation of the Uganda PRSP. Findings from the civil society consultations were incorporated into the PEAP draft, sometimes without changes (Gariyo, 2002).

The Uganda experience of civil society participation in the preparation of a PRSP shows that, for CSOs to effectively influence policies, there must be a conducive policy environment and a government commitment to these consultations is essential. In spite of the strict guidelines that civil society participation in the formulation of a country's PRSP is essential, most governments in Africa are not yet ready to accept CSOs as serious stakeholders in policy planning. The Government of Uganda ensured that CSOs were given enough space in the PEAP/PRSP process by organising independent consultations and incorporating as much of their inputs into the documents as possible. In recognition of their role as serious development partners and actors in the policy arena, civil society organisations have, since 1999, earned themselves an open space to participate in the Consultative Group (CG) meetings that are held annually in the country.

Final considerations on the Uganda case

Uganda's demonstration of economic recovery through commitment to sound economic policies, with country-owned initiatives for poverty reduction, provides a useful experience for other economies transiting from conflict to recovery. But significant challenges in sustaining growth-led poverty and debt sustainability provide equally important lessons for low-income countries. The Ugandan case is particularly interesting for the pro-poor growth debate, as high economic growth rates coincided with remarkable poverty reduction during the 1990s, but the country has not been able to maintain the pro-poor growth in recent years in spite of positive growth of the economy. Furthermore, Uganda is a clear case in which HIPC relief resources have been additional, with large and sustained inflows of external aid, as donors have continued to provide assistance in light of their sustained policy and reform efforts (OED, 2003). Even so, the country has not been able to maintain debt sustainability and is not expected to do so in the near future. Reductions in poverty levels have levelled off since 2002, presumably on account of adverse weather and a reduced rate of economic growth, especially in agriculture. Uganda is thus faced with the challenge of ensuring that economic growth is high and broad enough to ensure pro-poor growth, and still has to battle a heavy debt burden. This setback seriously reduces Uganda's chances to achieve its goal of reaching a poverty level of 10 percent or less by 2017.

As already hinted, a multitude of factors contribute to poverty, only a few of which have much to do with any neglect of social spending induced by the necessity to service external debts. The HIPC initiative has increased the share of allocations to social sector programs in Uganda. On the whole, Ugandans are more educated today and the country recently achieved its goal of universal primary education. Uganda's effort to battle the HIV/AIDS virus is of merit, as while good health may not convey a particular advantage, ill-health can, especially

in an environment characterized by HIV/AIDS and other diseases, easily throw a household into poverty. However, the quality of services remains a challenge, difficulties seem to continue in gaining entry into the labour market, and the overemphasis on social policies tended to direct budget cuts to other important activities for economic growth.

4. Conclusions

The HIPC initiative was an important improvement in the treatment of debt issues in poor countries, representing a comprehensive attempt to deal with the debt crisis on a case-to-case basis and involving multilateral debt for the first time. This paper has offered an overview of the theories behind the HIPC initiative structure and the literature concerning its link to the formulation and implementation of PRSPs. After reviewing theories on debt's impact on economic performance, it considers the launch of the HIPC initiative to be highly relevant, as heavy indebtedness presents an essential stumbling block to poor countries due to an adverse interaction between heavy debt burden, economic growth, and human development in heavily indebted poor countries.

The PRSPs have pushed poverty in recipient governments' policy agendas and also, through their emphasis on participatory approaches, have the potential to involve citizens and civil society much more in policy formation, monitoring and execution. Linking the enhanced HIPC initiative to the drawing up of a PRSP is seen by many as an important step forward, as what began as a limited debt reduction scheme increasingly took on the role of a poverty-reduction programme, placing debt relief within an overall framework of poverty reduction. But the criticism remains; PRSPs are another layer of conditionality in an already complicated qualification process for the HIPC Initiative. On the one hand, the need to develop and implement a PRSP for one year is delaying

debt relief, and on the other hand, the rush to get to the Completion Point is diminishing the quality of the PRSP. This conflict is an important one to solve for the HIPC initiative to fulfil its expectations. Furthermore, a question that remains to be answered is whether this PRSP process strengthens or threatens governance in countries where political participation is a relatively new phenomenon.

A big challenge now facing the initiative is to manage the expectations of what it can achieve, given current funding levels and the policy and institutional constraints in the HIPCs. A key assumption of the initiative is that the past aid levels will be maintained to make HIPC debt relief additional to other aid flows. But the initiative itself cannot ensure this, as its attention bias is real. Without additional resources, it is unclear how the fiscal space is to be created and, in the absence of additionality, what the implied tradeoffs are among priority actions for poverty reduction. The paper's overview of Uganda's experience of the HIPC initiative is relevant here, as the Uganda case shows that additional capital flows, alongside debt relief, contributed to the country's access to fresh resources and to creating a certain fiscal space for the country to work within. An important criticism levelled by the paper is on the initiative's particular and narrow approach to the task of reducing poverty, namely, the expansion of spending on social service to the neglect of wider growth and development priorities. Here the review of Uganda's passage through the HIPC initiative is also helpful, as it demonstrates the multitude of factors contributing to poverty, only a few of which have much to do with neglect of social spending induced by the necessity to service external debts.

The paper thus concludes that the HIPC initiative is an important step in the right direction to foster sustainable growth in low-income countries and to integrate debt relief into a global poverty reduction strategy, but emphasises that it is only a step. It is important to not overcharge the initiative with expectations of achievements. The HIPCs' unmanageable debt is a symptom of deep structural problems.

While the HIPC initiative provides much-needed fiscal breathing space from high debt service, debt relief is no panacea for broader economic development problems. Simultaneously achieving the initiative's multiple objectives of growth, poverty reduction and debt sustainability requires actions that are well beyond the scope and means of the initiative. And though not able to battle its high debt, we can see from Uganda's performance that in a committed political environment, accompanied by additional resources, the HIPC initiative can release resources for poverty reduction. Uganda is, however, just one case, the showcase, and it is by no means clear that this will be the experience of the remaining highly indebted poor countries. That remains to be seen.

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