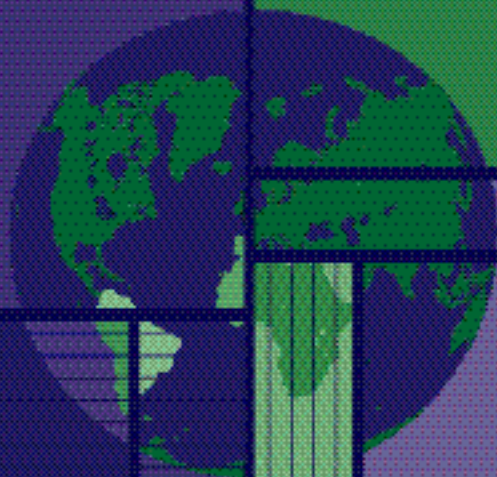


Children in Jeopardy

The challenge
of freeing poor
nations from the
shackles of debt



unicef 
United Nations Children's Fund

Children in Jeopardy

*The challenge of freeing poor
nations from the shackles of debt*



UNICEF/98-0224/Cemmen

The poverty trap: Years of drought followed by floods have impoverished and displaced thousands of families in north-eastern Kenya. Under-five mortality rates are escalating. Even when their children do survive, many parents cannot afford to put them in school.

Since the early 1980s, UNICEF has been voicing its concern about the plight of children in the world's heavily indebted poor nations, which are driven by unsustainable debt burdens to spend more on servicing their external debt than on the basic health and education that would safeguard their own and their children's future. Crippling debt has been one of the reasons why progress has not kept pace with the promises made at the 1990 World Summit for Children.

The borrowings of the past are undermining investments in the future: debt has a child's face, and UNICEF has long advocated more assertive measures to counter it. Putting principle into practice, UNICEF has helped to convert nominal debt of nearly \$200 million into programmes for children.

This report assesses the progress of the Heavily Indebted Poor Countries Initiative launched in 1996 to address the debt crisis, along with the major reforms to the Initiative suggested in June 1999 by the Group of Seven. It presents the joint UNICEF-Oxfam proposal to set the eradication of poverty at the heart of debt relief reform. By this we mean not only buttressing the overall economic stability of the debtor nations, but also ensuring that the benefits will reach the many millions of the poorest in these countries who struggle to survive on incomes below \$1 per person a day. The issues are complex, and many of them lie outside the purview of this brief report: poverty eradication requires action on a multiplicity of fronts, ranging from how international trade agreements are formulated and how nations handle liberalization and privatization, to the participation of local communities in the allocation of resources and the design and implementation of specific projects and programmes.

This report is a contribution to the continuing dialogue on how best to reconcile the interdependent objectives of human rights, economic growth and social development. UNICEF and Oxfam share the conviction that measures to ease the shackles of debt, and so improve the economic outlook for the heavily indebted countries, will in the end fall short unless they protect the spending on basic social services that will guarantee children's right to grow up into healthy, well-nourished, literate citizens, fully equipped to contribute in their turn to their nations' economic recovery.

Carol Bellamy
Executive Director
UNICEF
New York, 20 September 1999

“The problem is not that we have tried to eradicate global poverty and failed; it is that no serious and concerted attempt has ever been made.”

James P. Grant,
former Executive Director
of UNICEF, 1993

In the mid-1980s, Julius Nyerere, then President of Tanzania, captured the human costs of the debt crisis in a stark question to creditors: “Should we really let our children starve so that we can pay our debts?” The response was a deafening silence. Many of the world’s poorest countries have continued to service their debts at the cost of increased poverty, collapsing health systems and declining opportunities for education. Investments for the future have been undermined by the debts of the past.

This picture may be about to change. The debt problems of the poorest countries figured prominently on the agenda of the Group of Seven at their summit meeting in Cologne, in June 1999, and attention turned to the Heavily Indebted Poor Countries (HIPC) Initiative. The Initiative had been launched three years earlier to reduce the debt burden of some 41 poor countries to sustainable levels and provide them with an

exit from the perpetual rescheduling of debt arrears. The novelty of the Initiative was its comprehensive approach by involving all creditors, including the World Bank and the International Monetary Fund (IMF). At the Cologne summit, political leaders acknowledged that the implementation of the Initiative had been low: faster, broader and deeper debt relief was promised. The Cologne summit also brought poverty reduction to the centre of the debate. As the communiqué said, “The central objective of this initiative is to provide a greater focus on poverty reduction by releasing resources for investment in health, education and social needs.”

Does this mark the beginning of the end of the debt crisis? *If* the Cologne reforms provide a genuine exit from unsustainable debt, and *if* the resources freed are directed towards poverty reduction, there could be significant gains for human development. Debt relief could act as a catalyst for accelerated progress towards the development goals set for the year 2015 by the world community.¹ This is especially important for the world’s 41 HIPCs. Collectively, they not only suffer some of the most intense levels of deprivation in the developing world, but they are also far off track for achieving the 2015 targets. Unfortunately, it is far from certain that the reforms proposed in Cologne will achieve their stated goals. There are two core problems: funding, and mechanisms for strengthening the linkage between debt relief and poverty reduction.

The funding problem is that the creditor governments have yet to back their encouraging statements of intent with financial commitments. In the absence of new and additional resources, there is a danger that either the revised HIPC Initiative will be financed through a diversion of aid or that it will not be implemented. There is also a question as to whether the reformed Initiative will provide debt reduction of sufficient depth to allow governments to meet urgent social needs.

There is a broad consensus that the poor should benefit from debt relief. But there is no shared strategy for achieving this. Designing ways to make debt relief an effective instru-

ment for human development raises fundamental questions about the criteria qualifying countries for HIPC debt relief.

Under the existing framework, countries become eligible for HIPC debt relief when their levels of debt remain unsustainable despite the full application of traditional debt relief mechanisms, and when they have also established a track record of compliance with an IMF Enhanced Structural Adjustment Facility (ESAF) programme. Structural adjustment programmes are intended to achieve macroeconomic stability, which is critical to poverty reduction. However, poverty reduction goes beyond macroeconomic stability and involves a wider range of actors than the IMF.

If the full potential of debt relief as a mechanism for poverty reduction is to be realized, the revised HIPC framework must be integrated into national poverty reduction strategies — and eligibility should be consistent with these strategies. That means building on what already exists, including sector-wide approaches (SWAPs) in areas such as health, education and agriculture. Above all, it means building on the partnerships between national governments, civil society, the private sector and the donor community.

This implies a new approach to eligibility. Far more weight needs to be attached to strengthening the capacity of governments to absorb savings from debt relief into antipoverty plans and less weight to narrowly defined macroeconomic targets. This does not mean that the linkage with ESAF programmes should be broken. However, it does imply that a wider range of human development targets should be considered, and a broader range of development partners involved. United Nations agencies, the World Bank, bilateral donors and civil society groups all have important roles to play. In such a wide-ranging approach the IMF would be seen as one stakeholder in the poverty reduction process and not as ‘first among equals’. Failure to broaden the eligibility framework and widen the constituency involved in HIPC debt relief will diminish the potential for a stronger linkage between debt relief and poverty reduction. Nevertheless, the reluctance to move in this direction still persists, and some have argued that the IMF’s role in the HIPC framework should be strengthened.

Debt relief by itself will not resolve the human development problems facing highly indebted countries. Increased concessional aid, a more favourable international economic environment and a wider development effort will remain essential. What debt relief *can* do is provide a sustained flow of resources to support national efforts to reduce poverty and it will be most effective where it is integrated into a good policy environment. Reform of the HIPC Initiative should be seen as one strategy for supporting good practices in social policy.

Part I looks at the massive human development needs in the HIPCs, which are central to the case for a poverty-focused approach to debt relief. Part II explains how unsustainable debt contributes to poverty. It shows that even though net resource transfers have been positive for the HIPCs, unsustainable debt has contributed both to the diversion of resources from priority social budgets and to economic stagnation or decline. Part III looks at previous debt relief measures, outlines the HIPC framework and analyses the Cologne proposal. Part IV considers how the reformed HIPC Initiative could be integrated into national poverty reduction plans and sets out one possible approach to reforming the Initiative.

Debt sustainability cannot be captured solely by reference to financial indicators and trade statistics. Basic human needs must also be taken into account. For the HIPCs, the scale of unmet social need is too vast, and the rate of progress in human development too slow, to leave any doubt about the need for increased resources for poverty reduction. Debt relief is one mechanism through which these resources could be mobilized.

The human development deficit

The 41 HIPCs, most of them in sub-Saharan Africa, have some of the world's worst human development indicators. These indicators are improving at an abysmally slow rate, leaving the majority of HIPCs well off track for achieving the 2015 human development goals.

On any composite indicator for human welfare the HIPCs would register extremely poor scores. Of the 44 countries ranked in the 'low human development'

category in the United Nations Development Programme (UNDP) *Human Development Report 1999*, 30 are in the HIPC group.

Figure 1 illustrates the depth of the human development deficit in the HIPCs.

Deprivation extends across all aspects of human welfare. About half of the citizens in the HIPCs are believed to be living below the international poverty line of \$1 a day income. Average life expectancy is 53 years, 10 years less than the average for developing countries. In several HIPCs including Angola, Chad, Guinea-Bissau, Liberia, Mozambique, Niger and Sierra Leone over 5 per cent of children are not expected to reach the age of five. Almost half of the population in the HIPCs lacks access to sanitation and safe drinking water. Deep and pervasive poverty results in high child mortality rates. On average the under-five mortality rate is 154 deaths per 1,000 live births in the HIPCs. This translates into around 3.4 million deaths annually, most of them resulting from easily

preventable infectious diseases. Of the 30 countries at the bottom of the world league table for child deaths, 25 are in the HIPC group.

The picture is equally bleak in education. In the HIPCs, some 39 million children of primary school age, or 40 per cent, are not attending primary school. Many millions more drop out

Figure 1 Key human development indicators in the HIPCs

	Industrialized countries	Developing countries	HIPCs
Under-five mortality rate (deaths per 1,000 live births), 1997	7	96	155
% of under-fives severely/moderately underweight, 1990–1997		31	34
Average life expectancy at birth (years), 1997	78	63	53
% adults literate, 1995	98	71	61

Source: UNICEF, *The State of the World's Children 1999*

Figure 2 HIPC^s among the 35 countries with highest under-five mortality rates

Under-5 mortality rate 1997*								
1	Sierra Leone	316	13	Guinea	201	25	Côte d'Ivoire	150
2	Angola	292	14	Chad	198	26	Mongolia	150
3	Niger	285	15	Nigeria	187	27	Cameroon	145
4	Afghanistan	257	16	Mauritania	183	28	Gabon	145
5	Mali	239	17	Burundi	176	29	Tanzania	143
6	Liberia	235	18	Ethiopia	175	30	Lesotho	137
7	Guinea-Bissau	220	19	Cent. African Rep.	173	31	Uganda	137
8	Malawi	215	20	Rwanda	170	32	Pakistan	136
9	Somalia	211	21	Burkina Faso	169	33	Haiti	132
10	Mozambique	209	22	Benin	167	34	Togo	125
11	Congo, Dem.	207	23	Cambodia	167	35	Senegal	124
12	Zambia	202	24	Madagascar	158			

*Deaths per 1,000 live births

Source: UNICEF, *Progress of Nations 1999*

Note: HIPC^s are in green

of school before having gained basic literacy skills. In Ethiopia, one quarter of children who enter school drop out during the first two grades. Tanzania has the lowest rate of transition from primary to secondary school in the developing world. The quality of education in the HIPC^s is typically abysmal, partly because of chronic shortages of teaching materials. Over half of the children in Zambia's primary schools do not have a simple exercise book. Fewer girls than boys enrol in school, and this gender gap (currently averaging over 10 percentage points) is growing. The combination of low school enrolments, high drop-out rates and poor-quality education has restricted progress towards improved literacy. In HIPC^s such as Burkina Faso, Ethiopia, Mozambique, Niger and Senegal, women's literacy rates are below 25 per cent.²

Distressing as these statistics are, there are important respects in which they

understate the problems. New threats have emerged. The HIPC^s account for most of the 5,500 deaths that occur each day as a result of HIV/AIDS. Health systems are being stretched to breaking point by rapid increases in the incidence of the secondary infections such as tuberculosis, pneumonia and measles to which the HIV-positive fall prey. But the effects are not restricted to the health sector. In Zambia, where one fifth of the population is now estimated to be HIV-positive, over 10 per cent of children have lost one or both parents; and HIV/AIDS claims the lives of over 600 teachers a year — equivalent to half of the graduates from teaching colleges.³ Microbial evolution is posing further challenges. Deadly new strains of drug-resistant malaria are increasing the levels of sickness and death among vulnerable populations. Sub-Saharan Africa accounts for 9 out of 10 of the world's malaria deaths, with the vast majority of the victims

being young children. As with HIV/AIDS, the crisis in efforts to control malaria is placing huge strains on households and on national budgets. In some HIPCs, such as Burkina Faso, it has been estimated that malaria treatment now accounts for over one third of recurrent health expenditures.

Implications for the 2015 targets

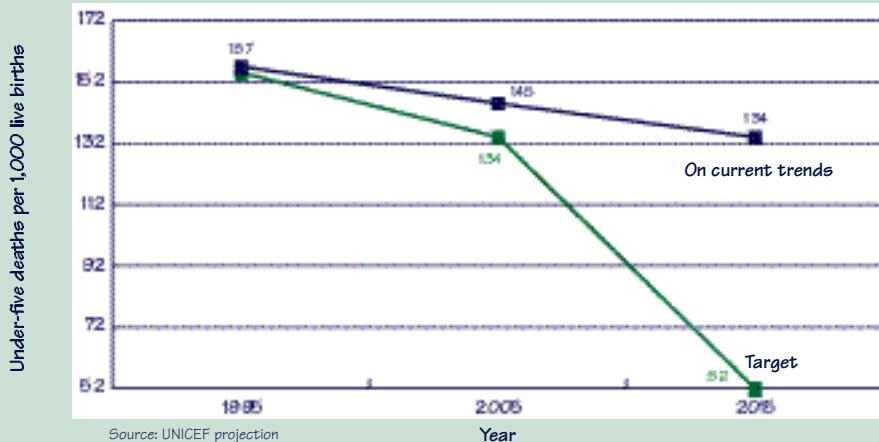
It is not just the current state of human development in the HIPCs that gives cause for concern. The outlook for the future is little better. In many countries, in fact, key human development indicators are deteriorating. According to data from the Center for International Development at Harvard University, nearly half of all HIPCs have recently started to register declines in per capita protein consumption.⁴ Life expectancy is declining in 13 countries, partly as a result of the HIV/AIDS epidemic. Even when the trends promise improvement, as they do for the HIPC group as a whole, the current rate of progress is far too slow to meet the internationally agreed targets for the year 2015, including the key

goals of reducing child mortality, achieving universal primary education and halving the numbers in extreme poverty.

Reducing under-five mortality by two thirds. For the HIPCs, this implies a target of 52 deaths per 1,000 live births. Projecting the 1990–1997 trends forward to 2015 indicates that the rate is likely to be 134 deaths per 1,000 live births — far from the target, as Figure 3 shows. To put the gap into perspective, it represents around 2 million child deaths per annum. Only three of the 41 HIPCs (Honduras, the Lao People’s Democratic Republic and Nicaragua) are on track to meet the target. At the other end of the spectrum, under-five mortality rates are either stagnating at high levels in several countries (Chad, Côte d’Ivoire and Mauritania) or deteriorating, as in the case of Kenya and Zambia.

Universal primary education. The 2015 target of universal primary education is on the verge of becoming out of reach for a large number of HIPCs. If the data on net enrolment for the period 1990–1995 are projected forward to 2015, taking into

Figure 3 Projected child mortality in the HIPCs in the year 2015



account the growth of the primary school-aged population, the resulting projection indicates that more than 50 million children will be out of school in 2015.⁵ It should be emphasized that this figure refers only to enrolment, the first step on the ladder to universal primary education. It takes into account neither the proportion of children who will drop out nor the poor quality of education they will receive.

Halving the proportion of people living in income poverty. Progress towards this goal will depend on two factors: the rate of economic growth and the distribution of increments to growth. There are no separate projections for the HIPCs, but trends for sub-Saharan Africa provide a close proxy. The most comprehensive recent estimate indicates that, even under favourable income distribution scenarios, sub-Saharan Africa will not meet the 2015 target for poverty reduction. Even assuming a sharp increase in the elasticity of poverty reduction with respect to growth, the region would still have to achieve growth rates in per capita income in excess of 2.3 per cent a year from now to 2015. This is more than double the growth rate projected by the World Bank, and it would imply a sharp break with historical trends. The authors of the projection conclude: “The prospects for sub-Saharan Africa are bleak. This implies that the global development effort has to be directed more towards this region, to stimulate economic growth as well as to develop policies that would directly target improvements in the income-generating

possibilities for the extreme poor in the region.”⁶ Resource mobilization has a central role to play. According to the Economic Commission for Africa, achieving the accelerated growth rates required to meet the 2015 target would require external financing equivalent to 14 per cent of sub-Saharan Africa’s gross domestic product (GDP).

The way ahead

Fortunately, in the case of the HIPCs, past trends need not be future destiny. Growth rates of the magnitude required to meet the target for reducing income poverty have been achieved in other developing regions in the past, so the challenge is not impossible. The same applies to progress in areas such as child mortality and education. Some countries in sub-Saharan Africa have achieved major advances in economic growth and human development. For instance, over the past decade Uganda has achieved annual growth rates of 3–4 per cent in GDP per capita, and the country has recently made rapid progress towards universal primary education.

Such examples offer a glimmer of hope. That said, the projections for the HIPCs point to the need for a renewed development effort across a broad front. Human development deficits have become self-reinforcing, with adverse multiplier effects setting in. Human resources deficits linked to the state of education are hampering growth, undermining equity in income distribution and limiting advances in other areas. To take an obvious illustration, international comparisons have shown that the children of educated



This toddler is one of half a million Nicaraguans who lost their homes to Hurricane Mitch in 1998. Nearly half of Nicaragua's population lives below the poverty line, and the country has one of the lowest primary school completion rates in Latin America.

mothers have a stronger chance of surviving, and being healthy and well nourished, than the children of uneducated mothers, which indicates the high cost to the HIPCs of the gender deficit in education.⁷

Failure to close the gap between current trends and the 2015 target will have grave implications for the future. For instance, in an increasingly knowledge-based global economy, failure to accelerate progress towards universal primary education will lead to further marginalization of HIPCs, which will translate into slower progress in reducing poverty.

Reversing the downward spiral will require a comprehensive approach. Concentrating on individual development targets would be mistaken, since sustained progress in any one area depends on advances in all areas. For example, improving access to education without parallel advances in public health will produce poor outcomes for an obvious reason: children who are sick and undernourished do not make attentive students.

The task of strengthening the linkage between debt relief and poverty reduction

has to be seen in this context.

Debt relief will be effective if it is integrated into comprehensive poverty reduction strategies. It follows that it should be geared towards the creation of conditions for broad-based economic growth and universal access to basic social services. In this context, the process of reforming the HIPC Initiative should be seen as one element in a broader development effort aimed at getting debtor countries back on track for the 2015 targets.

Debt is not the main factor responsible for poverty in the HIPCs; but it is part of the problem. The optimal conditions for meeting the 2015 targets are accelerated and more equitable economic growth and improved access to better-quality basic services. Unsustainable debt has undermined progress on each of these fronts, with devastating consequences for human well-being. This section looks at how basic human needs have been jeopardized by the debt crisis.

The fiscal burden on debtor governments

There are various ways of assessing debt. *Debt stock* indicators capture the accumulated burden of debt on the economy, while *debt servicing* indicators reflect the annual burden of repaying interest and principal on past loans. Part of the problem with debt relief initiatives — including the HIPC Initiative — is that they have defined debt sustainability on the basis of debt-to-export ratios. These are important, but it is governments, not exporters, that service debts. Most HIPCs have liberalized their trade policies and capital-account

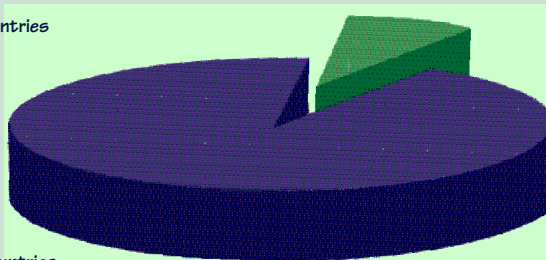
regulations, with the result that the private sector now accounts for 80–100 per cent of export earnings.⁸ Governments have only limited access to this revenue through taxation. It follows that the fiscal burden on governments, using budget revenue as the denominator, is a more sensitive indicator of repayment capacity. It is also a more sensitive indicator of the opportunity costs of debt servicing for human development. This is because debt servicing represents an implicit transfer of resources away from investment in basic services and economic growth.

The debt indicators for the HIPCs tell their own story. As shown in Figure 4, the debt stock of the HIPCs represents the small change of global debt, accounting for less than 10 per cent of the total, but it represents a massive burden on their economies. In 1998, their debt stock was estimated to total 386 per cent of their annual export earnings, which is more than double the average for developing countries. The burden is even greater when their debt stock is set against their gross national product (GNP), amounting to 121 per cent of GNP. This is almost

Figure 4 External debt stock of developing countries, 1996
(net present value, \$ billions, in 1998 dollars)

Total developing countries
2,670

HIPCs
205

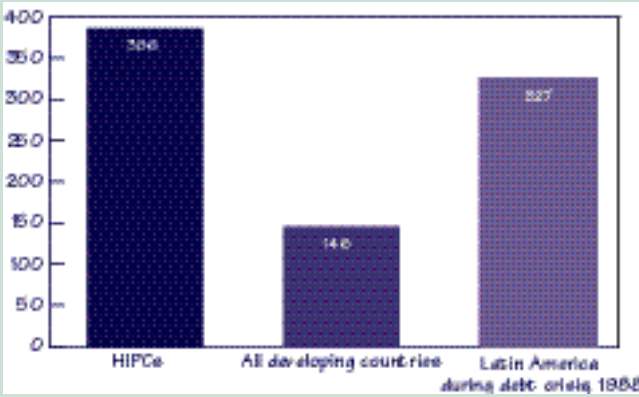


Other developing countries
2,465

Source: World Bank debtor reporting systems and staff estimates

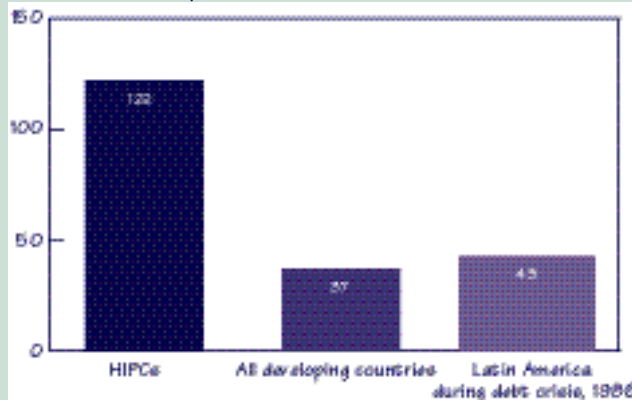
Figure 5 External debt stock of the HICPs and developing countries compared, 1998

% Debt stock as a percentage of annual export earnings



Source: World Bank, *Global Development Finance*, preliminary figures for 1998

% Debt stock as a percentage of GNP



Source: World Bank, *Global Development Finance 1999*, preliminary figures for 1998

three times the average for all developing countries. In fact, the debt burden on the HICPs today is heavier than it was on the countries of Latin America during the worst years of the debt crisis in the 1980s (Figure 5). The share of export earnings required yearly by the HICPs to service their debt has fallen during the 1990s, to about the equivalent of 14 per cent. However, this obscures another problem: namely, a widening gap between scheduled

payments and actual payments. This gap accounts for the sustained increase in debt stock over the past two decades; part of the debt servicing problem has been converted into a problem of arrears on debt payments (discussed in the next section).

The fiscal burden of debt in the HICPs is very large. For several countries, including Chad, Mali, Mozambique, Niger and Rwanda, annual debt service obligations exceed 20 per cent of government revenue. For Malawi, Tanzania and Zambia, the figure rises to over 30 per cent, and for Honduras and Nicaragua to around 50 per cent.

These heavy debt service burdens have to be seen in the context of limited and highly unstable revenue bases, for both direct and indirect taxes. On average, HIPC governments collect 14 per cent of GDP in revenue. Several, including Chad, Guinea-Bissau, Niger and Rwanda, collect less than 10 per cent. Low revenue collection results from a combination of poverty, dependence on trade taxes and institutional weaknesses. Some of these problems can be corrected,

for instance by improving tax administration. Others are a function of low levels of income and unstable primary commodity markets. It is not just the weight of the fiscal burden that matters. Debt service obligations are fixed, while government revenue flows are highly variable, because of climatic factors that influence production, volatile prices for commodity exports and other variables. This introduces a high level of uncertainty into budget planning.

The social costs of debt servicing

The heavy fiscal burden of debt implies opportunity costs for human development. Many HIPC governments are maintaining very high levels of debt servicing in relation to their budget resources, despite their inability to meet basic needs. The following cases demonstrate the problem:

- In Mozambique, debt servicing for 1997 absorbed around half of government revenue, or \$7 per capita. This compared to \$3 per capita spending on health services. Among the indicators of Mozambique's health deficit: 160,000 under-five deaths and 9,000 maternal deaths in 1997, linked to shortages of basic drugs and inadequate access to health services.⁹
- In Nicaragua, over one half of government revenue in 1997 was allocated to external debt servicing — equivalent to two and a half times recurrent spending on health and education combined. This is in a country with nearly half of the population living below the poverty line, and with one of the lowest primary school completion rates in Latin America.¹⁰
- In Tanzania, 1997 debt servicing represented the equivalent of nine times the spending on basic health services and four times the spending on basic education, in a nation where one in seven children dies before the age of five, and 2.4 million children are not in school. Recurrent expenditure per child in school averages about \$1 a year, resulting in extreme shortages of textbooks, pencils and other basic teaching materials. In rural areas there is an average of one textbook for every 20 children.¹¹
- In Zambia, over one third of government revenue has been allocated to servicing external debt. This represents more than the budgets for health and education *combined*. Debt servicing has been maintained in the face of deteriorating human welfare indicators. Child mortality rates are rising, and about a third of children are not fully vaccinated. The numbers of children out of school — estimated at 665,000 in 1998 — are increasing, and the quality of education is hampered by chronic shortages of books and other teaching materials.¹² The number of people living below the poverty line has increased by 1.6 million in the 1990s.

These are not isolated cases. Most of the HIPCs are allocating far more of their limited budgets to debt servicing than they are to basic needs. As a 1998 UNICEF-UNDP study has shown, six of the HIPCs in sub-Saharan Africa spend more than one third of the national budget on debt servicing, while spending between 4 per cent and 11 per cent on basic social services.¹³

The opportunity costs of such expenditure patterns are high. They translate into health clinics without basic drugs or vaccines or effective antenatal services, classrooms without books or pencils, and villages without clean water.

The fiscal burden of debt impacts most obviously on the supply side: it influences the capacity of governments to finance the provision of the basic services on which poor people depend. There are also 'demand-side' effects influencing the capacity of poor people to gain access to basic services. Inevitably, households have to fill the gap left by inadequate public expenditure.

Cost recovery, or the practice of charging users for basic services, is the most visible indicator of the transfer in financing responsibility from governments to households. This takes many forms, ranging from official government charges to informal arrangements, such as households donating cash and food to supplement the salaries of teachers and health workers, and donating labour and materials for buildings. In most HIPCs, cost recovery has resulted in households replacing government as the main source of finance for basic social services. It has been estimated that private spending in these nations accounts for two thirds of the total health expenditure.¹⁴ Evidence from a number of countries indicates that households carry a similar share of the spending on primary schooling. In Tanzania, the Education Sector Development Plan estimates household expenditure to be around three times government spending.¹⁵

But rising private costs have placed basic services beyond the reach of some of the poorest households, increasing their vulnerability to sickness and depriving their children of an opportunity to escape poverty through education.¹⁶ Cost recovery in the health sector has resulted in households jeopardizing their health by turning to self-medication, delaying treatment or avoiding it altogether. In Zambia, three quarters of the children who drop out of primary school do so because of cost factors.¹⁷ In Kenya, a participatory poverty assessment covering seven poor districts found that between one third and two thirds of poor households had withdrawn children from school: over 80 per cent had done so because they were unable to afford the cost.¹⁸

If the social costs of debt servicing in the HIPCs are high, it follows that debt relief could bring significant human development gains. It has been estimated that the cost of achieving universal primary education in sub-Saharan Africa would amount to between \$2 billion and \$3.6 billion per annum for 10 years. This sum is large in relation to existing education budgets, but small in relation to the \$14 billion a year that the region now spends on servicing debt. The transfer to basic education of even a small part of the resources currently tied up in debt servicing could yield very large returns. The same applies to the health sector. The \$7 per capita that sub-Saharan Africa now spends servicing debt every year compares with annual expenditures of \$3 to \$5 per capita on health services in many of the region's HIPCs. Commuting debt service



Safe water, a primary requisite for health: A child is bathed in Myanmar, which is one of the 41 countries obliged to spend more on servicing their external debt than on the basic health and education of their children. Myanmar owes \$5.07 billion, 233 per cent of its GNP

into cost-effective primary health care interventions could avert needless deaths and sickness on a large scale.

Such considerations point to the potential for accelerated human development through debt relief. Capturing that potential through appropriate national strategies is the challenge at the heart of the debate about reforming the HIPC debt relief initiative.

The myth of net resource flows

Despite the imbalance between debt servicing and priority social spending, the HIPCs

receive more in new aid than they repay on debt. This has prompted some to argue that the debt service issue is not relevant to the financing of the social sector. From an accounting perspective this may be true, though the net transfer of resources has been declining over time. In 1998, the transfer amounted to \$6 billion — 40 per cent less than in 1990.¹⁹ But even though net resource transfers have been positive, the fiscal burden of debt remains a problem.

One problem is the highly erratic nature of aid flows, which undermines the

budget planning process and makes the development of effective poverty reduction plans more difficult. Decisions to block the disbursements of aid or debt relief can open up large funding gaps, causing a collapse in health and education services. In Zambia, for example, when the IMF in 1997 ruled the country off track in its ESAF programme, other creditors also withheld aid. As a result of donors suspending their support, in 1998 the Government had to spend \$143 million from its own resources on servicing foreign debt, more than double its spending on education and training.

Another problem is that bilateral aid does not offset the budget burden of debt in practice, even if it appears to do so in theory. It certainly does not fully compensate the shortfall in funding for basic social services, for several reasons. For one thing, a large part of donor assistance is directed towards areas such as balance-of-payments support and economic infrastructure. For another, grants from donors frequently finance off-budget activities, with a bias towards capital expenditure on projects. In Tanzania, for example, only one third to a half of donor money passes through the national budget.²⁰ Meanwhile, the fiscal burden of debt falls directly on national budgets and allocations to line ministries. The overall

effect is to diminish governments' capacity to achieve universal coverage with basic services, while skewing public expenditure towards donor priorities.

The impact of unsustainable debt on economic growth and equity

Unsustainable debt has implications for economic growth and equity as well as social sector financing. Although the effects are complex, debt remains a barrier to accelerating growth and improving distribution so as to achieve the 2015 poverty reduction targets.

Here again, the positive net transfer of resources to the HIPC has led some commentators to question whether debt prob-



A health worker prepares health cards for children about to be immunized in Somalia, one of the 41 most highly indebted poor countries (HIPC). In most of those countries, more than a third of the children have not been immunized, and about half the population is illiterate.

lems have acted as a brake on growth. This assessment has to be qualified in at least two important respects. First, there is the 'debt overhang' effect. This occurs where limited ability to service debt leads to arrears on interest payments, and debt service charges are added to an already unsustainable debt stock. Such a situation creates strong disincentives for domestic and foreign investors, who are faced with uncertainties over future marginal tax rates, inflation and currency valuation.²¹ Domestic savers will seek investments elsewhere. Debt overhang is also likely to limit access to trade credit and thereby limit export growth. While it would be mistaken to attribute the low level of investment in HIPCs mainly to debt stock problems, it would be equally mistaken to underestimate their effect. During the 1980s debt crisis of middle-income countries, it was not until the Brady Plan brought a reduction in their debt stocks towards the end of the decade that investment recovered.²²

The second qualification relates to debt servicing. Even if net resource transfers have remained positive, debt servicing still represents a drain on scarce resources. As mentioned earlier, debt service payments absorb the equivalent of about 14 per cent of the HIPCs' export earnings, restricting these countries' ability to import the goods and services needed for enhanced capacity utilization, employment and investment. Moreover, as in the social sector, debt pressures can prevent governments from undertaking the improvements in economic infrastructure and services needed to attract investors.

This mix of debt overhang and fiscal pressure has two consequences that are of direct relevance to poverty reduction strategies. First, by restricting growth potential, unsustainable debt limits the rate at which *average* income can be increased. Second, by limiting government investment in economic infrastructure, debt servicing restricts the capacity of poor people to benefit from growth on equitable terms. This results in the poor capturing a smaller share of any increments to growth, causing their incomes to rise more slowly than average income.

One of the problems in the HIPCs, as in other poor countries, is that poor people are often excluded from market opportunities. In Zambia, for instance, over half of the poorest households live 5 kilometres or more from the nearest rural feeder road, which limits their capacity to market their produce on reasonable terms and to reach primary schools or rural health centres. Improving the coverage and quality of feeder roads can bring benefits for economic growth and social progress, particularly for the poor. Inadequate investment in infrastructure for the poorest areas has limited the ability of HIPCs to convert macroeconomic stability into high rates of poverty reduction in these areas. In Uganda, for instance, coffee-producing areas have reduced poverty at a rate three times faster than areas growing staple foods. Changing such inequalities requires public investment priorities specifically designed to benefit the poor, but the claims of foreign creditors on national budgets severely limit the scope for action in most HIPCs.

The HIPC Initiative represents the latest in a long line of debt relief exercises. At each stage in the evolution of the debt crisis in the poorest countries, creditors have failed to develop an effective response. The Initiative and the Cologne proposal offer new hope, but the future remains uncertain. This section examines the road from the 'special terms' strategy of the 1980s to the Cologne proposals of 1999.

The 'special terms' strategies

As the debt crisis developed in the early 1980s, most creditors took the view that debtors were facing temporary liquidity problems. Their debt relief strategy reflected this mistaken premise. It combined continued financial flows with short-term, non-concessional debt relief. By continuing the flow of finance, creditors sought to maintain debt servicing capacity and restore growth. The belief was that export-led growth under IMF-World Bank programmes would eventually resolve the balance-of-payments problems. Meanwhile, debt relief took the form of short-term rescheduling of small slices of principal and interest; debtor nations were given grace periods of 12 to 18 months to meet payments that had fallen due.²³

By the mid-1980s, it was apparent that this approach was not working. The exports of heavily indebted countries in Africa continued to perform poorly, which led to imports strangulation, declining capacity and falling investment. Public spending on economic and social services was reduced. Meanwhile, these countries' debt stock doubled over the period 1982–1987, reflecting their mounting

arrears as their debt service obligations were rescheduled.²⁴

Change came slowly. Multi-year rescheduling was introduced in 1984, extending the grace periods for repayment beyond 18 months. In 1987, creditors began to concede 'special terms', usually named after the city in which they were adopted. Under the Toronto Terms of 1988, the Paris Club of bilateral creditors provided longer-term rescheduling and introduced the option of debt forgiveness. The value of debt stock could be reduced by up to one third through a menu of options. The London Terms increased this reduction to half. The 'Enhanced Toronto Terms', as the name suggests, went a step further: half of the debt falling due over an 18-month period could be written off altogether, with the remainder rescheduled on a very long-term basis. Creditors gave themselves a range of options to choose from to reduce debt stocks, including debt write-offs, rescheduling at concessional interest rates and long-term rescheduling at market rates. In 1994, the Naples Terms provided for a 67 per cent reduction in debt contracted before a specified cut-off date. By the end of 1995, six countries had qualified for Naples Terms.

Not all countries were eligible for these special terms. The Naples Terms were open only to countries with low incomes (less than \$500 per capita a year), a debt stock far higher than their annual export earnings, and — critically — a three-year track record of compliance with ESAF programmes. These various elements were incorporated, in modified form, into the framework of the 1996 HIPC Initiative.

Towards a new approach

The failure of the 'special terms' debt strategies was reflected in the continued rise of debt stocks. Most of the heavily indebted countries continued to suffer from low growth and stagnant export earnings. As a result, the gap between their *scheduled* debt servicing obligations and their *actual* payments began to widen. Bilateral creditors made much of the fact that they were forgiving debts. However, their forgiveness amounted to less than the increase in debt stocks caused by the arrears in repaying interest and capital. By 1997, payments of arrears alone accounted for two thirds of debt service payments to bilateral creditors.²⁵

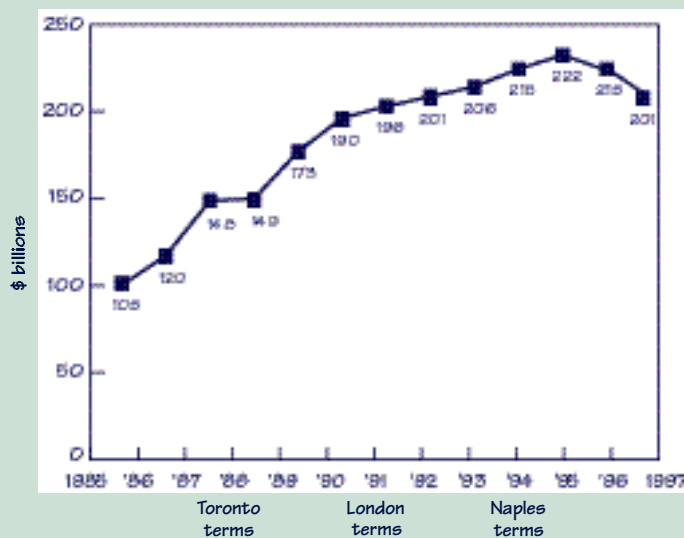
The cumulative failure of the various debt relief strategies is underlined by the experience of the HIPCs. Between 1985 and 1996, the debt stock of these countries doubled, to over \$200 billion

(Figure 6). It is true that the level of debt servicing fell in the first half of the 1990s, but this owed less to debt relief than to a widening gap between actual and scheduled payments. By 1996, less than one half of scheduled payments were being met. The experience of Mozambique illustrates the problem. Between 1990 and 1993, the country repaid creditors \$367 million. Over the same period some \$570 million was added to the national debt stock. The reason: only around one third of the payments falling due were being met. As in other HIPCs, the increase in debt stock was a direct consequence of the failure to service debt.

There were two basic design flaws with the 'special terms' strategies. The first problem was that they provided insufficient debt reduction to avert the relentless accumulation of debt arrears. At best, they slowed the rate of accumulation and marginally narrowed the gap between scheduled and actual payments.

The Naples Terms were supposed to resolve this problem, and were only granted to debtor countries on the understanding that they would not return for more debt relief. But it soon became apparent that the Naples Terms, too, had not gone far enough; several of the early beneficiaries, among them Benin, Burkina Faso and Mali,

Figure 6 The rise in HIPC debt stock, 1985–1997



Source: World Bank, *Global Development Finance 1999* (1986–1989 from earlier edition)

proved unable to meet their subsequent debt service obligations.

The second problem with the 'special terms' approach was that of coverage. Multilateral creditors were excluded from the debt relief framework, even though they had emerged as significant actors in the debt problem. By 1996, the IMF and the World Bank, the two largest multilateral creditors, accounted for around one quarter of the debt stock of severely indebted low-income countries.²⁶ More significantly, they absorbed one half of debt service payments. This discrepancy between their debt stock and debt service position was partly the result of a low level of concessionality in IMF lending; but the more important factor was the 'preferred creditor' status of the two institutions. As the gatekeepers to aid and the entire debt relief process, the IMF and the World Bank were the first creditors to be repaid. In effect, bilateral creditors were willing to tolerate an accumulation in arrears to themselves by insisting that debtors stay current in their repayment obligations to the IMF and the World Bank.

The treatment of multilateral debt became an issue of considerable controversy and a source of division within the international financial institutions. Both the IMF and the World Bank claimed that any move towards multilateral debt relief would generate 'moral hazard': it would, so the argument ran, encourage governments to borrow new money recklessly in anticipation of future debt relief. It was also claimed that multilateral debt reduction would threaten the credit rating of the World Bank (increasing the costs of loans

to borrowers in the process), while at the same time jeopardizing the stability of the IMF.²⁷

The third strand of the case against multilateral debt relief was the argument that there was no multilateral debt problem. In a similar vein, a World Bank Vice-President informed bilateral donors in 1993: "There is no reason to call for a general change in the current policy of international financial institutions, according to which these institutions do not forgive or reschedule debt. . . We therefore strongly urge all official agencies to refrain from making calls for changes in the international financial institutions' non-rescheduling policies."²⁸ Two years later, one IMF study famously concluded that only one country faced a genuinely unsustainable multilateral debt burden, the country in question being Sao Tome and Principe.²⁹

Such advice notwithstanding, by the mid-1990s bilateral donors had become seriously concerned over the multilateral debt problem — and for good reason. As much as 40 per cent of their aid was being recycled to multilateral creditors in the form of debt repayments. Rising debt stocks provided further evidence of the failure of existing debt relief strategies. The mould was finally broken in 1995. In a rigorous assessment of existing debt relief strategies, a World Bank task force concluded that "the fragmented approach followed thus far by the international financial community has reached its limit, and has left several of the poorest countries of the world with an unsustainable debt burden."³⁰ It went on to propose a

comprehensive approach to the debt problem covering all components of a country's debt, with a view to achieving overall debt sustainability. One year later, at the annual joint meeting of the IMF and World Bank, the HIPC Initiative came into operation.

The tortured history of debt relief up to the advent of the HIPC Initiative is instructive on a number of counts. It graphically illustrates the lack of political commitment on the part of creditors to address the debt crisis in the poorest countries. The contrast with the sense of urgency that culminated in the Brady Plan for middle-income debtor countries in the 1980s could hardly be starker. Nor, for that matter, could the contrast between what has happened under the HIPC Initiative and the international community's response to the debt problems of East Asia, Mexico and the Russian Federation in the second half of the 1990s. The international response to the East Asian crisis resulted

in \$100 billion being mobilized within a matter of weeks, whereas the HIPC Initiative has stuttered through its first three years providing debt relief to only four low-income countries, a fraction of those in need. If there is a lesson here for reforming the Initiative, it is that political will holds the key to successful debt relief.

The HIPC Initiative: Design and implementation

The HIPC Initiative marked a departure from the previous approach to debt relief in three important respects:

- It made debt sustainability, rather than repayment capacity, the central objective of debt relief. Sustainability was defined as achieving a given balance between debt and export earnings, taking into account various vulnerability factors. Another definition was added later, which assessed debt stock against government revenue. (See box for details.)

Drawing the line: When does unsustainable debt become sustainable?

The HIPC Initiative defined sustainability in terms of export-related indicators. In the original framework, specific thresholds were set for each country individually, all falling within the same range: total debt stock representing between 200 and 250 per cent of annual export earnings, and annual debt service obligations representing between 20 and 25 per cent of annual export earnings. The precise threshold for each country was decided on the basis of vulnerability indicators such as the concentration and variability of export earnings.

Subsequently, a revenue-related indicator was introduced for countries with high enough export earnings to disqualify them from HIPC debt relief on the standard criteria, but whose external trade indicators did not fully capture the fiscal burden of their debt. These countries would become eligible when their total debt stock represented 280 per cent or more of annual government revenue. However, eligibility was restricted to countries with strong export-oriented economies (exports representing at least 40 per cent of GDP) and high levels of revenue collection (at least 20 per cent of GDP). Only three HIPCs met these criteria.

Figure 7 The HIPC^s: Debt indicators, 1997

	Total debt stock		Total debt	% of
	\$ millions	% of GNP	service % of GNP	exports of goods and services
Angola	10160	232	19.2	15.9
Benin	1624	77	2.6	9.1
Bolivia	5248	68	6.1	32.5
Burkina Faso	1297	54	2.2	11.8
Burundi	1066	113	3.1	29.0
Cameroon	9293	109	6.0	20.4
Cent. African Rep.	885	88	1.3	6.2
Chad	1027	65	2.2	12.5
Congo	5071	278	6.2	6.2
Congo, Dem. Rep.	12330	232	0.2	0.9
Côte d'Ivoire	15609	165	14.4	27.4
Equatorial Guinea	283	58		
Ethiopia	10079	159	1.6	9.5
Ghana	5982	89	7.5	29.5
Guinea	3520	95	4.4	21.5
Guinea-Bissau	921	366	3.9	17.3
Guyana	1611	236		
Honduras	4698	103	11.1	20.9
Kenya	6486	65	6.5	21.5
Lao PDR	2320	132	1.6	6.5
Liberia	2012			
Madagascar	4105	119	6.2	27.0
Malawi	2206	89	3.1	12.4
Mali	2945	119	3.2	10.5
Mauritania	2453	235	10.9	24.2
Mozambique	5991	233	4.1	18.6
Myanmar	5074			8.0
Nicaragua	5677	306	17.5	31.7
Niger	1579	86	3.3	19.5
Rwanda	1111	60	1.2	13.3
Sao Tome and Principe	261	672		
Senegal	3671	83	5.6	15.3
Sierra Leone	1149	141	2.4	21.2
Somalia	2561			
Sudan	16326	182	0.6	9.2
Tanzania ^a	7177	97	2.2	12.9
Togo	1339	93	3.8	8.1
Uganda	3708	56	2.9	22.1
Viet Nam	21629	89	3.7	7.8
Yemen	3856	77	1.9	2.6
Zambia	6758	185	7.3	19.9
HIPC ^s	201095	128		

Source: World Bank, *Global Development Finance 1999* and *World Development Indicators*
 a. Data refer to mainland Tanzania only.

- It covered all categories of debt, notably multilateral debt.
- It provided for an increase in Paris Club debt relief to allow reductions in debt stock of 80 per cent and more, on a case-by-case basis.

The HIPC Initiative originally took a two-step approach to unsustainable debt. In the first step, debtor countries were required to establish a three-year track record of compliance with the IMF's ESAF programmes, at the end of which they would become eligible for traditional forms of debt relief from the Paris Club of bilateral creditors. This was the *Decision Point*. If the debt sustainability analysis carried out just prior to this point indicated that the Paris Club debt relief would not bring the nation's debt down to a sustainable level, the debtor nation had to build up another three-year track record with the IMF. At the end of this it reached the *Completion Point*, when HIPC debt relief was provided by all groups of creditors, the amount being decided on a case-by-case basis. Nations achieving sustainable debt levels, or judged at Decision Point able to do so by traditional debt relief mechanisms, were not eligible for the HIPC package.

Performance under the original HIPC Initiative has not matched up to expectation. Problems have emerged in two areas: namely, the timing of debt relief and the depth of debt relief.

Timing of HIPC debt relief

By mid-1999, only four countries — Bolivia, Guyana, Mozambique and Uganda — had received HIPC debt relief.

Another three had reached their Decision Point and were scheduled for debt reduction in 2000 (Burkina Faso) and 2001 (Côte d'Ivoire and Mali). Delay was built into the original design. Paris Club debt relief could be granted after a three-year track record with the IMF: the HIPC package required a six-year track record. Even under a best-case scenario, this was likely to produce a slower flow of benefits. The fact that only one third of the ESAF programmes were concluded without interruption made for even greater delays. In some cases, narrow interpretations of track-record performance caused further problems. For instance, interruptions to Tanzania's ESAF programme resulted in its earlier record of compliance being discounted, delaying its arrival at Decision Point by between one and two years.³¹

Levels of HIPC debt relief

The Initiative's original thresholds for rating debt sustainable were largely based on the experience of Latin American countries and were set too high to provide a viable exit from the HIPCs' debt crisis. The high thresholds reduced the amount of HIPC debt relief, leaving countries with an unmanageable fiscal burden. The case of Uganda, the first country to pass through the HIPC process, illustrates the problem. At Completion Point, the threshold for Uganda was a debt stock to export earnings ratio of 201 per cent. With the collapse of coffee prices in 1997, this ratio rose to over 270 per cent, well above the HIPC Initiative sustainability threshold.

While the headline figures for the amount of debt stock reduction in the four countries to have qualified to date are large, at around \$2.4 billion, the real budget savings have been small. This is because much of the debt relief provided has been diverted towards closing the gap between scheduled and actual payments, thus reducing debt stock which was not being serviced. Debt service obligations after HIPC debt relief have not been significantly different from the period before — hence the new resources available for funding the delivery of basic services have been minimal.³² At its Completion Point, Mozambique stood to save about \$12 million a year on its annual debt service bill of \$108 million, which would have left the country continuing to spend more on debt than on basic services. For some countries, such as Burkina Faso and Mali, actual debt service payments are projected to *increase* after reaching the Completion Point.

The Cologne proposal

The failure of the HIPC Initiative to provide a rapid exit from unsustainable debt led to calls for reform. Advocates of deeper and earlier debt relief ranged from the United Nations Secretary-General and African governments on the one hand, to the Jubilee 2000 coalition of churches, non-governmental organizations and trade unions on the other.

At the spring meeting of the IMF and World Bank in 1999, the Executive Boards of the two institutions agreed on the need to revise the framework of the Initiative. The Group of Seven summit in Cologne started the reform process by proposing

new thresholds and mechanisms to achieve what the communiqué describes as “faster, deeper and broader debt relief for the poorest countries that demonstrate a commitment to poverty reduction.” The Group of Seven also made an unequivocal pledge in Cologne to strengthen the linkage between debt relief and poverty reduction as their contribution to the HIPC review process, for discussion by the Executive Boards of the World Bank and the IMF at their September 1999 meeting.

The two core reforms proposed at the Cologne summit were revised definitions for unsustainable debt and the introduction of mechanisms to promote earlier debt relief.

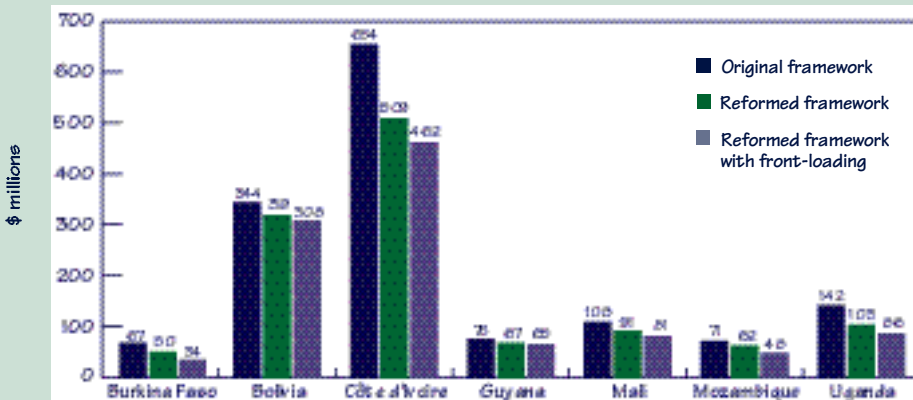
Expanding the definition of unsustainable debt. It is proposed to broaden the definition of unsustainable debt, and hence eligibility for HIPC debt relief, by introducing a single threshold figure of debt stock representing 150 per cent or more of annual export earnings. Other eligibility criteria for HIPC debt relief

would also be made less restrictive.³⁵

With this reform, the number of HIPCs that would be eligible for the full HIPC debt relief package would rise from 26 to 33.

Earlier debt reduction. There are two mechanisms through which the reformed HIPC Initiative might deliver earlier debt relief. The first is *interim financing*. At present, the bulk of HIPC debt relief is delivered after the Completion Point. Under the new arrangement there is scope for front-loading. Multilateral creditors could deliver part of their debt relief before Completion Point, releasing an earlier flow of resources. The Cologne proposal also provides for front-loading after the Completion Point, with multilateral institutions delivering higher levels of assistance in the early years. More widespread front-loading during the interim period and after the Completion Point could significantly increase the budgetary resources available for poverty reduction (Figure 8). The second innovation that could lead to earlier

Figure 8 Impact of the reformed HIPC Initiative: A verage annual debt service obligations between Completion Point and 2005



Source: IMF-World Bank, *Modifications to the HIPC Initiative*, July 1999

debt relief is the introduction of a *floating Completion Point*.³⁴ Under the new framework, countries that are able to meet specified policy targets early would be allowed to proceed to Completion Point more rapidly. Conversely, for countries slower to meet their targets, the Completion Point would come later. The floating Completion Point would create incentives for governments to implement reforms quickly. If the performance criteria are linked to human development goals, this could significantly strengthen the linkage between debt relief and poverty reduction.

If fully implemented, the Cologne proposal would have significant cost implications. The total cost of the HIPC Initiative under the current arrangement is estimated at \$12.5 billion a year (net present value). The proposed reforms would raise this figure to an estimated \$27.4 billion. This includes the financing of retroactive adjustments for countries that have already reached Completion Point. The increased costs would be distributed between bilateral and multilateral creditors on a roughly equal basis.

An assessment of the Cologne proposal

Evaluation of the reforms to the HIPC Initiative is hampered by an absence of details on implementation. In particular, the arrangements for front-loading and interim financing have yet to be agreed upon. There are, however, a number of issues that give cause for concern. Among the most important are uncertainty about funding the reformed Initiative, the fiscal implications for the debtor nations and

problems with the strategy for linking early debt relief to poverty reduction.

Financing the reformed Initiative

There is no agreement on how to pay for the Cologne Initiative. Some bilateral creditors with large non-concessional aid debts have indicated an unwillingness to meet their share of the costs from new resources. More broadly, bilateral commitments to the HIPC Trust Fund have been derisory when compared to the new requirements, amounting to only \$100 million since the Cologne summit. There is also considerable uncertainty over how regional development banks would finance their share: neither the African Development Bank nor the Inter-American Development Bank currently has the resources to cover their share of the increased costs.

The most likely sources of additional funds are the Bretton Woods institutions. Serious problems have emerged over the IMF's contribution. Finance ministers agreed at the Cologne summit that the IMF should sell up to 10 million ounces of its gold reserves to finance HIPC debt relief. This will require the support of 85 per cent of the votes on the IMF Executive Board. The US Administration, which currently holds 18 per cent of these votes, is in favour. However, it needs Congressional approval — and Congress is unlikely to sanction gold sales in the open market, on the grounds that such sales might further depress world prices for gold, with damaging implications for gold exporters. The argument is flawed, since IMF gold sales would be small in

comparison with world trade in gold, and markets have already discounted the likely effect on world prices. Fortunately, there are alternatives. The IMF's gold stocks are valued for internal accounting purposes at prices far below the world market rate. They could be revalued, with the capital gains used to finance debt relief. Another option is for the central banks of the Group of Seven to transfer gold at controlled prices.

The financing problem is important because genuinely additional flows of resources would make a significant impact on HIPC budgets, releasing resources for social and economic recovery. In the absence of new and additional resources, the Cologne proposal will either be put on the back burner, or it will be financed through a diversion of development assistance. If this diversion took place within individual HIPC countries, it would greatly diminish the net benefits. The alternative approach of diverting resources from non-HIPC countries would be unwarranted as well.

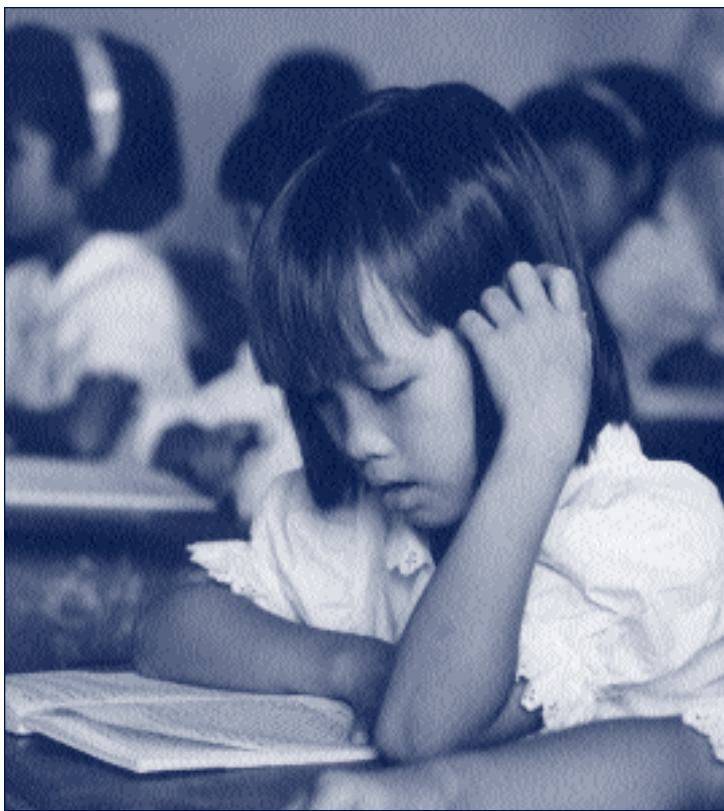
Donor concern over the financing requirements for the reformed HIPC Initiative has to be put in context. The headline figure for the total — \$27.4 billion — creates an exaggerated impression of the real cost. Many bilateral donors have already written down part of the value of their HIPC debt for national accounting purposes, so the real budget costs will be considerably lower than the nominal costs: in the US, for example, HIPC debt is held on official accounts at less than 10 per cent of its face value. At the same time, the costs of debt relief would be spread over

several years. In the unlikely event that all of the eligible HIPCs were to receive full debt relief within four years, and discounting the difference between real and nominal costs to bilateral creditors, the annual cost of the Cologne reforms would in reality amount to about \$6 billion. The bilateral share of this amounts to about 70 per cent of what has been cut from bilateral development assistance budgets if disbursements for 1997 are compared to the figure for 1992.

Against this background, the principle of creditors supplying new and additional resources should be brought to the centre of the HIPC reform process. If debtors are expected to meet conditions for good performance, they have a right to expect creditors to also meet minimum standards. If creditors are genuinely committed to partnerships for poverty reduction, and to integrating HIPC debt relief into such partnerships, they need to mobilize the resources for effective implementation. Robbing Peter to pay Paul is not a financing principle for debt relief. It is also inconsistent with the stated development cooperation aims by the donor community.

Fiscal implications for the debtor nations

If the reforms to the HIPC Initiative are fully funded from new and additional resources, the annual savings to the debtor nations will be considerable. One preliminary estimate indicates reductions in the HIPCs' debt service obligations of around \$2 billion per annum, rising to between \$3 billion and \$4 billion a year from 2000 onwards.³⁵ This compares to the roughly \$12 billion a year



In Ho Chi Minh City, classes are held after working hours to provide basic education for children like this Vietnamese girl who work to help their families survive.

amount to between \$260 million and \$378 million per annum, depending on assumptions about front-loading (Figure 8).

Budgetary savings on this scale would significantly improve the HIPCs' ability to reduce poverty. But a cautionary note is in order. While the aggregate savings would be large, there would be a wide difference in savings between debtor countries. Countries with large fiscal burdens would gain less than others. Whatever the aggregate savings, many countries' debt service

they receive in programme aid. Clearly, the Cologne reforms have the potential to mobilize resources on a scale that could make a real difference in terms of financing poverty reduction strategies.

Initial country-level projections by the IMF and World Bank confirm this assessment. For the seven countries that have reached their Decision Point or Completion Point, aggregate debt service obligations would fall by 27 per cent compared to the period 1993–1997.³⁶ This is double the projected savings under the current framework. The overall annual savings for these countries would

obligations after the Cologne reforms would still remain large in relation to government spending on basic services. The following cases illustrate the problem:

- Burkina Faso would continue to spend more on debt servicing than on primary health care, despite having one of the highest child mortality rates in Africa.
- Côte d'Ivoire would spend three times as much on debt servicing as on primary health care.
- Mali would spend more on debt servicing than on primary health care and basic education combined.

This is not to reduce the debate over the adequacy (or otherwise) of the proposed reforms. However, despite acknowledging the importance of strengthening the linkage between debt relief and poverty reduction, the Cologne proposal does not address the capacity of governments to finance the provision of basic services. If debt relief is to be seen as one element of a broader financing strategy for poverty reduction, implementation of the reformed HIPC Initiative needs to ensure that debt servicing does not crowd out important investments in human development.

Linking early debt relief to poverty reduction

There are several elements in the new Initiative that lend themselves to the creation of incentives for poverty reduction. The floating Completion Point is one such element. This could provide for an earlier flow of debt relief. If poverty reduction were used as a performance criterion for bringing early debt relief, the floating Completion Point could also generate incentives for policies likely to improve human development.

Much will depend on the choice of reforms and policy goals that will govern the decision on whether a floating Completion Point has been reached. Detailed proposals have yet to be developed. But there are strong indications that the most likely outcome will be ‘more of the same’. This appears to be the clear intention of the IMF and the World Bank. As a recent paper to their Executive Boards puts it: “The Fund would take the lead in defining and monitoring macroeconomic

policies in the context of ESAF-supported programmes, while the Bank would take the lead in defining and monitoring social policies and poverty reduction programmes.”³⁷

There are three major problems with this approach. First, the IMF is already taking the lead in defining and monitoring macroeconomic policies, yet the implementation of the HIPC initiative has been slow so far. There is an obvious contradiction between pledging a commitment to earlier debt relief on the one hand, and maintaining the very policies that have prevented early debt relief on the other.

The second problem is that the division of labour envisaged between the World Bank and the IMF is curiously anachronistic. In their policy statements, donors consistently stress the importance of integrating poverty reduction into a macroeconomic reform package. The World Bank’s Comprehensive Development Framework is designed to achieve this objective by breaking down artificial distinctions between ‘economic’ policies on the one side and ‘human development’ policies on the other; it explicitly considers economic and social development as two sides of the same coin. But under the proposed division of labour these distinctions would be reinforced. It is not only the relationship between the IMF and the World Bank that threatens to lock the reformed HIPC into an outmoded approach. Other actors — including United Nations agencies, bilateral donors and civil society — are conspicuous by their absence. Their exclusion threatens to undermine efforts to strengthen the linkage between debt relief and poverty reduction.

Third, and last, the IMF-World Bank perspective would make compliance with ESAF programmes the principal indicator of a government's commitment to poverty reduction. There is little justification for this. While there is a case for maintaining the link with ESAF programmes, since a stable macroeconomic environment is vital to growth and poverty reduction, economic stability goals have to be pursued as part of a comprehensive development strategy.

Part of the problem with the ESAF programme as it currently operates is that it has not been integrated into national poverty reduction plans. As the recent external review of the ESAF programme by a group of independent experts noted, public spending limits have often been set too tight, with detrimental effects on human capital and growth.³⁸ The external review also drew attention to the failure of ESAF programmes to develop a sense of national

ownership. One reason for this is that ESAF targets are typically drawn up by IMF staff without reference to the medium-term financial frameworks, sectoral plans and poverty reduction goals developed by governments with their donor partners. The challenge, then, is to integrate ESAF programmes into a wider eligibility framework. This should aim to ensure that early debt relief is available to all governments able to demonstrate a capacity to absorb the savings into national poverty reduction strategies. The final section of this paper examines what this might mean in practice.



Seventy per cent of all Bolivians live in poverty, and malnutrition is widespread. A rare treat of fortified milk and bread is being given to the children of a Quechua village .

Debt relief is not being introduced into a policy vacuum. Many of the HIPCs are developing plans to reduce poverty in the context of broader reforms, including economic stabilization, more transparent budgetary systems, medium-term financial frameworks and sectoral strategies for health and education. Efforts to strengthen the linkage between debt relief and poverty reduction should be built on these foundations.

At the outset, it has to be recognized that debt relief, like any form of donor financing, can only be as effective as the policy environment into which it is introduced. It is likely to have a lasting impact only in a climate conducive to both macroeconomic stability and human development. Attempts to create such a climate by imposing stringent conditions on debt relief are short cuts that are unlikely to succeed.

In the absence of a strong domestic momentum for change, conditionality does not work. Even the most rigorous project selection or loan conditions cannot guarantee effective aid in a distorted environment.³⁹ In such an environment aid tends to get treated as fungible, paying not for the items against which it is earmarked but for the marginal expenditure it makes possible. Once this is recognized, it is the overall quality of public sector finances that determines the effectiveness of aid. In terms of reforming the HIPC Initiative, this suggests that countries with a strong poverty focus in their spending priorities, allied to high levels of budget transparency, deserve immediate attention.

The new policy environment

What are the institutional indicators for a public policy environment benefiting the poor? Inevitably, these vary from country to country, but there are common elements. The most important — and the most relevant for the HIPC Initiative — include the following: a comprehensive poverty reduction plan; a medium-term financial framework; public expenditure reviews; and sector-wide approaches in areas such as health and education.

A comprehensive poverty reduction plan. Poverty reduction cannot be limited to changes in public spending. All aspects of policy — ranging from stabilization to structural reforms — have to be included. Public participation in the identification of strategies and actions is important, because top-down technocratic approaches can lead to the misallocation of resources. A comprehensive poverty reduction strategy needs to establish broad benchmarks against which to measure progress. It also needs to be reflected in national budget priorities.

A medium-term financial framework (MTFF). The MTFF provides the framework within which annual budgets can be rolled forward within the macroeconomic reform programme. It sets expenditure priorities over time, indicating how specific programmes and the overall budget will be financed. The requirement for a successful MTFF is a strong and transparent annual budget process, in which expenditures are allocated against identified targets. One of the strengths of the Poverty Eradication Action Plan in Uganda has been its integration into an MTFF and annual budget

process in which overall resource distribution is clearly established, with priority social sectors such as basic health and primary education kept insulated from reductions in spending.

Public expenditure reviews (PERs). The PER process is central to transparent budget management. Proper monitoring and auditing of public spending ensures conformity with budgetary priorities; the formulation of expenditure proposals; and analysis of whether expenditure allocations have contributed to their intended outcomes in human development. The PER process covers all areas of government policy and, in good-case scenarios, all line ministries. An important function is to cover all donor-financed expenditures, many of which are not recorded in the national budget. The PER process can also serve to better integrate the recurrent and investment budgets. It has also highlighted the potential for increasing expenditure in social policy areas through more effective management of budget expenditures and development assistance, as recommended by the 20/20 Initiative, which calls on governments to allocate 20 per cent of their budgets and 20 per cent of aid to basic social services.⁴⁰

Sector-wide approaches (SWAPs). SWAPs have been developed to reduce aid fragmentation that resulted from a multitude of often unsustainable donor projects. They have been defined as “an integrated programme ... that includes agreed goals and objectives, a comprehensive policy framework, a detailed investment plan, an operational programme of work with specific expenditure plans, and clear funding

commitments from governments and donors.”⁴¹ At the same time, they build a sense of ownership by providing broad budget support to a clear national strategy. The operating principle is that donors will give up the right to select projects on a ‘pick-and-mix’ basis, in exchange for helping to shape a broader sectoral strategy. An underlying assumption is that pooled funds can be channelled through national and sectoral budgets for a common programme of work at each level of implementation.⁴² Success in the development of SWAPs is contingent on the development of annual budget exercises and MTFs that allow the monitoring of spending patterns in relation to allocations. SWAPs are used to align donors and national authorities behind shared priorities and objectives. In Ethiopia, for example, the Education Sector Development Programme operates on the basis of a five-year cycle with clearly identified stepping-stone targets for achieving universal primary education by 2015. In the current cycle, targets include increasing primary school enrolment by 4 million by 2001; increasing the proportion of girls in primary school from 36 to 45 per cent; and increasing public spending as a share of GDP to finance improved access to textbooks and teacher training.⁴³

In considering how all these new practices can best be adapted to the framework of the HIPC Initiative, it is important to acknowledge problems in implementation. These are not quick-fix solutions. The Government of Ethiopia started developing strategic plans for the health and education sectors in 1994 but donors did not appraise the plans for joint funding until

1998.⁴⁴ The health sector strategies for Ghana and Zambia also underwent a four-year gestation period. Serious problems of ownership have arisen in many cases, reflecting a tension between donor concern to produce fast results and the need to develop the national capacity and sense of ownership that will ensure sustainability.⁴⁵

Despite these problems, the emerging policy environment has helped create positive conditions for strengthening the linkage between debt relief and poverty reduction. The Government of Uganda has shown through example what can be achieved. The Poverty Action Fund (PAF) was established in 1998 to direct funds released as a result of the HIPC Initiative towards priorities identified in the Poverty Eradication Action Plan.⁴⁶ These have amounted to around \$37 million per annum. The PAF has been used to finance public spending in five key areas: primary education, primary health care, water and sanitation, rural feeder roads and agricul-

tural extension. One specific target was to build or refurbish 1,056 classrooms as part of the national programme to achieve universal primary education. The goals for the PAF have been identified through a process of consultation with civil society at the local level, and funds are subject to stringent monitoring. A small proportion of each grant is set aside for auditing procedures. Line ministries are required to report on a quarterly basis on their use of PAF resources.

The PAF has succeeded above all because it is a component of the Poverty Eradication Action Plan. The actions and strategies are embedded in both the annual budgets and the MTFE, as well as sector-specific policies for education, health and rural development. The PAF has delivered results not because it is a stand-alone fund for poverty reduction, but because it is part of a comprehensive poverty reduction strategy.⁴⁷ The PAF model should not be viewed as a blueprint. Strategies and mechanisms for strengthening the linkage



In Sierra Leone, where over 5 per cent of children are not expected to reach the age of five, almost half the population lacks access to sanitation and safe drinking water. A girl hauls a heavy can of water, performing a common household chore.

between debt relief and poverty reduction will have to be elaborated on a country-by-country basis; but the Ugandan experience demonstrates the potential benefits of integrating debt relief into a public policy environment in which poverty reduction has been placed at the centre of a wider reform process.

A framework for strengthening the HIPC Initiative as a vehicle for poverty reduction

Bearing in mind the need to avoid detailed blueprints, a broad and flexible framework is needed to make the HIPC Initiative a more effective mechanism for poverty reduction. That framework should be based on three principles:

- Eligibility for HIPC debt relief should be determined on the basis of the commitment and capacity to reduce poverty, rather than the meeting of macroeconomic targets alone.
- Debt relief should augment the absorptive capacity to reduce poverty, achieve sustained and equitable growth, and invest in children and in human resources.
- In assessing national commitment and capacity, the IMF should be counted as one stakeholder in a wider group comprising donors, United Nations agencies and civil society.

UNICEF and Oxfam have developed one possible strategy for turning these principles into practice. It involves a two-phase process. The first phase would result in arrival at the Decision Point within a maximum of two years. Progress to Completion Point in the second phase would be determined by a Debt-for-Development Plan. This would set out approaches for absorbing debt relief into the national poverty reduction strategy. The Debt-for-Development Plan would be the principal performance criterion for progressing to the floating Completion Point. It would include macroeconomic criteria

and budget indicators, as part of a wider national poverty reduction strategy. IMF benchmarks would be included in the indicators, though these would be fully consistent with human development targets.

Phase 1: To the Decision Point

Debtors would be required to establish a track record indicating their commitment to reform and poverty reduction. However, the eligibility criteria would be reformed. The preferred option would be for the World Bank, the IMF, the United Nations Country Team and key donors to reach an agreement with the government on more flexible criteria for macroeconomic adjustment, which are compatible with the goal of poverty reduction. ESAF parameters would be brought into line with the policy requirements for achieving the 2015 targets for social development.

The length of the track-record period would be set in a more flexible manner, depending on country-specific events, economic shocks and other conditions. It should not be longer than two years and in most cases should vary between one and two years.

During this initial track-record period, governments would be expected to:

- Demonstrate progress towards an effective *poverty reduction strategy*. Benchmarks for measuring progress would have to be established on a country-by-country basis. For illustrative purposes, these might include the following indicators: equity and efficiency in public spending, drawing on the 20/20 targets; progress towards budget

transparency, including the publication of budgets and public expenditure frameworks; and progress towards macroeconomic adjustment, including fiscal deficit closure and improved revenue collection.

- Develop through dialogue with civil society and donors a clear profile of the underlying causes of poverty and inequality, including regional and gender inequalities. These would be set out in a *national poverty assessment*.
- Develop a *poverty reduction plan* that addresses the challenges set out in the poverty assessment. It would include medium-term budgetary provisions, poverty-focused public spending priorities, sector plans and mechanisms for strengthening engagement with civil society. The plan would:
 - set out clear priorities for action, along with well-defined targets and budgetary provisions;
 - identify timetables for the development and implementation of SWAPs in areas such as health and education;
 - demonstrate how poverty reduction goals would be accommodated in an MTF;
 - provide for annual publication of PERs and budgets;
 - set out strategies for engagement with civil society and local communities in the design, implementation and monitoring of poverty reduction strategies; and
 - establish mechanisms for evaluating and monitoring the impact of economic reforms and public spending on poverty and inequality.

Performance benchmarks should be developed with a view to capturing the pace, scale and quality of reform, rather than absolute levels of achievement. As with the floating tranches of the World Bank's Higher Impact Adjustment Lending, there would be no fixed timeframe for preparing a poverty reduction strategy. Countries reaching Decision Point with a strong national poverty reduction plan already in place could proceed straight to Completion Point. Under this arrangement, both Bolivia and Uganda would have received HIPC debt relief more than one year earlier than they did under the current framework.

Time lags in deciding that countries have reached Completion Point should be seen not as a mechanism for punishing 'bad' performance or delaying HIPC debt relief, but as a means of ensuring that the flow of HIPC debt relief after Completion Point will be used with maximum efficiency.

Phase 2: The interim from Decision Point to Completion Point

At the Completion Point, governments would receive the HIPC reduction in their debt stock and exit from the HIPC Initiative. To reach this point countries would need to meet just one condition: namely, *a demonstrable capacity to absorb debt relief to reduce poverty*. While some countries could proceed immediately from Decision Point to Completion Point with no interim, generous interim flows of debt relief would substantially reduce the costs of delayed progress for HIPCs with less well-developed poverty reduction strategies.

Performance criteria measuring progress in the development of a poverty

reduction strategy would include macro-economic and social policy indicators. Particular weight would be attached to:

- *Strengthened budget management*, including the prioritization of expenditures and adherence to budget allocations across spending categories; progress towards integrating the budgets for recurrent spending and capital spending; PERs evaluating performance against the approved budget frame and output targets; and improved transparency, including the timely publication of PERs.
- *The development of an MTFF* establishing clear priorities for annual budgeting.
- *Progress towards poverty-focused public spending priorities*, including commitments geared towards achieving the 2015 targets.

In order to demonstrate the capacity to absorb debt relief into the national poverty reduction plan, governments would be expected to develop, in cooperation with civil society and donors, a *Debt-for-Development Plan*. This would set out how savings released as a result of reduced debt servicing will contribute to accelerated progress towards the 2015 human development targets. The Ugandan Poverty Action Fund could serve as a useful model, though not as a blueprint. The Debt-for-Development Plan would detail:

- the proportion of debt relief that will be channelled into basic social services;
- the outcome targets of the increased spending on basic services, over and above those envisaged in existing sector strategies and projected trends;

- economic infrastructure specifically benefiting the poor, such as support for rural feeder roads, microcredit, irrigation and marketing support, specifying the regions and districts to be targeted; and
- monitoring and evaluation arrangements with civil society to assess the outcome.

The aim of the Debt-for-Development Plan would be to provide a broad indication of expenditure plans, with special focus on the 2015 goals. It would be developed with bilateral donors, United Nations agencies and the World Bank, and presented to a national consultative group. The Plan would not provide a checklist for project-by-project auditing, but would act as an agreement of understanding between creditors and debtor governments over spending intentions.

The Debt-for-Development Plan would also help to define the most appropriate rate of disbursement for HIPC debt relief. For countries who have well-developed antipoverty plans, but whose full implementation is constrained more by lack of funds than by lack of institutional capacity, the debt relief could be provided up front (subject to the need to avoid future humps in repayments). In other cases, there might be an emphasis on institutional development in the early phases, with heavier flows of debt relief coming on stream in, say, years three and four. In Zambia, for instance, donors spent two years supporting the creation of decentralized health structures before channelling substantially increased resource flows through those structures.

Conclusion

Poor countries have been shackled by debt for far too long. It has been allowed to deprive some of the world's poorest children of their basic rights to health, education and livelihoods. It has contributed to sickness, premature death and shocking levels of poverty. What makes this waste so tragic is the simple fact that the human costs of debt have been so high, while the financial costs of resolving the debt crisis are so relatively small.

The Cologne proposal has raised hopes that we will soon see the beginning of the end of one of the great social injustices of our century. Debt relief linked to poverty reduction would allow the HIPCs to make some headway on the challenges that

lie ahead. The challenges include improving the prospects for survival of the next generation and building the foundations for sustained economic recovery through the enlargement of opportunities. If the burden of debt can be removed, poor countries will have a better chance of achieving the broad-based growth and human development upon which their futures depend.

The financial costs of making the Cologne proposals work are minuscule in relation to the resources available. The human costs of failure are unthinkable. "The time for an assault on debt and destitution is not now — it was yesterday. For millions of children, tomorrow will be too late."⁴⁸



Two young girls play at 'washing day'. For many of the world's poorest children, safe water is just a dream.

The HIPC's: Key human development indicators

	Life expectancy at birth (years) 1997	% of population below \$1 a day 1990-95	Under-5 mortality per 1,000 live births 1997	Total adult literacy 1995	Net primary school enrolment/attendance (%) 1987-97	% of under-5 children under weight moderate & severe 1990-97
Angola	47	-	292	42	-	42
Benin	55	-	167	37	62	29
Bolivia	61	7	96	83	89	16
Burkina Faso	46	-	169	19	33	30
Burundi	47	-	176	35	52	37
Cameroon	56	-	145	63	65	14
Central African Rep.	49	-	173	60	63	27
Chad	48	-	198	48	52	39
Congo	51	-	108	75	-	17
Congo, Dem. Rep.	53	-	207	77	56	34
Côte d'Ivoire	51	18	150	40	55	24
Equatorial Guinea	50	-	172	79	-	-
Ethiopia	50	46	175	36	24	48
Ghana	58	-	107	65	70	27
Guinea	46	26	201	36	33	-
Guinea-Bissau	44	88	220	55	47	23
Guyana	64	-	82	98	87	12
Honduras	70	47	45	73	90	18
Kenya	54	50	87	78	84	23
Lao People's Dem. Rep	53	-	122	57	71	40
Liberia	50	-	235	38	56	-
Madagascar	58	72	158	46	59	40
Malawi	41	-	215	56	83	30
Mali	48	-	239	31	41	40
Mauritania	53	31	183	38	54	23
Mozambique	47	-	209	40	50	27
Myanmar	60	-	114	83	85	43
Nicaragua	68	44	57	66	83	12
Niger	48	62	285	14	24	43
Rwanda	40	46	170	61	61	27
Sao Tome and Principe	64	-	78	57	93	16
Senegal	51	54	124	33	59	22
Sierra Leone	37	-	316	31	-	29
Somalia	49	-	211	24	-	-
Sudan	55	-	115	46	55	34
Tanzania	51	11	143	68	48	27
Togo	50	-	125	52	81	19
Uganda	41	69	137	62	64	26
Viet Nam	67	-	43	94	81	41
Yemen	58	-	100	39	57	39
Zambia	43	85	202	78	74	24
Average data:						
HIP countries	53	44	155	61	60	34
Least developed countries	51	-	168	48	58	40
Developing countries	63	30	96	71	82	31
Industrialized countries	78	-	7	98	97	-

Sources: Under-5 mortality rate and the net primary enrolment/attendance data are from *The Progress of Nations 1999*. All other data: *The State of the World's Children 1999*.

- ¹ At the World Summit for Social Development, held in Copenhagen in 1995, over 180 governments committed to a range of social development targets for the year 2015. They were later synthesized by the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) into a set of goals, including achieving universal primary education, reducing 1995 child mortality rates by two thirds and halving the numbers living in extreme poverty, see DAC, *Shaping the 21st Century: The contribution of development co-operation*, OECD, May 1996.
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³⁸ IMF, *The External Review of the ESAF: A report by a group of independent experts*, 1998.

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⁴⁰ The 20/20 Initiative was formally endorsed at the World Summit for Social Development in 1995. As a compact between developing and industrialized countries, it calls for developing countries to allocate – on average – 20 per cent of the national budget and 20 per cent of official development assistance to basic social services. Its main purpose is to make an integrated package of basic social services available to all by spending more on these services and/or by spending with greater equity and efficiency. See *Implementing the 20/20 Initiative: Achieving universal access to basic social services*, published jointly by UNDP, UNESCO, the United Nations Population Fund (UNFPA), UNICEF, the World Health Organization (WHO) and the World Bank, September 1998.

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