

## THE AID ARCHITECTURE DEBATE: BEYOND BUSAN

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### DEBT RELIEF AS DISGUISED BUDGET SUPPORT

*The Research Platform on Aid Effectiveness is based at the Institute of Development Policy and Management (IOB, University of Antwerp, Belgium). This Platform studies the 'new aid architecture' (NAA) from four angles: (1) political economy of aid, reform and governance; (2) monitoring and evaluation; (3) gender; (4) macroeconomic and fiscal dimensions of aid. Policy briefs summarise the most important findings of research carried out by the team while presenting some specific recommendations. This brief sheds light on the degree of equivalence between recent major debt relief schemes and (general) budget support.*

#### PART I: EVIDENCE

##### Introduction

In 1996 the 'Heavily Indebted Poor Countries' (HIPC) Initiative for debt reduction was introduced. In 1999 it was replaced by a more generous, 'enhanced' version, which was succeeded in 2005 by the Multilateral Debt Relief Initiative (MDRI). Through these initiatives, debt relief has become an important feature in the relations between rich and poor countries, not only because of its sheer volume (also in ODA terms), but also because it is acknowledged as an 'alternative' financial instrument. Indeed, debt relief is now regarded as an important modality of aid, alongside more traditional project aid, technical assistance, balance of payments support in support of Structural Adjustment Programmes, sectoral (SBS) and general budget support (GBS).

At first glance, a reduction of public debt bears a close resemblance to grant-type GBS. Indeed, a reduction of public sector debt service obligations increases the amount of resources in the government's budget. In other words, it increases the fiscal space of a country, enabling the government to reduce the fiscal deficit, to increase spending, to reduce taxes, or any combination of the three, just like GBS would.

This brief discusses to what extent international debt relief granted under these recent international initiatives is indeed similar to GBS, and to what extent debt relief is as good as providing 'new' resources. To the extent that the answer to both questions is positive, we address the co-existence of two separately managed but basically identical aid modalities, i.e. debt relief and GBS. We also assess debt relief in case the answer to the above questions is not unequivocally positive. To start, we briefly list the most salient features of GBS.

##### Basic features of GBS

When aid is provided through GBS, it not only provides additional international purchasing power to the country, it also increases the spending capacity of the government. GBS flows into the budget and into its treasury system; in donor jargon, it is both policy-aligned and system-aligned. An important feature is also that it is intentionally 'fungible': donors pool their aid resources with taxes and other government revenue, and in this way finance the whole of government spending without being able to earmark certain types of expenditure. Another feature is the policy dialogue between the donor(s) and the recipient country government on issues related to technocratic and sometimes also democratic governance reforms (see also brief 1), with donors deciding on the continuation of the partnership on the basis of their assessment of the progress being made. For these reasons, GBS is considered the aid modality that best serves the principles of the 2005 Paris Declaration, especially recipient country ownership, alignment, and donor harmonisation.

##### Is debt relief similar to GBS?

As with other aid modalities, debt relief comes with some strings attached by donors. Donors may wish to steer the use of the debt relief savings. This can be done by micro-earmarking the use of resources, such as is typical in the project aid modality, or it can be done through sector-earmarking, such as with SWAPs or SBS, or it can be unearmarked, such as in the case where debt relief is granted in support of a broad recipient country development strategy. Only in the latter case is there equivalence with GBS. Furthermore, the donor may wish to make use of a particular system of managing the funds from debt relief, rather than using the recipient country system. Again, only in the latter case is there equivalence with GBS.

In sum, the degree of earmarking (or its reverse, policy-alignment) and the degree of system-alignment will be crucial elements in assessing the equivalence of debt relief with GBS.

### **Is debt relief as good as new resources?**

Determining the cash flow equivalence of debt relief with new aid resources is not straightforward. First of all, a decision to cancel a given nominal amount of debt does not lead to immediate equivalent cash flow gains. The cash flow gains arise over a period of time, depending on the original debt service schedule of the debt being relieved. To take into account both the volume of debt relief and the time dimension, the Present Value (PV) of future debt service payments relieved is used as the appropriate summary indicator of the (contractual) cash flow gains. For debt relief targeting debt service claims that are backloaded (i.e. mainly due in a distant future), the PV might be substantially less than the nominal value of the debt relieved. In order to determine the cash flow equivalence of debt relief with other aid flows in a particular year, we take the debt service savings of debt relief in that particular year only.

More importantly, to the extent that the debt service due would not have been paid in the absence of debt relief, no cash flow savings materialise. As in practice debt forgiven often would have been serviced only in part, debt relief is more correctly measured as the PV of debt service *that would have been serviced* in the absence of debt relief. This is sometimes referred to as the 'economic value' of debt relief. In a similar fashion, the annual cash flow equivalence of debt relief is determined by the cancelled debt service of that year *that would have been serviced* in the absence of the debt relief. Different assumptions about future debt servicing capacity (and debt service willingness) of the indebted country will lead to different estimates of this cash flow equivalence of debt relief.

### **Application to (enhanced) HIPC/ MDRI debt relief**

In 1996, the international community decided on a 'once and for all' effort to solve the problem of unsustainable external debts of about 40 countries, the HIPCs, by engaging in a concerted effort to reduce their debts to a sustainable level, defined in balance of payments terms (a fixed PV of debt to exports level) or in fiscal terms (a fixed PV of debt to fiscal revenue level). Harmonization of efforts between all creditors of a given recipient country was assured by fair burden-sharing principles, based on relative exposure. In order to be eligible (i.e. becoming HIPC), the recipient country had to be IDA-eligible, and hold an unsustainable external debt as defined according to the same sustainability levels mentioned above. In 1999, the initiative was enhanced by deepening debt

relief - the balance of payments and fiscal thresholds were lowered to 150% and 250% respectively - and by strengthening the link with poverty reduction.

Enhanced HIPC debt relief is granted after the successful completion of a donor-imposed set of conditionalities. Some of these conditionalities relate to macro-economic stability, and are comparable to an IMF programme. Others relate to the elaboration and implementation of a broadly-owned recipient country development and poverty reduction strategy (the PRSP). On top of this, some country-specific conditionalities ('triggers') may be included with regard to the quality of public service delivery, PFM, debt management, and the like. The enhanced HIPC initiative was engineered as a two-stage process. A *Decision Point* is reached after complying with some initial conditionalities (basically having a track record of macro-stability and IMF-like reform, and a preliminary PRSP strategy). This is followed by an interim period of further compliance with the remaining conditionalities leading to the *Completion Point*, when the debt stock is irrevocably relieved up to the fixed sustainability level. During the interim period, some donors already provide the recipient country with interim debt (service) relief, broadly consistent with final debt relief terms. As of now, 32 countries have completed the full trajectory and have received full HIPC debt relief, thereby in principle regaining a sustainable external debt level; 4 more countries are currently in the interim period.

Two categories of creditors have decided to go beyond enhanced HIPC debt relief. First, most Paris Club bilateral creditors decided to further cancel all their own remaining eligible claims of these HIPCs at Completion Point. Furthermore, from 2005 on, some major multilateral creditors (World Bank, IMF, AfDB and IADB) did the same through the MDRI with their remaining eligible claims, again for HIPCs only. As they have different characteristics, we will discuss these two 'topping up' debt relief interventions separately.

#### **1. (Enhanced) HIPC debt relief**

From the description of HIPC conditionalities described above, it is clear that enhanced HIPC debt relief in principle fully matches GBS. The process is situated within a country-owned development strategy, focuses on governance reform, is not earmarked and is fully policy and system-aligned. In practice however, in some countries, this was not always fully realised as donors insisted on some degree of earmarking, and imposed separate tracking systems of the use of 'their' funds, and/or used procedures other than those for genuine public resources. Such limitations made that debt relief became to resemble less GBS than 'lower' modalities of programme aid. It must be added that such donor restrictions were often limited to the interim debt

relief period. The broad equivalence between HIPC debt relief and GBS should not be surprising. In fact, the HIPC process functioned as a 'pilot' scheme to experiment with principles that later became embedded in the Paris Declaration.

What is more questionable is whether enhanced HIPC debt relief was as good as new resources. If HIPC debt relief was effective at targeting the cancellation of 'unsustainable' debt, it follows that most of the contractual debt relief did not lead to additional public resources in an economic value sense. This is unwittingly acknowledged in the IMF practice of insisting that only a part of the total HIPC debt service gains be budgeted as additional revenue in government accounts. In total, HIPC debt relief so far amounts to about 60 billion USD in PV terms, slightly less than half of which can be considered as additional resources, similar to grant-form GBS cash flows. This is a considerable amount of real resources, but it should be remembered that the geographical allocation of this GBS-like aid is heavily constrained by the strict HIPC rules. Furthermore, the extent to which this HIPC debt relief indeed delivers additional resources varies a lot across countries. Overall, the HIPC process, in addition to its considerable contribution to debt sustainability, can best be understood as a platform for governance reform and increased poverty-focus of the recipient country public sector, more so than a vehicle for increased resource availability.

## **2. Additional bilateral HIPC relief**

In their topping-up on HIPC debt relief, Paris Club bilateral creditors did not attach any additional conditionalities other than the ones already established through the HIPC process. Therefore, this constitutes a GBS-type aid modality.

Furthermore, to the extent that this additional bilateral action targeted debt titles that would in principle have been serviced in the absence of debt relief, we can assume close to full cash flow equivalence. At the moment of writing, total additional bilateral HIPC debt relief is estimated at around 7.8 billion USD in PV terms. In this respect, the equivalence with grant-form GBS is complete.

## **3. MDRI debt relief**

The assumption of full equivalence with grant-form GBS also applies to MDRI debt relief, as again we can assume close to full cash flow equivalence, and no additional conditionalities were attached to this topping-up. When it was introduced in 2006, those countries that had already achieved the full HIPC trajectory received it as a topping-up after a light ex-post conditionality check (macro-stability, broad adherence to PRSP, quality of PFM). Countries that achieved Completion Point status later immediately

received the topping-up. Additional GBS in debt relief form through MDRI debt relief is currently estimated at around 29.6 billion USD in PV terms.

## **Implications of two separate but almost identical aid modalities**

So, rather than being an alternative aid modality, part of enhanced HIPC debt relief, and most of additional bilateral HIPC as well as MDRI debt relief are best understood as almost identical to the GBS aid modality. What are the consequences of this conclusion?

For countries that receive both GBS and debt relief, debt relief de facto acts as a (disguised) supplement to the genuine GBS they receive, with the additional bonus that it is all in grant form. In fact it is even more interesting than this, for this is multi-annual quasi-GBS, extended over the full debt service horizon, in an irrevocable manner, unlike genuine GBS that is often granted on a one, two or three-year basis and subject to continuous policy dialogue between the donor community and the recipient government, and that can be discontinued in case the donors judge that there has been a breach of Underlying Principles. As such the debt relief modality acts as a kind of long-term fixed-tranche GBS.

The fact that some countries receive HIPC/MDRI quasi-GBS debt relief but not genuine GBS is puzzling, to say the least. How to explain that donors do not deem these countries eligible for GBS, yet through additional bilateral debt relief and MDRI, provide quasi-GBS support that is *not* linked to achieving debt sustainability in those countries?

Finally, for countries that receive GBS but are not considered by the donor community to be eligible for HIPC/MDRI, another inconsistency seems to occur. If they are eligible to GBS, why not to quasi-GBS debt relief that is unrelated to debt sustainability?

## **Does debt relief always look like GBS?**

So far, we have identified large-scale debt relief under the enhanced HIPC Initiative and its successor, the MDRI, and bilateral topping-up, as being very similar to GBS. Does this equivalence necessarily hold for all types of debt relief? More particularly, how can we assess pre-HIPC debt relief extended, mainly in the Paris Club, both through debt rescheduling operations ('consolidations') involving an element of debt relief, as well as through debt swap-related operations?

## **Paris Club consolidations**

From 1988 on, the Paris Club bilateral donors progressively included elements of debt relief in their

rescheduling operations, first in terms of debt service relief, later also on debt stocks. The only explicit conditionality was the requirement for the country to have an active IMF programme. Poverty-orientation was not an issue, and no other conditionality triggers were imposed. Such debt relief was thus comparable to aid delivered through the Structural Adjustment Programmes. Moreover, cash flow equivalence was limited as most of the debt relief would not have been serviced in the absence of the consolidation.

Note that the initial 1996 HIPC Initiative shared many elements of this approach. But because it included deeper debt relief, and multilateral debt relief for which the economic value was higher, the cash flow equivalence of this type of debt relief was nevertheless higher than pre-HIPC debt relief.

### **Debt-for-development swaps**

In a debt swap, external debt service is typically cancelled in exchange for local currency counterpart funds, usually at a discount, to be used for specific development purposes. It is typically earmarked and not policy-aligned. Often it is not system-aligned either. This looks very much like 'old' donor micro-managed project aid. Furthermore, cash flow equivalence seems to be very limited, as often the debt being forgiven would not have been serviced in the absence of the swap.

In recent years, we witness a comeback of debt swaps, in which debt is swapped for counterpart payments in education, health (e.g. the Global Fund 'Debt2Health' scheme) or environmental protection. These swaps typically target debt not eligible for the HIPC/MDRI, or, more importantly, debt of countries outside these debt relief initiatives. In the absence of an international agreement for additional comprehensive debt relief schemes, such isolated debt-swap initiatives seem to be the only alternative currently available. Overall, they have to be considered as inefficient, typically sharing most of the deficiencies of the first generation debt swaps. At best, and to the extent that they are engineered in an aligned way, they can be considered equivalent to 'new-style' projects, and fit into the Paris Declaration.

## **PART II: RECOMMENDATIONS**

- Debt relief is best provided in accordance with the principles underscoring the Paris Declaration. This results in debt relief that has quasi-GBS features.
- In order to increase the aid cash flow equivalence of debt relief, it should be targeting as much as possible hard-currency non-concessional debt titles that have a high probability of being serviced in the absence of debt relief, and with most of the cash flow savings arising in the first years ('frontloading')
- Donors should look at GBS and quasi-GBS debt relief jointly, so as to avoid policy inconsistencies. The decision to give long-term fixed tranche quasi-GBS debt relief to HIPC countries should be considered a prima facie argument to also provide genuine GBS, and the other way around.
- Donors should refrain from using debt swaps to reduce debt of countries currently ineligible for the major debt relief initiatives. Only careful engineering (including policy- and system-alignment) and scaling-up can turn such debt swaps into an efficient debt relief modality, in which case they would in fact again become almost indistinguishable from genuine budget support.

### **References and project information**

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