

New Scenarios for future debt-relief and financing for low income countries

Introduction

At international fora such as the Monterrey Summit, the G7 and other industrialised countries have made pledges to expand development assistance to the poorest countries, in part to meet global targets for poverty reduction such as the Millennium Development Goals (MDGs). While these promises of increased financial assistance to low income countries are welcome, an increase in the volume of aid is not necessarily what is most needed by all low income countries. Over the last decade, many low income countries have implemented major reforms to ensure sound macroeconomic and budgetary management, to rationalise their budgetary systems to ensure that sectoral budgetary allocations reflect strategic priorities, and to enhance national ownership of the budget. Increased aid can support these reforms and contribute to the achievement of development goals in the low income countries, but only if it meets certain conditions.

Unfortunately, there is a real danger that, in the rush by multilateral and bilateral donors to expand their aid programmes in response to international commitments, donors will undermine the important economic and budgetary reforms which low income countries have implemented over the last decade. To avoid this, it is essential that the following conditions are met.

Aggregate Expenditure Control

First, the governments of aid recipient countries must retain control over the overall level of public spending, to ensure that excessive increases in public spending, financed by aid, do not undermine macroeconomic stability or the sustainability of public finances. Low income countries should not be pressured by aid donors to absorb more aid than can prudently be used in these countries, simply to meet international targets. I want to emphasise this point, because some of the aspirations voiced by international organisations for increased aid to low income countries lack realism. To give an example of this, the World Health Organisation's Macroeconomic Commission on Health recently called for an increase in donor

funding for health expenditures in Least Developed Countries (LDCs) which amounts to an average of 7% of these countries GDP per annum. It is simply inconceivable that an increase in public spending equivalent to 7% of GDP for one single sector would be feasible, let alone an optimal allocation of public resources, for most of the LDCs. There appears to be a belief among some donors and NGOs that a lack of finance is the main constraint to providing the public services needed to achieve development goals. What has not been fully understood is that the bulk of public services consist of non traded services which must be produced, by definition, within the aid recipient. Increased aid alone cannot deliver more non traded services. There has to be an expansion of the production of these services within the aid recipient, or a transfer of non traded services from the private to the public sectors within these countries. This inevitably has consequences for the growth and development of the private sector, especially the producers of traded goods such as exports.

Sectoral Budgetary Allocations

The second condition that must apply to any increase in aid is that it should not distort the allocations of resources between different sectors of the budget. These sectoral budgetary allocations should rightly be determined through the national budget process, and should correspond to nationally agreed budgetary priorities. In countries such as Uganda, the national budget process, and the identification of strategic priorities through the Poverty Eradication Action Plan, already incorporate extensive consultation with stakeholders, including donors and NGOs. These are the appropriate fora for determining the overall sectoral composition of the national budget, so that the budget reflects a rational allocation of scarce budgetary resources among competing sectors.

What is not compatible with rational budgeting is for donors to provide additional aid and to insist that this aid is allocated to a specific sector, or even specific expenditures within that sector. Unfortunately, that is the logic behind the global funds, such as the global funds for health and education, which have recently been set up. I will return to the WHO's Macroeconomic Commission on Health to give an example of this flawed thinking. The Macroeconomic Commission on Health advocated setting up a National Commission on Macroeconomics and Health in each LDC, to mobilise resources from

donors, and to scale up health spending with these resources. This mechanism would effectively take health spending out of the normal budget process in LDCs.

While it is likely that the health sector deserves more resources in most LDCs, how much money is allocated to the sector cannot be determined in isolation from the rest of the budget. How much extra money should be allocated to health, and to other sectors such as education, should be determined through the national budget process on the basis of national budgetary priorities and absorptive capacities, not by the volume of financial resources that can be mobilised from a global fund, or from other forms of donor aid which are earmarked to specific sectors. I am not arguing that donors should not have a right to a say in how their resources are allocated in the budgets of aid recipients, but the donors' views should be articulated collectively through the appropriate fora in the budget process, such as the Public Expenditure Reviews.

Predictability of Resource Flows

The third condition that increased aid should meet is that it must make aid flows more, and not less, predictable. Disbursements of aid are volatile and unpredictable, even in countries which have a good track record: for example those which have maintained satisfactory performance under IMF programmes. Many low income countries now plan their budgets on a medium term basis, using Medium Term Expenditure Frameworks. Effective medium term budget planning will be undermined if resource flows are unpredictable, because Finance Ministries and individual sectors cannot draw up predictable spending plans if the resources required to fund this spending cannot be relied upon. I think everyone here will appreciate how damaging it will be for the sustainability of public finances in low income countries if governments in these countries increase public spending on the basis of promises of more aid which subsequently prove over-optimistic.

What sort of financial assistance meets these conditions and is, therefore, fully compatible with maintaining national ownership of budgetary policies in aid recipients and with maintaining sound public finances?

The most optimal form of aid is general budget support, because this allows the recipient the greatest flexibility in determining budget allocations, and it also ensures that the aid is channelled through the normal budget procedures. Many donors, including the World Bank, recognise the optimality of general budget support over other forms of aid and are gradually switching more of their aid into budget support from the traditional project aid modality. However, the benefits of this switch into budget support will be undermined if donors attempt to earmark aid to specific sectors, such as education and health, and thereby distort optimal budget allocations.

Debt Relief

Increased debt relief would be a useful modality for delivering increased financial assistance, especially if it entails the cancellation of debt, because this provides the greatest degree of long term predictability in resource flows.

The HIPC debt relief initiatives have proved very valuable in deepening debt relief for low income countries, and have yielded two important benefits. First, by reducing the burden of debt servicing, HIPC has freed up resources which can be used for expanding the provision of essential public services such as primary education and health care. Secondly, by reducing the external debt burden to more sustainable levels, HIPC has helped to bolster confidence in the long term economic prospects of the beneficiaries and the sustainability of their public finances, which is essential if these countries are to attract more private investment. However, the design and implementation of the HIPC initiative has proved flawed, for two main reasons, as is evident from our own experience in Uganda.

First, debt sustainability has been defined principally in terms of the net present value of the HIPC's external debt to its export earnings, with a 150% ratio of debt to exports being regarded as the maximum sustainable level. Unfortunately, the debt sustainability projections on which the amount of HIPC debt relief for countries such as Uganda was determined incorporated over optimistic projections of international commodity prices, such as coffee prices, with the result that their future export earnings were overestimated. The consequence is that the actual debt relief provided under the Enhanced HIPC initiative has proved insufficient to ensure that the HIPC's

external debt remained below the threshold level for sustainability, given that their export earnings have been adversely affected by the fall in world market commodity prices.

The second problem that Uganda is facing is that the HIPC Initiative has not been able to ensure that all creditors provide debt relief on the basis of equal burden sharing. Equal burden sharing is a cardinal principle of international debt relief initiatives, to prevent some creditors free riding on the generosity of others. Regretably, several non Paris Club bilateral creditors have refused to provide debt relief in accord with the HIPC principles, even though these countries are represented on the Executive Boards of the IMF and IDA which unanimously approved the granting of HIPC debt relief to Uganda. Alongside these non Paris Club creditors, a few multilateral creditors (mainly regional development banks) and commercial creditors have also refused to offer debt relief which is consistent with the Enhanced HIPC initiative, and some of these creditors have instigated legal proceedings against the Government of Uganda in the Ugandan courts.

While there is probably not much which can be done by the international community to discipline commercial creditors, there is an urgent need for the international community to devise a mechanism to ensure that the bilateral official creditors of the HIPCs actually meet their obligations to provide debt relief under the Enhanced HIPC Initiative, alongwith the multilateral development banks, which are owned by sovereign governments. Unless this is done quickly, many of the HIPCs risk being forced to pay out far more money to the recalcitrant creditors who have refused to participate in the HIPC Initiative than they will receive in debt relief under the Enhanced HIPC Initiative. To give an example of this, Uganda receives approximately \$85 million a year in debt relief under the HIPC initiatives, but faces demands for almost double this amount from just one bilateral creditor – Libya.

Conclusion

I will conclude by briefly summing up the points I have made. Increased financial assistance can contribute to development in low income countries but the modalities of this aid are crucial. Governments in the aid recipient countries must retain control

other the aggregate level of public spending, and the amount and timing of any increases in public spending funded from aid. The benefits of increased funding for social services must be balanced against the possible costs to other sectors of the economy. Governments must also retain control over the sectoral composition of their budgets, through the national budget process. Greater long term predictability of aid flows is essential if larger transfers of financial resources to low income countries are to be the basis of increased public spending in these countries. Finally, the Enhanced HIPC debt relief initiative has brought important benefits to the low income countries which have received debt relief under the initiative, but these benefits risk being undermined for two reasons. First, because over optimistic projections of the recipients' export earnings were used to determine the debt relief that would be required to maintain their external debt at sustainable levels, and secondly, because the international community has not been able to ensure that all of the HIPCs' creditors provide debt relief on the basis of equal burden sharing.