LINKING HIPC II DEBT RELIEF WITH POVERTY REDUCTION AND WIDER AID ISSUES : SOME REFLECTIONS AND SUGGESTIONS

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Executive summary

This paper has been prepared by an independent expert group to explore how the link between debt relief and poverty reduction (PR) may be strengthened in the modalities for HIPC II and to examine the wider implications for donors and aid arising from the new debt relief initiative. It draws particularly from experience of the Sub Saharan African countries and the work commissioned by the Special Programme for Africa (SPA).

The starting point is the perspective that PR is a long-term process going well beyond HIPC operations. It is not just about social spending priorities. It requires a comprehensive approach involving a whole range of policies, expenditures, administrative and political processes and capacities. Nevertheless the Cologne initiative provides a very welcome impetus to PR and potentially significant additional resources for the HIPC countries to pursue it.

First, we suggest a new approach to performance conditions/criteria for meeting poverty reduction (PR) objectives under HIPC II which include the following recommendations.

- A switch away from sets of multiple micro-conditions, social targets and the earmarking of funds to a more comprehensive approach to 'completion' under HIPC II.

- The focus to be on the budgetary and planning processes required to ensure a more effective basic poverty reduction framework. The key would be an effective Medium Term Budget Framework (MTBF) with a flexible medium term rolling budget.

- The government should be at the centre of process to draw up plans and budgeting for poverty reduction in a way which is more responsive and accountable to domestic society and parliamentary institutions and especially the needs of the poor.

- Broad PR benchmarks should be established to judge the progress of change towards completion under HIPC II. These benchmarks might include the development of an anti-poverty strategy, a genuine poverty reduction action plan with costed programmes, progress in monitoring procedures for tracking expenditures, outputs and outcomes for PR, improvements in transparency and participation in planning and budgeting.

- There should be no pre-set menu for judging the pro-poor content of each governments strategy, plan and budgets. Intra-sectoral shifts in education and health spending (subsidies) may often be a priority in African countries but equally there may be cases where greater priority attaches to infrastructure improvements to increase livelihoods of poor regions and poor groups or provision of more effective safety nets for the vulnerable.

- Review procedures involving domestic and external stakeholders will be required.

- ESAF should be reformed to be more compatible with poverty reduction objectives. In particular the IMF should be less conservative in its approach to the incorporation of new aid flows in setting budget ceilings. The process of ESAF negotiation should be more open and involve a wider range of actors to ensure the stronger incorporation of poverty reduction objectives.

- Structural adjustment programmes can and should be designed in a more pro-poor way, not only taking proper account of the likely impact of policy changes on the poor but taking account of inequalities in income and asset distribution.

- *To achieve completion under HIPC II and gain access to debt relief, countries should be required to meet the proposed 'broad PR benchmarks' and remain 'broadly on track' with their macro-stability targets under ESAF. These PR*
- *benchmarks should replace and not add to, existing social and structural conditions for reform in determining access to debt relief under HIPC II.*

Second, it proposes changes to maximise the contribution of HIPC to poverty reduction including the following recommendations.

- The formal triggers should relate more to budget revenues than exports. The ratios of debt service/budget revenue and the revenue/ GDP should be determined on a case- by- case basis not *a priori*. Depth of relief should relate to the degree of discretionary revenue available to countries.

- To speed access to resources for implementing new pro-poor programmes, interim relief should be available before completion and 'floating conditionality' should be adopted to enable countries to move from decision to completion as rapidly as possible provided the benchmarks are met.

- Front loading of the debt service reduction is a priority in the implementation of HIPC II. Creditors are urged to work for the maximum degree of early relief in their pursuit of funding sources for HIPC II. Targets might be set for the percentage of debt service reduction in the earlier years in countries.

- It is essential that funding for HIPC II should be fully additional to the level of government concessional aid flows to developing countries which would otherwise occur. The sourcing of HIPC II needs to be independently and critically monitored for any apparent evidence that debt relief merely displaces existing or likely aid flows overall.

Third, donors generally need to focus on the wider implications of the adoption of HIPC. These include the following :

- There are likely to be potential distortions in the overall country allocation of aid flows because debt rather than poverty criteria predominate under HIPC. These need to be 'balanced-up'. All aid agencies should undertake some reappraisal of their overall country allocation of aid from a PR perspective and after debt relief.

- HIPC II should be a catalyst for bilateral agencies to be involved much more in dialogue at country level on national budgetary & PR priorities. More vigorous and co-ordinated work is required with the IFI's on country poverty reduction objectives within Consultative Groups and SPA forums.

- Donors should subordinate their Country Assistance Strategies to genuine government plans and budgeting with a PR orientation; channel more of their funds into governments general budgets on a medium term commitment basis; integrate their operations with the governments overall spending framework through support for PR focussed sectoral programmes and away from ad hoc projects.

- For poor countries overall some public mechanism should be established to review progress towards the International Development Goals / poverty reduction objectives This might be an annual review in the IMF / WB Board and would look at the aid and debt relief funding needs and availability for all these countries.

Introduction: Purpose of Paper

The main purpose of this paper is to make suggestions for the way in which HIPC II might more effectively link debt relief to poverty reduction objectives. It also seeks to put the debt relief initiative in the wider context of all aid flows and ongoing donor operations for poverty reduction.

The paper is primarily concerned with the sub Saharan African countries which constitute the majority of the HIPCs. It also draws on experience coming out of work commissioned by the Special Programme for Africa (SPA) and from insights and guidance emerging from the work of the Sub Committees of the SPA covering economic and budget management and poverty and social policy. These include a current Status Report on Poverty in Africa as well as ongoing studies on the institutional and political processes involved in creating a poverty reduction framework in some African countries. This is supplemented by insights gained from reviewing the working of HIPC I operations in several countries.

The Cologne Initiative 1999 proposes a mix of both debt sustainability and poverty reduction criteria. The debt eligibility criteria of HIPC I and II and therefore the allocation of the potential cash savings are geared primarily to poor countries with debt sustainability problems. The new criteria widen the range of 'IDA only' countries eligible. Cologne points to an enhanced poverty reduction framework for the provision of relief and suggests links with certain types of social spending priorities. However, the eligibility criteria for debt relief on debt sustainability grounds and those on poverty reduction (PR) grounds are not the same though they overlap. Hence the paper takes up these two perspectives sequentially and then considers the wider aid implications of the implementation of HIPC II. The paper is thus in three parts.

Part I explores poverty reduction performance criteria and benchmarks as well as the challenge of ensuring that ESAF programmes are more poverty focussed. Part II focuses on ways to maximise the debt relief contribution to poverty reduction through speed of access to relief, interim measures and 'front loading' of debt service relief . It also examines the question of the additionality of HIPC II funding. Part III looks at the wider aid implications of HIPIC II and the need to balance potential distortions in aid allocation and how to integrate debt relief with ongoing aid flows and operations.

Part I: POVERTY REDUCTION CRITERIA AND PERFORMANCE

1.1 A Critique of Poverty Reduction Criteria under HIPC I

Before embarking on an exploration of a potential new orientation for performance under HIPC II we set out a brief critique of how poverty and social objectives were handled under HIPC I. It is based on recorded experience with the first eight countries which became eligible for the initiative (Bolivia, Burkina Faso, Cote d'Ivoire, Guyana, Guinea- Bissau, Mali, Mozambique and Uganda).

While the introduction of social criteria in the context of debt relief was innovatory, this review suggests some important deficiencies both in the types of criteria used and

the way they were applied from the point of view of a balanced and effective poverty orientation and likely ownership. These can be summed up as follows.

Variation and inconsistency

Some set objectives for spending allocations for education or health sectors as a whole while others focussed on sub-sectoral allocation to primary levels of education and health. There has been considerable focus on social targets; output indicators such as primary school enrolment or infant vaccination or targets for provision of clinics and drugs. A few chose outcome indicators such as infant mortality. This variation to some extent reflects the weaker state of play on PR in earlier cases. Table 1 provides a summary of the social targets in eight countries.

TABLE 1

HIPC SOCIAL SECTOR TARGETS
(in %, unless specified otherwise)

	Bolivia		Burkina Faso		Côte d'Ivoire		Guinea-Bissau		Guyana		Mali		Mozambique		Uganda	
	1996	1999	1996	1999	1996	2000	1996	2000	1995/6	2000	1996	2000	1996	2000	1997	2000
HEALTH																
Health expenditure / total budget			10,3	12	7,1	10,8		11 (1998)						8 (1998)		
Life expectancy at birth (years)	59						38		66		50		47			
Infant mortality (per 1,000 births)	69						138		43		123	73,8	134			
Maternal mortality (per 100,000)							800				1249	874,3	1100			
Primary health care											30	60	40	60		
Infant vaccinations	78	85	58	80	60	80	45	50					58	80	50	70
Access to family planning						100										
Access to safe water	55						25		73							
urban					75	85										
rural					50	65									39	55
EDUCATION																
Basic education expenditure / total budget			8,8	13	31,6	39	10	16 (1999)						18 (1998)		
Children's primary enrolment			40	47	51	55	59	63 (2001)			42	50	62	79	83	95
rural coverage - male	66	72														
rural coverage - female	54	64														
Female primary enrolment			30	38	42	44	35				34	40	45			
Literacy rate	77				43	48	26		98		32		40			
female literacy	70								95							
Expenditure / GDP	5,4															
Health	1,8		2,2		1	1,5			3	3,8						
Basic education	3,1	3,9	1,9		4,5	5,4			4	5,3						
Expenditure per capita																
Health			5													
Basic education			4,4													

Sources: IMF/IDA, HIPC Board Papers

Bolivia (final) pp. 5, 27-29 * Burkina Faso (final) pp. 12, 29 * Côte d'Ivoire (final) pp. 15, 30-31 * Guinea-Bissau (preliminary) pp. 10-11, 44 * Guyana (final) pp. 20-24 * Mali (preliminary) pp. 4, Mozambique (final) pp. 15, 18-20, 36-37 * Uganda (final) pp. 8-9, 17

Too narrow PR focus

While most HIPC I conditions tended to focus heavily on education and health, few attempted to tackle a wider range of social services e.g.. access to clean water etc. Only one went beyond the social sectors. There was normally no approach to coverage of the whole range of poverty relevant issues beyond the social sectors such as infrastructure to open up poor regions or to give the poor better access to markets or services, skills and physical assets for livelihood creation.

Lack of a comprehensive approach to poverty reduction.

Most HIPC programmes appeared as though PR criteria were 'add-ons'. Moreover, it is not clear that the whole set of ESAF and related IDA structural conditions have incorporated any poverty implications in their focus or design. Structural reforms such as liberalisation of markets de-regulation, privatisation and tax reform need also to be related to their potential implications for inequality in ownership, income or impact on poor people.

The Uganda and Mozambique cases come closest to the concept of a comprehensive approach to with their National Poverty Strategies / Plans, the integration or planned integration of PR orientation into a Medium Term Budgetary Framework and annual budget processes. While they may not necessarily be perfect models their approaches are a useful guide in the development of more effective approaches under HIPC II.

Lack of focus on prioritisation and resourcing

There was no focus on the need for hard prioritisation of public spending and no indication usually of the costing of plans and how the priorities might be changed under tight budgetary ceilings or under more relaxed ones. There was some sense (not systematically tested) that the targets may have been tailored to the amount of debt relief available or the donor community's perception of the absorptive capacity of the countries social sector line Ministries. In other words there was no concept of a strategy for PR to build capacity and expand resources for this.

Ownership considerations

While those countries engaged in a more protracted and consultative process of formulating a poverty reduction programme (Bolivia, Uganda) feel a sense of ownership, others appear to see the HIPC conditions as more imposed conditionality with little consultation.

Earmarking

There have been several examples of 'earmarking' of donor funds to specific poverty reduction uses (not all necessarily under HIPC). Experience suggests that *earmarking* for special uses even if related to poverty objectives, is not an appropriate instrument.

To earmark to narrowly defined specific uses may avoid fungibility problems if some agreement on additionality is enforced but this is not easy to achieve. There are bureaucratic complexities and difficulties in setting and monitoring the use of funds. This is a too donor-driven model.

Special funds

The use of *special funds* devoted to PR objectives has been attractive to certain donors and may be necessary to attract their budgetary funds. They usually involve setting up an account into which the domestic currency-equivalent of the value of debt relief provided by donors is paid, and drawn down against, budget expenditures on poverty programme. A recent example is the Uganda Poverty Action Fund. Special funds are compatible with sound budget management only if they are fully integrated into the budget. The conditionality established under The Multilateral Debt Funds (MDFs) established in Bolivia Burkina Faso, Mozambique, Tanzania and Uganda has involved reviewing progress in implementing budget frameworks and poverty reduction programmes. These have allowed flexibility in advancing poverty reduction. However, special funds are only likely to ensure additional spending on PR / social areas in the short- run and they may provide an excuse for governments to avoid a more comprehensive commitment to poverty and social objectives in their spending. It is not always appropriate to have one-for-one debt relief to special fund spending especially if the full additionality of HIPC relief is not assured. There may also be an absorption problem if both development assistance and the MDF are targeting budget support to poverty programmes in health and education.

Summary conclusions from past experience

- Lists of micro-conditions and targets do not seem an appropriate or effective way of determining completion under HIPC.

- Earmarking of funds for social or PR purposes is not an appropriate instrument.

- Linking debt relief to special funds such as MDFs or Poverty Action Funds have some advantages and disadvantages. However, if used they should not have separate accounting arrangements and should be integrated into the whole budget.

- The accounting and audit for such funds should stop at the point where funds are drawn down into the budget lines of specific departmental programmes as part of the general budget resources available to the receiving department.

1.2 A New Orientation for Poverty Reduction under HIPC II.

Starting Assumptions:

First poverty reduction is a *long- term* process. The framework for implementing it for many countries will require a period going beyond the operations of HIPC. Moreover debt relief is only one element in the financing of poverty reducing measures although

a significant source of funds for it. Second, it requires a *comprehensive* approach. Poverty reduction cannot be limited to changes in the patterns of social spending. All aspects of policy – including governance, budgetary management, stabilisation and structural reforms –must be oriented towards more effective focus on problems of poverty than in the past. Third, a key element is the need for a *Medium Term Budgetary Framework* which feeds into annual budgeting. This will allow the prioritisation of a whole range of expenditures in each specific country. Poverty reduction is not just about a specific set of social sector priorities important as these are. It goes well beyond this into conditions for the creation of livelihoods and employment. Fourth the government must be at the centre of poverty oriented planning but it must provide a focus for participation and dialogue for all parties. Budget systems should be *accountable* in terms of being consolidated or unified, with processes that allow real involvement of domestic parliaments and domestic civil interests as well as the external funding stakeholders in the process of determining the priorities and scrutinising the outcomes. There needs to be improvement in budget execution to ensure that outcomes reflect their original intentions much more than they have in the past. This includes systems for monitoring the budgetary and subsequent outcomes to ensure they meet the poverty reduction objectives set originally. Fifth, there needs to be steady monitorable progress towards a satisfactory standard of *public management capacity* which allows a poverty strategy and action plan to be drawn-up on the basis of an adequate information/analysis as a basis for designing effective policy options.

The proposed approach to PR performance requirements.

The requirement for satisfactory completion on grounds of meeting the PR/social objectives under HIPC II, would therefore have the following characteristics.

- Focus on the budgetary and planning processes required to ensure a more effective basic poverty reduction framework. The main institutional processes at the centre of these concerns would be: an effective *Medium Term Expenditure Framework (MTEF) with a medium term rolling budget process*. Spending plans and how they would be financed from the government, debt relief and other donor sources should be set-out in transparent form and subject to annual dialogue and rolling forward.

- *Broad benchmarks*. The comprehensive approach to poverty reduction would need some broad benchmarks to judge the progress of change. If the starting point for most countries is likely to be the existence of a poverty profile and solid annual budget framework then some benchmarks could be set for achievement between decision and completion point in HIPC which would be an indication of their commitment These should include include:

  - a poverty strategy which looks at the poverty content of all policies;

  - a genuine Poverty Reduction Action Plan or equivalent with costed programmes of expenditure;

  - moves to integrate this plan with the MTEF to make sure that the latter is fully poverty oriented;

- the governments own plans/budgets should spell out reasonable and feasible output or outcome indicators by which achievement of their PR objectives would be monitored and judged in future.

- the development of the governments poverty monitoring system and use of quantitative surveys and participatory work;

- progress in transparency and accountability in planning and budgeting which should involve domestic parliaments and civil interests as well as external funding stakehholders in the process of determining priorities and scrutinising outcomes

- These broad benchmarks should largely *replace any multiple lists of specific micro targets* (for social sector budget allocations, outputs or outcomes) There should be *no proliferation* of conditions between HIPC I and HIPC II. In particular these benchmarks which focus on the process of setting up a PR oriented budgetary framework, *should replace and not add to existing structural reform conditions.*

- The government should be at the centre of poverty oriented planning and should be asked to present its poverty strategy, policies and spending plans based on diagnosis of the poverty situation. It should indicate how its budget management processes will evolve in order to ensure implementation, monitoring and review of the outcomes of its budget proposal and measures.

- It is not appropriate for the external agencies to pre-set a collection of specific indicators (relating to social or poverty outcomes) as a basis for completion under HIPC II. Instead each government itself should set out its own.

- There will need to be regular reviews of progress in relation to these benchmarks. There will be some lessons from the review processes used in Uganda for the Poverty Action Fund. These will need to involve Consultative Group or Round Table meetings preferably held in-country to maximise local participation and consultation. In Africa, these could be supplemented by discussions of SPA-group progress on poverty reduction and funding at SPA meetings.

Judging Progress on Benchmarks

In judging the degree of commitment and quality of a governments performance under these main benchmarks, the following considerations should be pre-eminent.

- It should be quite *clear* in advance what is expected of governments in relation to establishment of a poverty reduction framework for completion under HIPC II.

- There should be demonstrated moves towards more accountability in planning and budget processes. These should preferably not be *ad hoc* in character but built on *existing political institutional systems* as far as possible (a point made strongly by

Christian Aid). There should be an expectation of efforts to achieve *inter alia*, timely and adequate publication, wide consultation processes, a strengthened parliamentary role in debate, scrutiny and approval, limits on supplementary budgeting etc[2]

- There should be *no pre-set menu* for judging the content of a each governments PR strategy, plans and budgets. Each country case would need to be judged against its specific context.

  The Cologne proposals give a lot of attention to specific social sector spending priorities which are very important but a poverty reduction perspective requires a much broader & more flexible approach to judging priorities.

  Although there is no clear-cut methodology or guidebook for budget allocation in line with poverty objectives, nevertheless major insights are emerging from recent and ongoing work.

  In sub Saharan Africa it is often a priority to shift the distribution of public subsidies in a more pro poor direction especially in the intra-sectoral allocation of spending on education and health etc. The links between spending and indicators of impact on people are stronger for certain services than others, . Provision of better quality health and education at primary and preventive levels would seem to warrant more attention as well as effective targeting on very poor groups and areas.

  However, there are likely to be countries where pro-poor priorities suggest much more attention to the creation of livelihoods and employment for poor people. A major priority is often to bring the benefits of infrastructure particularly to those who lack opportunities for livelihoods and access to markets through remoteness or subsistence activities. Also there is need to give more attention to initial inequalities which are particularly large and widening in Africa; paying attention to the distributional impact of policy measures like tax reform and privatisation, modifying policies or introducing compensatory measures where appropriate. There is often a need to address the problems of vulnerable groups especially those unlikely to benefit from growth including dependants (e.g.orphans,widows/abandoned women, children from poor families)as well as wider coverage and improved implementation of safety nets including schemes of public works to construct and maintain rural infrastructure. [3]

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[2] There is now a consensus on the need to shift the balance of government accountability for resource use away from external funders (especially the IFIs) towards domestic society. Currently this is tending to be pursued through *ad hoc* national or sectoral consultative forums. More thought needs to be given to how accountability can be effectively achieved both internally and externally through existing domestic institutions and processes; e.g. the regular responsive functioning of government departments, the role of parliament and its committees, elected representatives, civil interest groups, and of course elections. In particular more attention is needed to how the concerns of all the providers of concessional resources can be meshed into these processes without undermining them

[3] These points emerge from the current Status Report on Poverty in Sub Saharan Africa, commissioned by the SPA

- *Tracking the outcomes* of the PR plans and budgets will be a major test. Judgement is therefore required on the relevance and feasibility of government-set indicators as well as the procedures and capacities being put into place to effectively track performance on budget outcomes (compared to allocations), outputs and impact on people. There should be evidence of the domestic development and use of quantitative survey data and participatory methods.

- *Changes/improvements* are normally the main focus for judgement of performance. Although all countries which qualify should ideally be at comparable levels of achievement this may not be possible in practice where they are starting from different initial political and institutional positions at pre-decision or decision point. Although we consider significant improvements in tbe budgetary framework can be achieved in a reasonable time-scale, some capacities will take some time to establish.

- Judgements on individual countries should be informed by *comparison* with the achievements of 'benchmark' countries in comparable situations.

1.3. Feasibility of this approach: a typology of cases/approaches.

How feasible is this approach given the wide range of country situations and stages? A brief survey of SPA countries reveals three broad groups of countries:

- A small group of countries which are at an early stage of stabilisation, structural adjustment and budget management, where the priority is probably to reduce the budget deficit rather than to raise total expenditure. None of these have reached their decision point (and almost all have not reached their entry point) under HIPC. They are also almost all countries which have made little progress on giving priority to poverty reduction within expenditures. In this case there is an argument for more intrusive conditions to ensure more stabilisation and poverty focus up to decision point, followed by a more process-oriented conditionality in the second phase. Such countries may also well need a full three year second phase to reach the types of benchmarks discussed above.

- There are around two-thirds of the SPA countries with a relatively stable macro-economy and considerable progress on structural adjustment and budget management, and therefore room to increase total expenditure - but which have a mixed performance on poverty orientation of policy and public expenditure. These are almost all countries which are soon to reach their decision points under HIPC. This is the group of countries where the above proposals for performance benchmarks for completion are likely to be applicable and feasible. It is our judgement that it is feasible to improve public budget management systems in timescales which will permit early completion (less than three years) in some cases.

- A small group of countries with sound macro policies and budget management, and good poverty orientation in their spending, mostly through integrated medium-term budget management and costed poverty reduction programmes. Most of these countries are already past their HIPC decision point, and some have

already reached completion point. Performance conditions here would revolve around an annual joint review of progress, priorities and spending needs to reduce poverty.

The key group of countries currently is therefore the second one, and the key phase is the period between the decision and completion points. We therefore suggest for them a typology of actions between the decision and completion points of the HIPC II process, as shown in the attached Table 2

Table 2

	TYPOLOGY OF POVERTY			
	"PROCESS" CONDITIONALITY			
	Decision			**Completion**
	Point			**Point**
MACRO POLICY	Basic Stabilisation/	Broadly On Track with Pro-Poor Focus ESAF/PFP		
GOVERNANCE	Basic Governance	Maintenance of Basic Governance		
BUDGET MANAGEMENT	Transparent Annual	Rolling 3-Year Budget Process	Medium-Term Budget	
	Budget Framework		Framework (MTBF)	
				POVERTY-ORIENTED
				MEDIUM TERM
POVERTY ORIENTATION				BUDGET FRAMEWORK
Monitoring	Baseline Poverty Assessment	Continued Improvements in Poverty Monitoring & Tracking of outcomes		
Expenditure Planning	Baseline Poverty Orientation	Anti-Poverty Strategy	Costed Poverty Reduction Plan	
Implementation	Continuous Implementation of Broad Poverty Expenditure Targets			

1.4. A Pro-poor Orientation in ESAF

The Cologne 1999 initiative intends a more flexible setting of the length between decision and completion point by the systematic application of “floating conditionality”, enabling countries to move rapidly to completion provided they meet the conditions. As indicated earlier, we argue strongly that, where conditions are satisfied, countries should be able to move to completion as quickly as possible. However, it is intended in the Cologne agreement that the release of funds will still depend on uninterrupted performance with an ESAF and IDA adjustment credit. Much criticism of HIPC I focussed on the link to ESAF, which was seen by many in the NGO community as imposing conditions incompatible with poverty reduction objectives.

Three proposals are made in this regard: (1) the link with ESAF should be maintained; (2) ESAF should be reformed so as to be more compatible with poverty reduction objectives and (3) completion under HIPC should be judged to have been reached once the poverty reduction conditions have been satisfied and the country has remained ‘broadly on track’ with economic policy. These are elaborated below.

The link with ESAF should be maintained since we accept that a stable macroeconomic environment is a precondition for sustained growth. Also that control of inflation contributes to a more pro-poor environment. However, at times spending limits can be too tight and so undermine investments in human and physical capital and so be detrimental to growth. This was argued in the recent independent evaluation of ESAF, There is a difficult trade-off, but the requirements for meeting poverty reduction targets indicate some shift is required toward higher spending in cases where inflation has been held in check. The proposal to permit higher spending is not a blanket recommendation and should be judged on a case-by-case basis: but it should be borne in mind that conditions should be set with poverty reduction as the overarching objective.

One issue that has arisen in several countries is the way in which IMF benchmarks may restrict the spending of aid funds (or enable aid funds to crowd out government's own spending). This occurs if the deficit target is set 'before grants" (rather than the "deficit after grants"), so that increased grants cannot be used in full to raise spending limits. Clearly, subject to absorptive capacity constraints, it is preferable that countries be allowed to spend aid on its intended purposes. Whilst IMF staff claim to assess each specific case based on the likely sustainability of concessional flows and possible inflationary demand effects of higher expenditures to allow grants to increase expenditure where this is deemed appropriate, nevertheless experience from several countries suggest that a rather conservative stance continues to be taken with respect to budget ceilings. If restraint is required then the IMF and donors need to be aware of the problem of displacing government's own priority spending.
' quickly to completion.

Our third and major recommendation relates to the requirement for a country to move to completion as quickly as possible under the proposed ‘floating conditionality’ approach. **We propose that in order to achieve completion under HIPC II, a country should have remained ‘broadly on track’ with its macro-stability agreement and to have met the ‘broad poverty benchmarks’ (proposed in section**

1.3 above). There should be no lists of specific social targets and if there are any existing or new structural adjustment conditions they should not influence the outcome under HIPC II and the access of the country to debt relief. They can of course operate outside this facility. Without such an approach the notion of "floating conditionality" will be meaningless. We believe that this approach will allow a number of countries in the second group of countries (see 1.2 above) to move more quickly to completion.

The IMF now offers countries the option of Review Missions rather than more mechanistic sets of performance criteria. The former offer a potentially more flexible way of assessing an overall adherence to the terms of the programme. It is necessary to open up what has been so far a rather narrow clandestine process of dialogue. We understand that IMF missions are now actively encouraging participation of a broader range of Ministries in programme negotiations that there is now a presumption that the content of all IMF-supported programmes (letters of intent, PFPs) will be made public. This is welcome.

We think also that j*oint* review missions with both IMF and World Bank staff strengthen poverty orientation by bringing to bear the more intensive research and thinking on poverty in the latter institution. However, there is need for formal consultation with the wider donor/creditor grouping whichfinance the programmes but which currently have little say in the content. There would be merit in wider adoption of the practice introduced in Uganda and Tanzania, of involving donors in annual consultation on a medium-term budget framework which covers as far as possible how both Government and donor resources are to be used.

It is also important that IMF missions take place at appropriate points in the budget cycle to ensure that they reinforce a process of rational prioritisation and reduce the risk of undermining it with late revisions to the macro framework.

In addition, we have some observations on structural reforms (which the Cologne agreement said should be "deepened"). First, to repeat, HIPC II should not result in a proliferation of conditionality. Poverty reduction conditions should not be additional to existing conditions but replace them. The ultimate objective is poverty reduction, and conditions should be retained only insofar as they relate to that objective. Second, structural adjustment programmes can and should be designed in a more pro-poor way, not only taking proper account of the likely impact of policy changes on the poor, but tackling issues such as asset distribution, which are at the root of much poverty.[4] However, structural conditions are not necessary for completion under HIPC II (see above)

[4] We believe there are several areas where the IFIs need to review the design of their structural reforms from the PR perspective. Major inequalities of income and ownership of assets in African countries are currently seen as a major barrier to quicker poverty reduction through growth. This suggests the need to review privatisation policies, the privatisation of land markets in particular, which may have damaging consequences for the poor. It suggests more focus on the equity aspects of tax reforms, charging the better-off for public services and the effects on the poor of the removal of some subsidies. Civil service reforms should pay greater attention to 'mainstreaming' poverty reduction (e.g. systematic mechanisms and incentives for officials to be more responsive to the needs of poor people and pursue these objectives).

Part II: MAXIMISING THE DEBT RELIEF CONTRIBUTION TO POVERTY REDUCTION

2.1 Depth of Relief

The more relaxed criteria which allow greater depth of relief after Cologne is welcome; viz. the reduction in the NPV debt to export and revenue triggers for debt sustainability and the lowering of the revenue / GDP and export / GDP ratios.

What is lacking from a PR perspective, is any focus on the budget liquidity problems of each specific country which are a vital potential constraint on more social spending and other spending measures to reduce poverty. This is particularly so when debtors are being expected to set higher social spending targets under HIPC.

Ideally the formal triggers should relate to revenues, i.e. the ratio of debt service to budget revenue but without any fixed pre-requisite level for the revenue/GDP ratio. Instead they should be linked to compliance with revenue levels agreed under ESAF programmes for each country. There is a strong justification for this alternative to fixed ratios.

The key starting point is the level and growth prospects for discretionary revenue (particularly revenue *per capita*) available to a country after meeting debt service and other unavoidable charges. These should reflect the country circumstances rather than some standard desirable ratio or 'effort'. There needs to be some comparison of each country with other countries of similar income levels in determining eligibility for relief. This encompasses domestic revenue (tax) effort as a proportion of GDP taking account of the structure of economy (especially the size and diversity of the modern sector) while recognising the difficulties of changing this quickly. Uganda experience suggests that it is hard to sustain an increase of more 0.5% of the government revenue/ GDP ratio *per annum*..

In principle, deeper debt relief should go to those countries which will otherwise have lower than average discretionary revenue to spend on their chosen programmes including poverty focussed priorities. This approach would capture the existence of domestic as well as an external debt problem which may be squeezing public disposable revenues. The sustainable growth of discretionary per capita spending should be assessed after meeting any deficit reduction target agreed with the IMF

2.2. Front-loading of debt relief.

First, it is desirable to ensure maximum front loading of debt relief under the new HIPC proposals so that there is maximum release of budget funds in the early years after completion. There are strong reasons for this. Severe budget constraints limit potential new spending on poverty related services in many African economies. If HIPC countries are expected to commit to more effective PR policies they need

access to additional budgetary funds quickly. It is also only possible for them to convince donors of their integrity in poverty reduction in the early years. This should not impede the sustainability of their efforts especially if recovery, growth and hence improved revenues become available in the later years.

Second, the 'interim relief' measures which are envisaged in the Cologne agreement will give a welcome opportunity to countries between decision and completion to prove that that they can effectively increase spending for poverty-related purposes. However they will need to have formulated workable ways of doing so otherwise their own credibility will be undermined.

2.3. Speed of access to relief.

The Cologne initiative on HIPC gives some impetus to speed of access since it encourages earlier assistance by endorsing the flexible setting of the length of the interim period between decision and completion. It also gives consideration to 'floating tranche' arrangements for triggering completion point and it encourages debt service relief from MDBs in the interim period between decision and completion. Under HIPC I, there was flexibility based on length of prior track- record, which was applied for several of the early candidates (e.g. Uganda). As most of the countries with a long track- record have already reached their decision points, it is welcome that Cologne has given further impetus to this by suggesting floating tranche arrangements etc.

About 24 countries might reach decision point by end 1999 and most countries (about 32) are expected to reach their decision points by end 2000. Yet there is a high chance of slippage unless special efforts are made. It is essential in our view for these 32 countries which are already embarked on a course to successful decision, to reach completion soon afterwards. The basis for them reaching completion has been indicated in section 1.2 above.

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In sum, we suggest that the formal triggers should relate more to revenues than exports i.e. the ratio of debt service to budget revenue, that revenue to GDP ratios should be determined on a case-by-case basis and depth of relief should relate to the degree of discretionary revenue available to countries. Front loading of the flow of liquid funds available should be a key priority in the implementation of HIPC II. We consider that this objective would be best achieved by setting targets for the percentage of debt service reduction in the earlier years. Creditors should be urged to work for the maximum degree of early relief in their pursuit of funding sources for the initiative.

2.4 Ensuring that resources for HIPC are fully additional

Orders of Magnitude

Deeper and broader debt relief is proposed under the Cologne 1999 initiative. The NPV of debt reduction estimated under HIPC I was $12.5Bn. Eligible countries after 3 years of adjustment were expected get 80% reduction of their bilateral debt plus 85-

92% of their commercial debt. In practice, most countries have so far not received the 80% service reduction from the Paris club.

Under HIPC II, the NPV of debt reduction is estimated to more than double to $27Bn with nominal debt service relief over time estimated at $50Bn for a larger number of potentially qualifying countries. Under its broader coverage, 36 out of 41 HIPCs would qualify using the new targets to meet debt eligibility criteria, compared to 29 under HIPC I framework. It is estimated by the World Bank that the public debt of 33 HIPCs ($90Bn) is likely to qualify and is likely to be reduced by about 50% taking account of the enhanced HIPC and traditional debt relief.

Based on experience with HIPC I and the faster relief due from HIPC II, it seems likely that HIPC II would provide around US$2 Bn. *per annum* of cash flow relief, rising to US$ 3-4 Bn. early in the next century. For the SPA HIPCs this might produce around US$ 1.5Bn. rising to US$2-2.5Bn. It therefore represents a substantial release of funds if it is fully additional. [5]

How to assess and assure additional funds for HIPC ?

Ideally the funding for the debt relief flows under HIPC should be fully additional to the flow of concessional resources that governments would otherwise have made available globally for developing countries. It is not easy to test this conclusively or to quantify it especially over a long period. Funds drawn from non–aid budgets (e.g. sales of IMF gold for the HIPC Trust Fund) are less likely to displace bilateral aid flows than if they come from aid budgets. It is quite possible for bilateral creditor governments to offset their contribution to HIPC by reducing their total aid programmes in future years. It may be easier for the few governments with increasing prospective aid programmes to conceal this than the more numerous agencies which are reducing aid programmes. Funding from internal sources such as net income of the World Bank and other Multilateral agencies also seems unlikely to be additional in the long run although such sources are likely to be limited quantitatively.

There is a major accountability point for creditors here. Ideally, creditor governments should meet performance criteria to parallel those proposed for the debtors. That is the essence of 'partnership' which several currently espouse. Governments should be urged to ensure additional flows of resources for HIPC II. Some careful independent monitoring of the way different creditors propose to meet the demands of additional funds should be undertaken. The usual OECD Aid Review processes can play some role here with peer pressure and self-discipline operating. An independent NGO/expert panel to monitor practices would help focus continuing attention on this important issue.

Part III: THE WIDER IMPLICATIONS OF COLOGNE FOR AID FLOWS

[5] A recent IMF estimate that savings on debt service for the first 7 qualifying countries might constitute 9% of government revenues helps to confirm this conclusion.

3.1. Overcoming Potential Distortions in Aid Allocation.

The Cologne 1999 initiative mixes debt sustainability and poverty reduction criteria. The eligibility criteria of HIPC I and II and therefore the allocation of available relief flows are geared primarily to poor countries with debt sustainability problems. The new HIPC triggering criteria widen the range of countries eligible among those which are in the IDA-only category of current funding though not enormously.

These criteria which may be justified on grounds of reducing the 'debt overhang', do not obviously meet full poverty reduction criteria. There are several areas of potential distortion.

First, it is biased against those IDA-only poor countries which may not have the heaviest debt problems but may have more difficult poverty problems. Second, among the IDA-only countries there is a bias to those arbitrarily classified as HIPC because they have rescheduled concessionally at the Paris Club rather than to the most severely indebted which include Haiti and Nigeria. Seven moderately indebted low-income countries are not classified as HIPC (Bangladesh, Cambodia, Comoros, Gambia, India, Pakistan and Zimbabwe). These include some of the largest very poor populations. Third, among the HIPCs themselves there are vastly different degrees of assistance depending on their debt levels, between those which qualify for assistance and those which do not. The allocation of any extra released resources on purely poverty reduction grounds – to help countries to meet International Development Targets – might well suggest quite a different picture. It is only possible to speculate on the degree of potential distortion involved. Recent research work on the likely achievability of the international poverty related targets (e.g. Hanmer and Naschold, 1999, *Are the International Targets Attainable?* ODI) suggest that these targets are likely to be met by 2015 in most regions except Sub Saharan Africa which is the main region likely to benefit from the HIPC arrangements. Nevertheless these are informed guesses and may be wrong. The fact remains that a range of poor countries outside of the likely HIPC beneficiaries will need assistance in meeting their poverty reduction needs. They are often countries with very large populations of poor people.

We strongly recommend that bilateral aid agencies (including the EC) should undertake some reappraisal of their overall country aid allocation on poverty criteria with the implementation of the HIPC II proposals. While the degree of distortion in absolute terms will be less the greater the additionality of debt relief, nevertheless the agencies need to take account of all the distortions mentioned above in particular the relative position of the non-HIPC poor countries with no HIPC relief and considerable poverty problems and commitment to poverty reduction. There are some major donors which continue pay too little attention to the priority claims of poor countries and poor people in their rather ' regressive' pattern of aid allocation. This challenge becomes even more acute post-Cologne. IDA might also play a role as a 'swing donor' to fill new patterns of gaps in the light of debt relief and other aid available.

3.2. Integration of Debt Relief Operations with Ongoing Aid Flows and Operations for Poverty Reduction

Currently the bilateral development co-operation agencies are increasingly committed to poverty reduction objectives. However they are not usually sharply or fully focussed on the content of specific country pro poor strategies. They do not co-ordinate well on these issues nor are they in dialogue at national level. At the same time they are to move in this direction and some are seeking to shift from a predominantly project approach towards more budgetary support and SWAPs. The World Bank is moving towards a more rigorous poverty orientation in their Country Assistance Strategies and in their consultation processes recently.

The HIPC II process should not be dominated by the IFIs. But the Cologne mandate can be a 'catalyst' to involve the bilateral agencies as well as the IFIs in a more co-ordinated / joint approach and dialogue on PR issues at national level as well as sectoral levels in the next few years. It is also necessary to ensure a more unified and collective partnership approach by all parties and to keep the administrative burden on the debt country authorities to a minimum. Poverty reduction will require a longer time frame than that for ESAF and HIPC II for debt relief and the responsibility for this will lie with ongoing aid operations.

There are several areas in which the aid agencies need to go much further;

- In individual countries the bilateral agencies should be involved with the dialogue at country level on national budgetary priorities and not just in individual projects and sometimes sector programmes. They need to work with the IFIs and country partners more vigorously and collectively on poverty reduction objectives within Consultative Groups and SPA forums.

- They need to subordinate their Country Assistance Strategies to genuine government plans and budgeting with a PR orientation.

- More bilateral funds should be channelled into the budget; integrated into the governments own spending framework and not outside. This would match the debt relief savings and strengthen the potential scope for greater focus on poverty priorities.

- Make medium term aid commitments where governments have medium-term expenditure plans and good accountability.

Finally, for poor countries overall, there is a strong case for some public mechanism by which progress towards the International Development Goals / poverty reduction objectives can be reviewed annually or semi-annually. Such a review would look at the aid and debt relief funding needs and availability for all these countries. It might be done through the IMF / World Bank Boards in their Spring / Annual meetings.