PUTTING POVERTY REDUCTION FIRST

Why a poverty approach to debt sustainability must be adopted

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“Rather than looking at how much debt relief countries really need if they are to fight disease and give even a basic education to their children, G7 summiteers in Cologne in 1999 arbitrarily defined a “sustainable” level of debt as equal to 150 per cent of exports […] an approach based on evidence would start with the needs of poverty reduction and fashion debt relief to help meet these needs”.

Jeffrey Sachs, Financial Times, 24/07/01.

The current HIPC initiative will not go far enough in changing the poverty situation of HIPCs because it does not take into consideration the resources these countries need for poverty-reducing expenditures and for spurring growth. This paper sets out why a new approach is needed – and makes new calculations of what levels of external debt service are ‘affordable’ for HIPCs.

Introduction: the current approach to debt sustainability is inappropriate

The current set-up of the HIPC Initiative assesses how much debt a country has in relation to its exports. If the net present value of debt exceeds 150% of exports, then the country qualifies for debt reduction of an amount that will bring the ratio down to or below 150%.¹ In theory, the criterion takes the availability of foreign exchange from exports as the main constraint for debt sustainability. However, this approach has repeatedly been criticised for several reasons:²

- Looking at exports is the wrong approach:
  - Rapid growth in exports may not always translate into more budgetary resources for the government to use to pay its obligations.
  - The volatility of commodity markets makes the debt-to-export ratio an unreliable benchmark to predict debt sustainability in the medium term.
  - But most importantly, an exports-based approach does not take into account what the poverty needs of a country are, and creates incentives for macroeconomic orientation that may not always be pro-poor.

- From the perspective of the amount of resources available to spend on poverty reduction, it is annual debt servicing that counts, not the absolute amounts of debt. It is, of course, the overall debt stock that dictates how much debt servicing will occur, but the best way to approach debt sustainability is to understand the maximum ‘affordable’ amount of debt servicing, and then cancel the debt stocks that would lead to debt servicing at a higher level than that.

A poverty approach to debt sustainability is needed

Eurodad has, amongst others³, urged that debt sustainability be seen in a broader context that incorporates the human development needs of the beneficiary countries. We propose the use of a poverty-focused debt sustainability criterion which takes as its starting point, for each country, an

¹ For more background information explaining the HIPC Initiative framework, please see: www.eurodad.org/1debts/analyses/general/hipcdiagram.pdf
² Note that countries can also qualify for debt relief under the ‘fiscal’ criterion which defines unsustainability as a debt-to-government revenue ratio of 250% or more. Although this criterion is conceptually closer to our proposal since it takes into account the resources available to governments, it was deliberately sidelined by setting the associated sustainability thresholds too high for countries to effectively qualify under this criterion. Moreover, it was accompanied by stringent ‘qualifying conditions’ (an Exports/GDP ratio of 30% or more, and a Government Revenues/GDP ratio of 15% or more) so that only five countries qualified under this criterion. For a more detailed overview of the current approach to debt sustainability, and its shortcomings, see www.eurodad.org/1debts/analyses/general/hipcdiagram.pdf
³ Notably CAFOD who first proposed the use of a Human Development Approach to debt sustainability (see www.cafod.org.uk/policy/debt-hda.htm) but also Zambian NGOs, and academics including Daniel Cohen, Jeffrey Sachs and the ‘PAIR proposal’ from a group of Belgian economists.
assessment of the resources that HIPCs will need to achieve poverty reduction and human development.

The main assumption is simple: that resources available to HIPC governments must first be used for essential expenditures that are necessary to fight poverty: clean water, primary health care, education and basic infrastructure, as well as for servicing domestic debt. Government resources that are left after these essential expenditures have been ‘ring-fenced’ can then be spent on other important but non-essential items, such as capital expenditure, civil infrastructure, police, security - and external debt servicing. Thus external debt service is here seen as a secondary concern and human development expenditures a priority. This reverses the current HIPC Initiative approach, where external debt service is the priority.

The proposed approach to debt sustainability would thus replace a debt-to-exports measure with one that measures what debt servicing is ‘affordable’ as a percentage of government resources. Unlike the existing HIPC Initiative sustainability criteria, however, the criterion would not be set at any one level in a top-down fashion, but would vary between countries. This allows the approach to be responsive to the fact that the ability to service debt is not the same in all countries. Some HIPCs can ‘afford’ to dedicate a significant percentage of government resources to debt servicing, without compromising essential poverty spending. In others, government resources are so small, and the costs of achieving basic poverty reduction objectives so relatively large, that they have no capacity at all to service external debt. Finally, similarly to the HIPC Initiative, any debt stock that results in annual debt servicing bills higher than that calculated as being sustainable should be cancelled.

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 such an initiative. Countries that are relatively less indebted relatively less poor, or have relatively high government revenues would as a result receive a lower absolute amount of debt reduction. Such an approach would be empirical and consistent across countries, avoiding the arbitrary and unfair current distinction between LDCs that are HIPCs and those that are not HIPCs, which is sometimes advanced by the IFIs as a reason for not proceeding further with debt reduction.

The conservative calculations that we have made demonstrate that, of the first 21 countries to reach Decision Point, at least 7 have no capacity whatsoever to service external debt, and that at least an additional 9 require significant extra debt reduction.

Note that this paper aims to outline a more pro-poor debt service methodology. However, getting the right environment in place so that the benefits of debt reduction actually accrue to the poor is also vital. NGOs have repeatedly stressed that debt cancellation is a one-off opportunity for increased poverty-reducing expenditures that cannot be wasted because of bad governance and corruption.

The approach

The methodology used is simple. The starting point consists in assessing, for each country, the overall resources available to the 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 development.

4 A lot of information required to determine the amounts of resources required could be derived from the analysis and costings set out in a country’s strategy for poverty reduction. Indirectly, this would also lead towards achieving the 2015 International Development Goals.

5 For more on this important issue, including a review of mechanisms that ensure freed-up resources are channelled to the right place, see http://www.eurodad.org/1debts/indexdebts1.htm for details.

6 Disbursements on new loans are also not included for two reasons:
   • Essential spending programs on health, education or water supply and sanitation do not directly generate foreign exchange earnings, and therefore should not be financed through loans. Grants, on the other hand, are assumed to be ‘sustainable’ resources. It could additionally be argued that the tied character of much ODA means that less than 100% of the nominal value is available to the authorities for discretionary spending, but we have not attempted to include here the impact of this.
   • More fundamentally, what we are saying here is that past borrowing has not succeeded in accelerating growth in low-income countries, but has instead led to debt burdens that have reduced governments’ capacity to pay for essential poverty-reducing expenditures. The solution is not simply to start once again on an indebtedness cycle by using long-term loans to finance current poverty expenditures, but to understand what resources are needed to achieve shorter-term poverty reduction targets in a sustainable fashion. This is NOT to say, however, that there is no role for appropriate
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 meet the essential human needs of its population. These needs are defined somewhat narrowly as the access for all citizens to primary health care services (including AIDS prevention and basic treatments), safe drinking water and sanitation, and to primary education. A more detailed explanation of the data used is provided in appendix 2.7

Next, we argue that repayment of domestic creditors should also be prioritised over external debt payments, as this is particularly important for maintaining macro-economic stability and the integrity of the financial sector. Finally, it is also assumed that no more than a third of remaining resources should be used to service foreign debt in order to take into account other ‘non-essential’ but nonetheless important public expenditures that need to be made.8 These would include the costs of running the civil service, police force and judiciary, as well as basic investments in infrastructure. ‘Affordable debt service’ thus represents a third of the government’s remaining resources after essential expenditures and domestic debt service payments have been made.

What does such an approach tell us about HIPC’s future debt sustainability?

The figures used for this exercise are only approximations of the real sums that will be needed, and more work is certainly needed to get more robust estimates for the resource requirements. These estimates are also likely to evolve according to national and international events (for example, with regarding to both donor flows - as illustrated by the planned decreases in both the Japanese and German ODA budgets - and the possibility for recipient countries to generate resources domestically as growth rates change). They do, however, provide interesting benchmarks to assess the needs of HIPC’s relative to their resources and to judge the impact that current debt levels, and subsequent debt service levels have on their progress towards achieving basic human development requirements.

Comparing ‘affordable debt service’ levels derived from this methodology with current debt service levels shows that the 21 HIPC’s analysed9 can be divided into three different categories:

- **The ‘bankrupt countries’**: For seven countries (Burkina Faso, Gambia, Guinea-Bissau, Malawi, Niger, Tanzania and Uganda), the sum of essential spending needs and domestic debt service payments are already greater than available resources. In other words, these six bankrupt nations cannot afford to spend any resources on debt service whatsoever. These countries need to have their external debt cancelled in its entirety. They also desperately need additional transfers in the form of grants if they are to have sufficient resources for essential poverty reduction expenditures, let alone for other ‘non-essential’ expenditures.

  The case of Malawi provides a good illustration of the constraints facing this group of countries. It can be seen from the chart overleaf that even after allocating all resources to essential spending (i.e. without any spending on other expenditures or external debt service), the human development needs identified will still be unfulfilled. Malawi needs additional grant financing both to bridge this financing gap and then also to have some resources to devote to other non-essential expenditures. There is no room for external debt servicing.

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7 The amounts of resources required are generally country-specific estimates of the minimum levels of average annual public expenditure needed to reach the internationally-agreed development goals for 2015.
8 Note that given the low level of fiscal revenues committing 33% of remaining resources to external debt service is a very generous assumption indeed. CAFOD, for example, argued for a figure of 20%. However, we have made this analysis as conservative as possible in order to be convincing.
9 These are 21 out of the 23 HIPC’s that have reached a Decision Point in the enhanced HIPC Initiative. Chad and Sao Tomé are not included because of a lack of data.
The ‘overindebted countries’: For an additional nine countries, some level of external debt servicing is possible, as the total resources available to the government are greater than the essential spending requirements. However, the level of ‘affordable’ debt service calculated from a poverty perspective is lower than the amount of debt servicing that these countries are currently paying. These countries thus need additional debt reduction beyond what is on offer in the HIPC Initiative.

In the case of Benin, for example, essential needs related costs and domestic debt service payments take up to three quarters of overall resources. If Benin allocates one-third of the resources remaining (after deducting essential poverty spending) to external debt service (thus about 10% of the overall resources available), then external debt servicing would have to drop by at least $8 million per year.

At the same time, Benin’s ‘non-essential’ expenditure would be limited to a mere 15% of overall resources. Although this could be seen as sustainable from an essential needs perspective, it is obvious that additional resources would need to be mobilised to allow for more expenditures on the rest of the economy.

NB: Affordable debt service: $37 mil.  Actual debt service: $46 mil.
• The ‘currently sustainable’ countries: for the five remaining countries (Bolivia, Honduras, Mozambique, Nicaragua and Senegal) the situation is not so acute. Resources required for essential needs are significantly less than total resources available, and our approach shows that the external debt-servicing levels after the HIPC Initiative are likely to be sustainable from a human development perspective.

For Honduras, for example, resources that could safely be employed to finance ‘non-essential’ expenditures take the lion’s share of total resources and the affordable debt service is above the levels reached after the implementation of HIPC debt relief. It should be remembered though that we have used very conservative assumptions in these calculations; the poverty situation in these countries is still very concerning.

### Conclusion

It should be stressed again that the calculations presented are to illustrate the approach and are not intended to make specific recommendations on appropriate debt servicing levels, country by country. We have been deliberately conservative in order to make the case for additional debt reduction clear and compelling. The analysis clearly shows nonetheless that the enhanced HIPC Initiative is inadequate when the debt issue is approached from a poverty perspective. Eurodad proposes that the current HIPC Initiative be replaced by this new approach to debt sustainability. This approach would identify, in an empirical fashion, those low income countries that have high levels of indebtedness, high levels of poverty but that have insufficient resources to meet the basic needs of their population in order to reach the 2015 international Development Goals.

This paper looks at the debt issue from an ‘economic’ perspective, not a political perspective. One has also to bear in mind the broader context, including the capacity and willingness of recipient governments to use resources freed up by debt relief to reduce poverty. A commitment to use the one-off opportunity of debt reduction appropriately is a vital enabling factor.

**Poverty in a wider perspective: the link to pro-poor growth**

This poverty approach focuses on the resources that countries need to address constraints on vital poverty-reducing expenditures. We of course realise that government spending can only ever be part
of the solution to poverty reduction. Pro-poor growth - that is, growth that creates economic opportunities that poor people can participate in and benefit from - is clearly key, and Eurodad maintains that loan financing (at a sufficiently concessional rate) has an important role to play in enhancing these opportunities. Non-income aspects of poverty reduction, such as protecting poor people from risks, are similarly important. This poverty approach to debt sustainability is thus just one part of a larger picture. But by focusing on the domestic resources available to the government, this approach will enhance the prospects of a pick-up in economic growth by ensuring investments in human and social capital can occur, as well as focusing public expenditure on pro-poor aspects.
Debt service reduction needed / current external debt service (%)

- **Bankrupt countries**: Countries needing 100% debt cancellation
- **Overindebted countries**: Countries needing additional debt reduction
- **Currently sustainable countries**: Countries whose debt service levels are affordable from an essential needs perspective

Bankrupt countries will need additional grants even to meet basic poverty reduction targets.
### Appendix 1

<table>
<thead>
<tr>
<th>HIPC Countries that have reached Decision Point (except Chad and Sao Tome &amp; Principe)</th>
<th>Fiscal revenue (99-01 average)</th>
<th>Grants (97-99 average)</th>
<th>Total resources available</th>
<th>Resources</th>
<th>Essential Needs Spending</th>
<th>Affordable d.s.</th>
<th>Additional resource needs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US$ millions</td>
<td></td>
<td>AIDs</td>
<td>Health &quot;minimum package&quot; 185$ per person per year (excluding AIDS)</td>
<td>Water Supply &amp; basic infrastructure 20$/ca/year</td>
<td>Education expenditures 1999 (1995-97)</td>
<td>Education annual additional expenditures required</td>
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<tr>
<td>Benin</td>
<td>429</td>
<td>114</td>
<td>543</td>
<td>15</td>
<td>110</td>
<td>122</td>
<td>74</td>
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<td>Bolivia</td>
<td>2,054</td>
<td>245</td>
<td>2,300</td>
<td>24</td>
<td>146</td>
<td>162</td>
<td>392</td>
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<td>398</td>
<td>216</td>
<td>614</td>
<td>45</td>
<td>202</td>
<td>224</td>
<td>94</td>
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<tr>
<td>Cameroon</td>
<td>1,759</td>
<td>202</td>
<td>1,961</td>
<td>20</td>
<td>263</td>
<td>292</td>
<td>252</td>
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<tr>
<td>Gambia</td>
<td>78</td>
<td>19</td>
<td>96</td>
<td>7</td>
<td>23</td>
<td>26</td>
<td>20</td>
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<tr>
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<td>369</td>
<td>152</td>
<td>521</td>
<td>25</td>
<td>144</td>
<td>160</td>
<td>72</td>
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<tr>
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<td>47</td>
<td>90</td>
<td>6</td>
<td>22</td>
<td>24</td>
<td>12</td>
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<tr>
<td>Guyana</td>
<td>238</td>
<td>110</td>
<td>348</td>
<td>2</td>
<td>14</td>
<td>16</td>
<td>35</td>
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<tr>
<td>Honduras</td>
<td>1,173</td>
<td>180</td>
<td>1,353</td>
<td>19</td>
<td>113</td>
<td>126</td>
<td>166</td>
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<td>Madagascar</td>
<td>488</td>
<td>367</td>
<td>854</td>
<td>48</td>
<td>279</td>
<td>310</td>
<td>70</td>
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<tr>
<td>Malawi</td>
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<td>195</td>
<td>558</td>
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<tr>
<td>Mali</td>
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<td>661</td>
<td>20</td>
<td>198</td>
<td>220</td>
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<tr>
<td>Mauritania</td>
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<td>150</td>
<td>436</td>
<td>13</td>
<td>47</td>
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<td>51</td>
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<tr>
<td>Mozambique</td>
<td>540</td>
<td>605</td>
<td>1,145</td>
<td>75</td>
<td>322</td>
<td>358</td>
<td>106</td>
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<tr>
<td>Nicaragua</td>
<td>639</td>
<td>299</td>
<td>938</td>
<td>15</td>
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<td>98</td>
<td>70</td>
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<tr>
<td>Niger</td>
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<td>157</td>
<td>325</td>
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<td>189</td>
<td>210</td>
<td>46</td>
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<tr>
<td>Rwanda</td>
<td>190</td>
<td>184</td>
<td>374</td>
<td>15</td>
<td>128</td>
<td>142</td>
<td>36</td>
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<tr>
<td>Senegal</td>
<td>880</td>
<td>288</td>
<td>1,168</td>
<td>30</td>
<td>166</td>
<td>184</td>
<td>174</td>
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<tr>
<td>Tanzania</td>
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<td>551</td>
<td>1,626</td>
<td>120</td>
<td>617</td>
<td>686</td>
<td>201</td>
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<tr>
<td>Uganda</td>
<td>891</td>
<td>359</td>
<td>1,251</td>
<td>110</td>
<td>407</td>
<td>452</td>
<td>172</td>
</tr>
<tr>
<td>Zambia</td>
<td>611</td>
<td>285</td>
<td>895</td>
<td>70</td>
<td>184</td>
<td>204</td>
<td>70</td>
</tr>
</tbody>
</table>

| number of countries | 16 | 7 |
Appendix 2: Technical Notes

Sample

Due to the limited availability of the whole range of data necessary for this exercise, we originally limited our sample to 23 qualified HIPCs less Chad and Sao Tome & Principe. It would be interesting in future work to include non-qualified HIPCs and other LDCs in the analysis in order to have a more diverse range of countries and judge the relative merits of the HPC initiative from a poverty perspective. The new approach that we have set out above would identify countries that have high levels of debt and poverty coupled with low levels of domestic resources.

Data

On the resource side:

- Fiscal revenue figures are 1999 - 2001 averages (complete datasets were not available for earlier periods), taken from The Financial Impact of HIPC, first 23 cases (World Bank, August 2001).

- Data on Grants was taken from the Global Development Finance CD-Rom (World Bank, March 2001).

On the ‘needs’ side:

Essential needs were defined to include health, aids, education, water supply & sanitation and other basic infrastructure related costs. These choices were partially derived from the 2015 development targets although environment and income poverty issues are not explicitly covered in our selection of cost indicators. We tried whenever possible to use costing figures aggregated at the national level.

- Health essential expenditure estimates are taken form World Bank's "health minimum package" presented in the 1993 World Development Report and valued by World Bank researchers at US$ 12 per person in 1990 dollars. This package is comprised of public health interventions and essential clinical services. Note that the package does not include spending allocated for the fight against the AIDS epidemic.

- AIDS expenditures are taken from a joint study made by the World Bank and UNAIDS about the costs of scaling up HIV Program activities to a national level in Sub-Saharan Africa. The study provides estimates of additional national expenditures for all African countries. For Latin American countries, a conservative per capita average cost was extrapolated from our sample of African countries. These figures represent minimum costs, they do not, for instance, take into account the additional cost of providing anti-retroviral therapy. Note that the costings do not take into account current expenditures on AIDS, for which disaggregated data is lacking. This is not a major problem for countries that do not spend a large share of their budget on AIDS compared to what is needed. For other countries like Uganda or Malawi that already have an important AIDS budget, this represents a caveat that will need to be addressed.

- Education costs are the sums of current total spending on education (1995-1997 average) taken from the Word Development Report 2000 and estimates of the annual additional spending on primary education required to achieve universal primary education by 2015 taken from a recent UNICEF study. The methodology used UNICEF researchers was as follows: first, the number of children that will need to be enrolled to reach universal primary education by 2015 was estimated using current enrolment rate and demographic projections. Then, unit cost for the provision of primary education were estimated. Multiplying these two numbers gives the total additional expenditures needed until 2015. Finally this number was divided by 15 to get annual spending estimates. These estimations including unit costs were made whenever possible on a country basis.

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10 Costs of Scaling HIV Program Activities to a National Level in Sub-Saharan Africa: Methods and Estimates, AIDS Campaign Team for Africa (ACTafrica) March 31, 2001 World Bank
- Water supply and sanitation costs and other basic infrastructure costs were valued at a unit cost of 22$ per year per person. This is a very crude figure that would certainly need to be refined on a country basis.