Debt and the Millennium Development Goals

A new deal for low-income countries: financing development through debt cancellation and aid

Working paper by CAFOD Christian Aid and Eurodad
Supported by Oxfam GB, Jubilee Research, Jubilee Debt Campaign and CIDSE and Caritas Internationalis

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1. Achieving the Millennium Development Goals by 2015

The global consensus around the achievement of the Millennium Development Goals (MDGs) has elevated the development targets to the new "gold standard" of international development cooperation. Increasingly donor policy and performance is measured against the global effort towards reaching the goals. The humanitarian imperative behind the Millennium Declaration and the reiteration of unanimous political support in the *Monterrey Consensus*, the G8 Kananaskis declaration, and a host of other UN and international communiqués places a new onus on the full range of development agencies – civil society organisations, bilateral donors, recipient governments, inter-governmental and multilateral institutions – to respond in good faith with a full commitment to the achievement of these targets. This paper sets out the policy actions required by the World Bank, IMF, and bilateral donors if their stated commitment to the fulfilment of the MDGs is to be taken seriously.

What is increasingly clear is that most low-income countries (LICs) are on trajectories that will result in failure to meet the MDGs[1]. While recipient and donor government pro-poor policy reforms are necessary conditions for meeting the goals, a *sine qua non* for achieving the MDGs is having the requisite finance. The 2002 Financing for Development Conference estimated that aid would need to double, from US$50billion to (then) US$100 billion. These figures have recently been confirmed by the UK Treasury[2], and the World Bank[3]. It is also clear that while the World Bank and IMF have signed up to the MDGs, they have yet to recast their policy frameworks and financing instruments – including the HIPC Initiative – around the pursuit of the goals.

Before proposing the form and direction that aid and debt policy reforms will have to take if the Millennial Development Compact has a realistic prospect of being met, it is important to clearly identify the sources of finance and their potential role as drivers of the MDGs.

There are finite sources of finance that low-income countries can realistically be expected to draw on to bridge the MDG funding gap in low-income countries. These are: domestic revenues; domestic and external private sector investment and economic growth; trade;

[1] P.200-202 Human Development Report 2003
[2] HM Treasury – International Finance Facility proposal January 2003
[3] Forthcoming World Bank report on financing the MDGs

and, capital flows in the form of official aid and debt reduction. The challenge is to fashion all these towards meeting the MDGs.

While private sector flows must form an important part of the overall mix of resources necessary for the achievement of the MDGs, flows from official sources constitute the major share of capital flows for most low-income countries[4].

In the short to medium term, private sector flows are unlikely to fill the MDG financing deficit. The capacity of low-income countries to attract private capital flows is constrained by weak infrastructures and a lack of flexibility or the levels of savings and investments necessary to respond to rapid changes in the global economic and market environments.

From the point of view of low-income country governments, the importance attached to aid and debt relief is further underscored by the unsteady flow of income from domestic revenue sources. Least developed economies are largely dependent on exports of one or two primary commodities that are vulnerable to slumps in prices. This high concentration of exports and domestic production in, mostly, rain-fed agriculture produce further exposes them to the vagaries of unpredictable weather patterns.

In sum, the small and highly volatile domestic revenue-base available to low-income country governments makes them highly dependent on external aid flows. Where current donor flows often amount to over half of government revenues, aid policy and aid effectiveness become critical in determining the prospects of LICs meeting the MDGs. So not only is it important to examine the volume of official capital flows but also their effectiveness as aid and development instruments.

If the donor community is serious in its intent to achieve the MDGs, the challenge is twofold. First the volume of finance needs to be in place to ensure that no country committed to achieving the MDGs goes without the required resources. And second, donor financing instruments have to be made sufficiently adaptable to respond to the unevenness of LICs' domestic revenue flows and consistent with the objective of assisting recipient governments deliver their "owned" pro-poor policies.

Many low income countries are also heavily indebted. Some commentators (mostly the donors themselves) have argued that providing additional debt relief penalises those countries that have not built up large debts, at the expense of those who have.

Partly in response to this critique, we propose that a common approach to financing low-income countries needs to be adopted, one that cancels debt in highly indebted countries as an efficient way of transferring resources for development, and that gives corresponding quantities of aid in the form of budget support to countries that are low-income but not indebted. This proposal is reached by looking at how current aid practice and debt cancellation meet some 'best practice' indicators of how to manage development assistance.

[4] p.293 Human Development Report 2003 - In 2001, ODA flows to all LDCs amounted to an average of 7.5% of GDP as opposed to an average net flow of FDI amounting to 2.2% of GDP and, where figures are available, an average net ouflow of other private flows of 0.5% of GDP

2. Mechanisms for increasing development finance

The Monterrey Conference on Financing for Development concluded 18 months ago, with promises to increase development finance moderately from 2006[5]. Since then, several ideas have risen to prominence on how to fill the much larger financing gap. Many civil society groups favour a small tax on currency speculation – a so called 'currency transaction tax' – with the dual objectives of stabilising currency markets and raising in excess of US$50 billion for development annually. While studies on the technical feasibility of such a proposal have gained in number and credibility in recent years[6], the political will required to implement a new international tax is less than apparent.

With annual increments in aid flows unlikely to double development financing before 2015, the UK Chancellor Gordon Brown has proposed an innovative financing mechanism to double aid flows more quickly. An International Financing Facility (IFF) would raise funds through issuing bonds on capital markets, set against predictable and guaranteed donor flows up to 2015. Thereafter, when the bonds are due to be repaid, aid flows will fall. The proponents of such a scheme argue that its benefits come from being able to provide large and predictable increases in aid in the years building up to when the MDGs should be met. The economic benefits of investing in aid now rather than tomorrow will augment in the years up to 2015. They also point out that the political will to implement other financing mechanisms is practically non-existent. In other words, the IFF is the only game in town.

Development finance for low-income countries – indebted or not – could be much increased through such a proposal. In order for the IFF to contribute as much as possible to effective development finance, its founding principles need to be consistent with and supportive of the general 'best practices' in aid as outlined above. The IFF should be supportive of national plans to reduce poverty, and be predictable enough to finance holistic medium- and long-term strategies. Aid money should be free of burdensome donor transaction costs, requirements to purchase goods and technical assistance from the donor country, and conditions that stifle nationally owned and context specific policymaking. Current plans to allocate IFF monies through existing donor channels present a challenge to bring the practices of participating donors up to best practice.

The following section examines the principles that should underpin the forms of development assistance consistent with achieving the MDGs. But the final point to be made here is that it is not politically tenable for the donor community to give rhetorical support to the achievement of the internationally agreed poverty targets while refusing to implement the means by which to mobilise the outstanding financial support. The world's richest governments cannot refuse proposals for a currency transaction tax or the IFF or for increases in aid or debt relief without coming up with feasible alternatives. Such an omission alongside their espoused commitments to meet the MDGs opens the world's richest countries to the charge of grave political cynicism.

[5] The US has signalled a US$5 billion increase per year with EU member states providing an additional US$7 billion. The major donors have signalled that up to half of this will be channelled to Africa.

[6] On the Feasibility of a Tax on Foreign Exchange Transactions", Report commissioned by the Federal Ministry for Economic Cooperation and Development, Bonn (January 2002). Prof Paul Bernd Spahn

3 Best practice in development assistance

Given the massive financing needs of both indebted and non-indebted countries, what is the best way to deliver development finance?

In the last decade a framework of best practice has developed guiding how donors and recipients engage with development assistance. This has been informed by studies into the effectiveness of aid, and is captured for example in the OECD guidelines on development assistance, as well as in the Monterrey Consensus.

Poverty focus

Development assistance should be focussed on poverty reduction. The MDGs provide an international framework of poverty goals by which to assess how well we are meeting the goals at the global level. At a country level, PRSPs can identify the most binding forms of poverty – be they low incomes, poor health, access to education, vulnerability or lack of voice – and policies for tackling each. Together, the MDGs and PRSP approaches combine to ensure that development financing has a poverty focus. The magnitude of assistance needed can be derived from working backwards from financing needs as identified in PRSPs. Conversely, aid is less likely to be poverty focussed if it is being used to meet other domestic or foreign policy objectives[7].

Ownership and flexibility

Aid is much more likely to be effective when recipients 'own' the development process – that is, policies to promote poverty reduction have been developed drawing on the inputs and priorities of a broad group of stakeholders within a country. Through seeking the active participation of all levels of government, NGOs, church networks and business, policies can be developed that address local realities and constraints on poverty reduction. PRSPs in principle contribute to shifting ownership of the development agenda, although evidence to date suggests that the actual experience of PRSPs has been mixed. In particular, the macroeconomic elements of PRSPs have all too often retained the essential elements of traditional IMF 'structual adjustment' style policies.Nevertheless, as NGOs with a long history of working in development within partnership frameworks, we are convinced that sustainable development is dependent on aid recipients becoming the custodians of their poverty reduction strategies.

Reduced transaction costs

Partly as a fiduciary obligation to tax payers in donor countries, and partly because of different experiences and philosophies behind aid, donors have developed different approaches to development assistance. Each usually entails different planning, reporting, monitoring and evaluation processes, and attempts to exert influence on domestic policy makers through meetings, workshops, and not least conditions on loans. Together, the result has been huge transaction costs for aid recipients as they are made to be accountable to donors for the use of their resources. The drawbacks of burdensome donor engagement

[7] Domestic priorities such as tying aid to the procurement of goods and services provided by the donor country, or foreign policy objectives such as stemming immigration or protecting business interests overseas.

are well documented[8] in terms of both effectiveness of aid and erosion of domestic ownership of the development process. Donor practice, particularly of a few European bilaterals, has evolved considerably in recent years. In countries where donors judge the policy environment to be conducive[9], donors have moved away from small project based approaches to aid, to modes of aid that support separate sectors of an economy (e.g. health or transport) and often entire budgets. In doing so they are explicitly supporting national planning and expenditure priorities as evidenced through budget allocations. By coordinating their approaches around a common country owned tool (the budget) donors have managed to significantly reduce the costs they impose on recipients.

Predictability

Finally, donor finance in the past has too often been unpredictable and prone to policy reversal. In order to provide the stability of resources that poor countries need to invest in promoting growth and improved public services, donors have to commit to longer time frames in their pledges.

3. Assessing resource transfers against pro-development principles

Given this background, the next issue arising involves choosing the right set of instruments and donor practices to ensure aid is transferred according to these principles. Official flows to low-income countries can take three broad forms:

- Project support, financed through a loan or a grant
- Budget support, also in the form of a grant or a loan
- Debt relief

Project support

In light of the principles presented above, project support can be described as the least desirable form of aid. First, because it involves huge transaction costs and a low predictability of future aid flows for recipient countries since each project is linked to donor specific conditions and reporting requirements. Moreover, because they tend to reflect donor specific preferences, discrete projects are unlikely to be embedded in an overall framework or strategy to reduce poverty and, therefore, do not contribute to local ownership.

Budget support

Direct budget support, provided it is targeted at poverty reduction and in support of homegrown processes such as the PRSP, avoids most of these problems. Most importantly, this form aid delivery effectively comes as a direct support of national planning and expenditure priorities. In this regard, the recent move of some donors towards supporting medium-term expenditure frameworks, should also lead to longer-term commitments thereby increasing the predictability of aid flows. Finally, direct budget support minimises transaction costs since all reporting is concentrated at the budget level.

[8] A recent OECD survey of recipient countries showed a marked degree of frustration in recipient administrations for cumbersome donor procedures and reporting requirement and dealing with donor aid that "lacks fit with national priorities". http://www.oecd.org/dataoecd/26/27/1958543.pdf Phillip Amis and Lara Green International Development Department School of Public Policy Birmingham

[9] Where the rule of law is upheld, governance structures are reasonably democratic, macroeconomic policy is sound, and efforts to combat corruption are in place.

Debt relief

Debt relief, acts as *de facto* direct budget support provided in the form of grants, thereby producing the desirable effects described above. But this form of resource transfer also has other side effects, potentially increasing significantly its impact on poverty reduction and growth compared to alternative resource transfer channels.

Firstly, the expected savings associated with debt relief are clear once the relief is committed by creditors. They do not exhibit some of the problematic characteristics of donor aid flows of low predictability, low stability, and high pro-cyclicality.

Secondly, external debt reduction is more pro-growth than conventional ODA. Particularly in those LICs where domestic debt burdens are significant, channelling additional resources to retiring domestic debt can reduce the crowding-out of private sector investment, which would in turn spur economic growth. More generally, recent empirical evidence[10] clearly shows a positive relationship between debt stock reduction and rising economic growth notably through an increase in the quality and quantity of domestic and foreign investment.

Finally, amongst official donors there is a consensus on the advantages of aid allocations made in the form of budget support and in common pooled approaches. But despite this publicly espoused commitment to enhancing donor coordination, official donors still show a marked resistance to entering into agreed resource transfer mechanisms that cut down on recipient country transaction costs. Debt reduction could enhance the effectiveness of recipient country expenditures by allocating development funds according to transparent human development criteria, thus avoiding the recurrent geographical and political biases and institutional priorities found in most donors' aid allocation processes.

The advantages of using debt relief to transfer additional resources of poverty reduction is compounded by the fact that the political realities of aid allocation are still preventing many donors from adopting more progressive – and efficient – ways of distributing aid.

In fact, notwithstanding the general consensus over the best ways to maximise aid effectiveness in tackling poverty, donor practices have hardly changed. Aid flows to low income and least developed countries have only increased by less than 5% from 1998 to 2001 and close to half of total aid flows are a still allocated to middle income countries. The same trend can be observed at the sector level where programme aid related flows account for only 6% of total bilateral ODA commitments up only 1% since 1998. These disappointing trends reflect the fact that bilateral donors are still hesitatant in the provision of direct budget support preferring instead to promote their own political priorities or development vision. We put the blame entirely on bilateral donors for continuing to promote their own political priorities or development vision. But of course an additional factor is donors not deeming (often correctly) that recipients have met basic standards in transparency and governance This is notably the case for major bilateral donors like France, United States and Japan, who account for nearly half of global ODA[11].

In these circumstances, the impact of raising debt relief related flows on the progress towards the MDGs is much greater than that of conventional ODA flows in the short to medium term.

[10] "External Debt and Growth" IMF working paper April 2002 Catherine Pattillo, Helene Poirson, and Luca Ricci

[11] DAC International Development Statistic Database - http://www1.oecd.org/dac/htm/online.htm

4. Debt sustainability and achieving the MDGs

If debt relief is considered alongside aid as a highly efficient and effective form of transfer of development finance, the question is when should debt relief be considered over and above grant aid or concessional finance as the most appropriate form of development assistance? And what do such choices imply for future borrowing and debt sustainability in low-income countries' forward financing strategies?

The organising principle around aid and debt reduction must be the mobilisation of the additional finance necessary to bridge the current funding gap for reaching the MDGs. While it is also clear that a number of considerations need to be included in assessments of debt sustainability, a consistent and serious approach to the MDGs requires a close integration of debt relief with outstanding development financing requirements.

The current enhanced HIPC Initiative's problems, if not clear failure, in delivering a durable debt sustainability stem in part from a reductive and inappropriate analytical approach (the 150% debt-to-exports criterion) to assessments of what level of debts LICs can afford to sustain. The export criterion is a wholly unreliable predictor of debt sustainability for a group of countries characterised by an extreme vulnerability to shock and steep fluctuations in export earnings. Uganda, has rarely achieved debt sustainability despite early graduation from the first and enhanced HIPC Initiatives. This status of debt sustainability "drop-out" has been earned not because of any significant new borrowing, but rather from diminished forex earnings as a result of plunging coffee prices. Moreover, while the export criterion benefits from simplicity and clarity, it bears little relationship either to the conditional requirement for governments to produce Poverty Reduction Strategies and pro-poor outcomes or countries' future PRS financing requirements.

Clearly, debt sustainability analyses require the integration of a wider set of human development indicators. While exports and LICs' foreign exchange earning capacities are important considerations in assessments of the "repayability" of debts, a crucial part of the analytical framework must be the feasible revenue available to governments and the trade off between maintaining debt-servicing obligations and financing poverty reduction goals.

Agencies supporting the Jubilee 2000 (UK) campaign have long argued that debt reduction frameworks have to be integrated with national governments' poverty reduction financing strategies and capacities. While there is a consensus that debt sustainability is not an objective in itself but the means to achieve poverty reduction and growth objectives[12], then it is clear that growth and poverty reduction objectives must form an indispensable part of debt sustainability analyses. The fiscal dimension and the financing of the MDGs needs to occupy the central ground in the determination of thresholds of debt sustainability.

When human development imperatives are taken into account, it is clear that with the outstanding revenue gaps in LICs' capacity to finance the MDGs, and in the absence of a sufficient volume of donor aid available to bridge those gaps, further debt reductions are necessary. According to preliminary calculations, most HIPCs will require a total cancellation and further aid flows if their revenues are feasibly expected to meet the objective of financing the MDGs[13].

[12] Masood Ahmed (IMF) – keynote address at InWent debt sustainability conference – 19 May 2003
[13] "Real HIPC Report" – Romilly Greenhill and Elena Sista Jubilee Research September 2003

Future calculations of debt sustainability must include an assessment of the feasible net revenue[14] available to recipient/debtor governments. A number of variants of this model have been proposed[15], but the underlying principle is that the calculus used to measure the amount of debt-servicing governments can afford to sustain must give priority to financing poverty reduction expenditures and the MDGs.

Such an approach does raise issues over the volume of resource transfers for countries that are not debt-stressed but are nevertheless counted as low-income with low human development indices. It would, after all, amount to a perverse incentive to enhance resource transfers in the form of debt relief to countries that are debt-stressed and poor while ignoring LICs that are managing their debt servicing outflows but are also subject to MDG financing deficits. The principle asserted in this paper is about fully resourcing the MDGs – heavily indebted or not.

In view of the efficiencies of debt relief over aid discussed above, we propose that where an LIC is indebted, debt cancellation is the initial priority followed by supplements of aid. The overall financial envelope, whether in the form of aid or debt relief would be determined by the costed MDG or poverty reduction funding gap. This approach would include non-debt stressed LICs where current aid flows and government revenues are not sufficient to fully fund the MDGs. In such a case, debt relief would be a first option followed by a mix of concessional finance and grant aid.

5. Forwarding Financing the MDGs

The full cancellation of debts in order to mobilise the finance necessary to meet the internationally agreed development targets raises questions about the levels of future borrowing. If the MDG-compliant debt sustainability approach prompts a total cancellation of debts, what is the status of new borrowing? Where there is an outstanding financing gap after grant aid and full debt relief does the model preclude any new borrowing, even at the most concessional rates, as unsustainable?

In reality, this is the newest in a series of difficulties facing the enhanced HIPC Initiative. In fact, the HIPC Initiative is now an impediment to achieving the MDGs. Ethiopia, Rwanda and Niger need additional finance to fund their commitments contained in their Poverty Reduction Strategy Papers. But as their current debt stocks are pushing at the HIPC Initiative's debt sustainability thresholds and with only concessional loans of finance available to them, the international financial and development communities are facing a stark choice: either they allow these HIPCs to break through their officially recognised debt sustainability ceilings or they go without the requisite finance and miss out on achieving the MDGs.

A first step in any MDG forward financing package must view a 100 percent debt cancellation as part of a one-off investment in achieving the poverty targets. It is a policy action tied to "a sunset clause" as originally envisaged in the HIPC Initiative.

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[14] A feasible net revenue approach would also include receipts of donor flows.

[15] *A Human Development Approach to Debt Sustainability Analyses for the World's Poor* – CAFOD Northover, Joyner, Woodward 1998 and 2001*; Forever in your debt? Eight poor nations and the G-8* - Lockwood, Donlan, Joyner, Simms Christian Aid 1998*; Putting Poverty Reduction First* – Eurodad 2001*; The unbreakable link – debt relief and the MDGs* – Greenhill Jubilee Research. 2002.

It is not within the scope of this paper to determine an optimal level of future borrowing that would cover the range of different country circumstances. However, forward financing and borrowing strategies should be designed with the objective of maximising the prospects of recipient countries achieving the Millennial Compact. The following indicators need to be integrated into the design of MDG borrowing strategies:

- Lower income countries are likely to be characterised by deeper MDG financing gaps. The donors should aim to give higher volumes of aid in grant form where per capita GDP is lower. In other words, the degree of concessionality in new flows for LICs, running from grant aid to concessional loans, should be adjusted according to the depth of financing needs in LICs.
- The determination of the optimal levels of new borrowing for recipient countries needs to include assessments of the levels of additional finance that will maximise growth levels consistent with the objective of halving the numbers of people living in absolute poverty. An optimal level of debt sustainability will need to balance the benefits accruing from increased investments and medium to longer-term economic growth with affordable levels of future debt servicing[16].
- Where LICs are prone to destabilising shocks, the international donor community needs to respond by evening out revenue spikes with contingency financing facilities. The HIPC Initiative's post-Completion Point "topping up" facility is, in part, a recognition that LICs are highly prone to exogenous contingencies and therefore in need of compensatory arrangements.
- Grants and concessional finance need to be directed towards poverty reduction strategies that are determined by widely owned in-country processes with embedded debt and borrowing oversight and management mechanisms.

A credible forward financing strategy requires an overhaul in current donor, Bank and Fund financing instruments. If the official financial and development institutions are serious in their intent to position as many low-income countries as possible with a realistic chance of meeting the MDGs, it is not only the volume and type of flows that requires a fundamental rethink but also the degree to which current instruments are sufficiently flexible to respond to recipient country financing needs.

Currently low-income government finances absorb the risks and shocks associated with a range of economic, geopolitical, epidemiological and climatic uncertainties. Donor instruments and finances need now to share some of that risk burden. It may, for instance, be possible to use the World Bank's IDA facility's allocations, or the Fund and Bank's PRSC and PRGF credits to hedge against the steep revenue fluctuations arising from sudden downturns. But clearly current donor financing arrangements for LICs are not geared to respond with anything like the flexibility required by recipient countries.

7. Conclusion

[16] IMF Working Paper – "External Debt and Growth" by Catherine Pattillo, Helene Poirson, and Luca Ricci' April 2002. This paper proposed a wider set of considerations in determining optimal levels of debt-servicing, including stress testing external, fiscal and financial sector linkages. It is clear from this research that optimal levels of debt servicing are significantly lower than those defined by the enhanced HIPC Initiative's definition of debt sustainability thresholds.

In signing up to the Millennium Development Goals, the international community has set itself an audacious challenge. The aid agencies and networks supporting this paper regard these goals as nothing less than global imperatives. The donor community has now to respond to this historic opportunity by ensuring that financial flows and financing instruments are consistent with achieving the MDGs. Failure to respond with appropriate and measured policy reforms calibrated against the achievement of the development targets will be a tragedy for millions of the world's most impoverished people.

Summary of required policy actions

1. As a one off investment in meeting the MDGs, the World Bank and IMF, non-G7 bilaterals and private creditors must cancel the outstanding debts owed to them by low income countries whose feasible revenues and levels of donor aid are not sufficient to finance their nationally owned development goals.
2. All relevant IFI Board papers and HIPC documents should present the MDG financing needs of all low income countries. The IMF should include projections of economic growth following a 100% debt cancellation.
3. Lower income countries are likely to be characterised by deeper MDG financing gaps. The response of donors should be to give higher volumes of aid in grant form where per capita GDP is lower. In other words, the degree of concessionality in new flows for LICs, running from grant aid to concessional finance, should be adjusted according to the depth of financing needs in LICs. This will require a substantial increase in the level of grant aid to LICs.
4. Where LICs are prone to destabilising shocks, the international donor community needs to respond by cushioning the impact of revenue spikes with contingency financing facilities. The HIPC Initiative's post-Completion Point "topping up" facility is, in part, a recognition that LICs are highly prone to exogenous contingencies and therefore in need of compensatory arrangements.
5. The international financial community needs to incorporate realistic assessments of vulnerability in debt sustainability analyses.
6. Donor aid should be recast to enhance recipient governments' capacity to deliver pro-poor outcomes. The guiding principles for resource transfers should be poverty reduction, ownership, flexibility, minimising transaction costs and enhancing predictability.

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