PUTTING SUSTAINABLE DEVELOPMENT FIRST

WHY COUNTRIES’ ABILITY TO SUSTAIN DEBT SHOULD BE ASSESSED FROM A SUSTAINABLE DEVELOPMENT PERSPECTIVE

DRAFT

Ted Van Hees, Francis Lemoine, Arno Haegens

July 2002
This paper considers the intrinsic link existing between debt sustainability and sustainable development. It shows how the use of a ‘bottom-up’ approach to debt sustainability can present this relationship explicitly while at the same time giving a more precise account of what constitutes an affordable level of debt from a sustainable development perspective.

The World Summit on Sustainable Development (WSSD) covers important ground on many development and environmental issues. For many, however, the key opportunity linked with such global gathering lies in adopting a framework that will enable developing and developed countries to deliver and build on the promises made at the Rio Earth summit and at Monterrey’s international conference on Financing for Development.

In this regard, high expectations have been raised after heads of states’ commitment in Monterrey to provide countries committed to poverty reduction with the necessary financial resources to reach the Millennium Development Goals (MDGs) by 2015. Indeed, there is now wide consensus among the international community that the WSSD process should strengthen this commitment by devising the next steps to be taken towards its full and timely implementation.

Most would also agree that unsustainable debt burdens remain one of the main stumbling blocks for developing countries to raise these necessary resources. This concern has been addressed in the Monterrey consensus paper and the Draft Plan of Implementation for the WSSD who put debt relief, alongside improved market access and higher levels of official development assistance, as a crucial milestone towards reaching the MDGs. In this regard, the Monterrey consensus paper further states that “future reviews of debt sustainability should also bear in mind the impact of debt relief on progress towards the achievement of the development goals contained in the Millennium Declaration”.

The acknowledgement that debt sustainability should not only be judged on whether or not a country has the financial resources to service its debt, but also on the pressure that high levels of debt service can exert on other essential public expenditures such as health, education, or environmental conservation, represents an important progress towards adopting a more comprehensive approach to debt problems.

On the ground however, little change has been observed and debt sustainability is, in most cases - including the HIPC initiative, still being assessed according to narrow macro-economic criteria. A recent paper by Jeffrey Sachs summarises the inconsistency of such an approach, noting that “it is perfectly possible, and indeed is currently the case, for a country or region to have a ‘sustainable debt’ (and significant debt servicing) according to [IMF macroeconomic criteria], while millions of people within the country are dying of hunger or disease”.

An alternative approach to debt problems has long been urged by Eurodad and other NGOs who advocate for debt sustainability to be seen in a broader context incorporating the poverty needs of beneficiary countries. Moreover, Eurodad has also put forward a concrete methodology to assess debt according to a ‘bottom-up’ debt sustainability criterion, based on the poverty conditions within each country, and which takes as its starting point the assessment of the resources that a country needs to achieve basic poverty reduction. From this perspective, it is argued that external debt service should be seen as a secondary concern and human development expenditures a

---

1 More recently, G8 leaders reiterated this commitment at Kananaskis stating: “no country genuinely committed to poverty reduction, good governance and economic reform will be denied the chance to achieve the Millennium Goals through lack of finance”.

priority when allocating poor countries’ scarce resources. This reverses the current approach, where external debt service is given priority and poverty reducing expenditures are only seen as residuals in the budgeting process.

At the same time, it has now become clear to most of the actors participating in the WSSD that poverty is multidimensional, and in fact closely linked to other development concerns such as social inclusion or the environment. In this respect, the concept of sustainable development, which links these different dimensions, has helped to recognise these dependencies and successively devise a comprehensive agenda to deal with them. This summit thus represents a unique opportunity to take a step forward and bring these different dimensions into the forefront in particular with regards to their link with debt sustainability.

The impact of debt on poverty, social inclusion and the environment

Unsustainable debts negatively affect the poverty, social, and environmental situation of a country in at least three ways:

First, by constraining the government to use most of its resources to service debt, it limits the scope to finance other activities geared at reducing poverty, enhancing social inclusion or promoting environmental conservation. It has been shown clearly in the case of the countries labelled as ‘HIPC’ that the lack of spending on education, health, water supply and sanitation was, to a large extent, due to their revenues being diverted towards debt servicing. A closer look at government spending in low income countries suffering from high levels of debt would show that other spending items such as those linked with environmental concerns have also been undermined as a result of unsustainably high levels of debt payments. This is most obvious in the case of water supply and sanitation where insufficient investment has led to shortages of drinking water for the poor but also to the mismanagement of water resources jeopardising entire ecosystems.

Secondly, unsustainable levels of debt are also the cause of important distortions with respect to the way resources are allocated and to the choices of policies to be pursued. The main reason for that being that debts are usually serviced in foreign currency thereby increasing the need for indebted countries to raise their export earnings. Given the limited added value of homegrown industries, extractive industries or other resource-based activities are ‘ideal’ candidates to generate the foreign currency needed to repay debt. However, these industries also generate significant negative externalities and have usually a limited impact on poor people’s revenues. In addition, this distortion in the allocation of scarce resources towards outward orientated activities also crowds out investments for activities potentially more poverty reducing and more environmentally friendly.

Thirdly, high levels of debt also act as a disincentive for governments to take a long-term view when designing and implementing their development policies. The debt overhang literature has shown extensively that high levels of debt systematically undermine reforms geared at achieving long-term objectives because any positive developments in the country’s economy will only result in increased revenue being allocated to debt repayment.

An alternative approach to debt sustainability based on the achievement of the MDGs

A simple yet attractive way to take these elements into account in a ‘bottom-up’ approach to debt sustainability is to use the Millennium Development Goals to define the essential items a government should prioritise in its budget. Firstly, because they include most of the factors that preclude countries from following sustainable development paths, and secondly, because their

---

2 That is if one assumes that debt was not repaid in full or that the country could expect to see its debt reschedule in the future. A highly plausible assumption, when one knows that virtually all LICs with high levels of debt have benefited form such treatments.
relevance as policy, as well as analytical tools, is now widely recognised among policy makers. The simple ‘3-steps’ methodology set out below illustrates how such an approach could be operationalised.

Step 1:
The starting point consists in assessing the overall resources available to a government’s central budget. This is defined here by fiscal revenue and donor grants. Other sources of donor support such as technical assistance are not taken into account because these funds do not constitute resources available to country authorities for spending on sustainable development. We also argue that loan disbursements should not be included in this definition, as they would be used to finance activities that are not directly profitable.

Step 2:
From this starting point of the resources available to the government, we then subtract the amount of resources that each country will need to spend to achieve the MDGs. This figure can be assessed by computing, for each ‘goal’, the annual level of investment required to meet the 2015 target. Valuing the resources needed is notoriously difficult for some of the MDGs. We have thus decided to limit our scope to ‘goals’ related to health (combat HIV/AIDS, malaria and other diseases, Improve maternal health and Reduce child mortality), education (achieve universal primary education), and environmental sustainability (halve the proportion of people without sustainable access to safe drinking water and improve in the lives of at least 100 million slum dwellers).

Step 3:
Next, we argue that repayment of domestic creditors should also be prioritised over external debt payments, particularly with respect to the stability of national financial systems.

Step 4:
Finally, it is also assumed that no more than a third of the remaining resources should be used to service foreign debt in order to take into account other ‘non-essential’ but nonetheless key public expenditures that need to be made. These would include the costs of running the civil service, police force and judiciary, as well as basic investments on infrastructure. An ‘affordable debt service’ thus represents a third of the budget’s remaining resources after essential needs expenditures – as defined in the MDGs - and domestic debt service payments have been made.

From this perspective, any low-income country that currently suffers from high levels of indebtedness coupled with low government revenues and widespread poverty should be eligible for debt relief. Countries that are relatively less indebted, or have relatively high government revenues would as a result receive a lower absolute amount of debt reduction.

This ‘bottom-up’ approach focuses on the resources needed by countries to commit to vital expenditures to achieve the MDGs by 2015. We of course realise that government spending can only ever be part of the solution to poverty reduction. Sustainable growth - that is, growth that creates economic opportunities that poor people can participate in and benefit from, while at the same time guaranteeing the sustainable use natural resources and ecosystems – should not, as a result, be overlooked. It, nevertheless, remains true that governments have an essential role to play in developing countries both for reducing poverty and fostering sustainable use of resources provided that they enjoy the fiscal space necessary to invest meaningfully in these issues.

____________________________

1