4

What Form of More?

Perhaps the biggest difference between Group A (the finance ministry types) and Group B (the civil society types) is how they react to a positive answer to the question discussed in the last chapter. Many in Group B tend to take it as axiomatic that a positive answer implies the desirability of more debt relief: How can one even think of forcing countries to service their debts when they cannot provide minimally adequate social services to their people?

Group A members are more wedded to the principle that debt contracts should be regarded as sacrosanct unless there are strong reasons for revising them, on the ground that the observance of debt contracts is the basic prerequisite for credit markets to function. They note that countries can be provided with the same balance of payments help in an alternative way that avoids rewriting debt contracts, namely, by providing more aid. Another relevant factor is the differing distributional effects that result from debt cancellation versus the provision of additional aid, which may argue for preferring additional new aid.

We take the view that it is wrong to assume automatically that one route is superior to the other. We see the force of the proposition that debt contracts should be regarded as sacrosanct, and that increased aid should therefore be preferred, ceteris paribus. But we also see several reasons why ceteris may not be paribus.

In this chapter, we explore the five considerations that we believe are relevant in choosing between more debt relief and more new aid. We start by examining *political resonance*: whether and why debt relief generates more political support than additional aid. This is one factor that may enable debt relief to generate *additionality*, meaning that it results in a bigger transfer of resources to developing countries than would otherwise occur.

To the extent that debt relief does not generate additionality, however, some developing countries must be paying the bill for the debt relief that is granted to others. It is important to have an understanding of these *distributional effects*, both to avoid inadvertently penalizing some countries and to minimize the danger that the debt relief may come at the expense of countries that could make better use of resources in tackling poverty.

There are also *efficiency* considerations involved: We argue that these may make debt relief worthwhile even if there is no additionality or redistribution. Finally, debt relief may have a benefit by allowing donor countries to exhibit greater *selectivity*: that is, to target their future aid with more discrimination (in the positive sense) across poor countries—to those countries most willing and able to use aid effectively for social and economic development.

All these considerations need to be factored into the design of a program to improve the HIPC Initiative itself, and to reform the development assistance architecture so as to avoid reconstituting another generation of unsustainable debt. Those are the tasks we address in the next chapter.

Political Resonance

One difference between debt relief and new aid that never occurred to Group A types is that the debt campaigners would succeed in tapping into a political nerve that they had more or less despaired of exploiting. Aid fatigue had come to be accepted as a political fact of life, nurtured both by the widespread perception that much aid fed corruption and by the empirical finding that the level of aid a country received had no effect on how fast it grew (Boone 1996).

We told ourselves that David Dollar and his associates (World Bank 1998; Burnside and Dollar 2000) have established that the reason for the "failure" of aid is that so much of it has been driven by commercial or strategic considerations rather than a concern to promote development. Their analysis implied that aid is still a worthy cause if it is directed toward countries that have a lot of poor people and that have the good policies and reasonably competent institutions to enable aid to be effective. But we had more or less written off the possibility of overcoming aid fatigue. And then along come the debt campaigners, who mobilize a substantial segment of what we had thought of as an apathetic public in the cause of debt relief. Why the difference?

At one level, we must admit that it is because the leaders of the debt relief campaign proved far more adept at public relations than the worthy Group A types whose idea of action is to sponsor a UN resolution calling for countries to give 0.7 percent of their GNP as aid. But that simply pushes the question back a stage. Why were the Group B types who sponsored the debt campaign motivated to push for debt relief instead of for an increase in the aid budget?

Three reasons spring to mind. One is that aid has got a bad name for the reasons alluded to above: because statistics seemed to show that it does not do any good in combating poverty and promoting development, and because of its association with corruption. Debt relief seems so far, at least, free of that baggage. Drop the Debt (2001, section 3) relates a number of anecdotes about how debt relief has released resources for increased social spending. Surely the World Bank or the Canadian International Development Agency could find some equally compelling stories about how their lending has supported better education and more health facilities, but these would probably be greeted by a cynicism that does not yet plague stories about debt relief.

Another reason is the biblical foundation of the Jubilee movement, which provided a simple, emotionally appealing rationale to wipe the debt slate clean. It was the religiously inspired nature of this movement that brought individuals like Pope John Paul II, Senator Spencer Bachus, and Pat Robertson to strongly support it. This factor was also influential in bringing out much grass roots support for the cause.

But we suspect there is a more fundamental reason. Though many of the most militant debt campaigners have implicitly called for unconditional aid, from its beginning the Jubilee movement itself called for linking debt relief to an entirely new approach to aid. It called for an end to the traditional use of economic conditionality in favor of the link to a poverty strategy ''owned'' by each country; that is, a link to greater social spending, more budget transparency, and greater openness to civil society and public participation in formulating and monitoring the use of resources ''released'' by debt relief. Debt campaigners in the United Kingdom and the rest of Europe took this position because their partner groups within debtor countries insisted on it, fearing that their own governments would otherwise waste or steal any new resources.[1] In the United States, debt campaigners supported the legislative efforts in Congress to link debt relief to poverty reduction.[2]

This concern that released resources should be used for legitimate purposes is the flip side of what we believe fueled the political momentum behind the debt campaign. This is the belief that the debts the HIPCs

1. Personal conversations, at the World Institute for Development Economics Research (WIDER) conference in Helsinki in August 2001, and with Ann Pettifor in October and November 2001.

2. The campaigners urged that third-party civil society groups rather than official donors, including the World Bank, have greater monitoring power.

were being asked to service were "unjust" or "illegitimate" debts, in the sense that they had not been incurred to promote the well-being of the populace of the countries in whose name they were taken on.

As was described in the last criticism of the HIPC Initiative at the end of chapter 2, much of the debt was incurred by dictatorial regimes that showed little concern for promoting the public good. Some of it was used to buy arms used to repress the population, some was promptly recycled in capital flight by the elite, and some was used to build white elephants rather than to make investments likely to generate growth. In the past three decades, as much as 60 percent of the value of all new debt commitments seems to have been made to countries that were subsequently ranked as "not free" or "corrupt" in international classifications (see appendix C for an elaboration of the figures). Many debt campaigners were clearly motivated by the injustice of requiring the mass of the population to undergo privation to service debts incurred for such dubious purposes, and this theme also resonated strongly with the larger public in both donor and debtor countries.[3]

A recent paper by Kremer and Jayachandran (2001) reminds us that there used to be a legal doctrine of odious debt, which argued that "debt incurred without the consent of the people and not for their benefit should not be transferable to successor governments." This doctrine was based on arguments advanced by none other than the US government. After the end of the Spanish-American War in 1898, the United States decided to repudiate the debt accumulated by Cuba under Spanish rule, and it developed this doctrine to justify its decision. The doctrine lingered on between the two world wars, but it has been forgotten in recent years. Even South Africa assumed the debts incurred by its former apartheid government, swayed by a concern that debt repudiation would be interpreted as a violation of the rules of capitalism that would jeopardize its standing in the international financial community and hence its possibilities for development.

But life is complicated, and there are good arguments against a sweeping use of the doctrine of odious debt. These arguments go beyond cynical creditor self-interest to the needs and interests of borrower countries and their citizens. Consider what effect the doctrine might have had on Indonesia during the long rule of Suharto, if its adoption had taken the form of allowing some quasi-judicial body to rule debts odious, and therefore uncollectible, ex post. Many people realized at the time that there was significant corruption in Suharto's Indonesia (although many

3. A group of Alabama church members brought to Washington by an NGO in 1998 talked about how wrong it would be to require people to choose between paying their debts and buying shoes for their children, and it was these individuals who were responsible for converting Republican Spencer Bachus into the champion for debt relief in the House (personal correspondence with Gerry Flood).

of us were surprised by revelations about its scale). Under the doctrine of odious debt, this would presumably have impeded Indonesian access to international loans, which were a significant support for Indonesia's impressive growth at the time.

Many people have forgotten it today, but acute poverty[4] in Indonesia fell from about 60 percent in 1970 to around 10 percent in 1996, possibly the fastest decline ever seen in a major country in all history. Unless one is quite sure that an inability to raise international loans on reasonable terms would have persuaded Suharto to mend his ways, or else that those loans were inessential to Indonesia's success, one might hesitate to endorse a policy that could have had the calamitous consequence of sabotaging the Indonesian miracle.

More generally, if unjust or odious debts were legally unenforceable, creditors and perhaps donors would soon recognize that they could not be sure debts that might be labeled odious would be honored in the future, and much lending that does do good would not take place. For example, lending that has, at least indirectly, supported strengthening of health and education systems would not go to countries with weak and unstable democracies (e.g., Côte d'Ivoire, Nigeria, Paraguay, and Peru), or to quasi-democratically elected leaders who have hung on to office for decades by less than democratic means (e.g., Egypt, Kenya, and Zimbabwe).

Even more perverse outcomes can be envisioned. Consider loans to Pakistan. No one could classify President Pervez Musharraf's regime as democratic. If Pakistan had been denied new loans when Musharraf first took office, he would have had no option but to suspend debt service. Would the donors then have retaliated against an action that they had effectively forced on Pakistan? If not, and they had let Pakistan ''get away with it,'' the country would in effect have benefited from having acquired a government that was unambiguously undemocratic. That is hardly what advocates are hoping for.

In fact, Kremer and Jayachandran (2001) suggest that the doctrine of odious debt should be applied ex ante rather than ex post. That is, the quasi-judicial organ responsible would rule a regime odious, and from then on no debt incurred by that regime would be legally binding on a successor regime. That would mitigate the ''Suharto problem'' and the ''Pakistan problem'' identified above, but it would not resolve them. For if creditors feared that a regime such as that of Suharto—which for at least a decade was increasing the ability of its own people to effectively demand their political rights (as indeed they finally did)[5]—might be

4. Using the World Bank's ''dollar-a-day'' poverty line: $1 a day in 1985 prices, using purchasing power parity to convert from local currency into dollars.

5. Sen (1999) makes the point that political rights are intrinsic to and instrumental for economic development.

declared odious in the future, they would be quite rational in refusing to lend even in advance of such a declaration being issued, because the inability to raise new loans after the declaration would impede the servicing of loans signed before it.

Whatever the difficulties of legally codifying the doctrine, the fact remains that the sort of abuses that might justify considering debt to be odious provide a powerful political argument in favor of debt cancellation, one that may have helped to draw figures like the pope and Bono into the debt campaign. It is therefore worth examining how common it is to find the sort of grievances that make the case for declaring debt odious. We decided that the best way of getting some feel for that would be to examine a series of case histories. Appendix C therefore discusses five country case studies to give an idea of what proportion of the debt may have been incurred for dubious purposes. It examines the experiences of the Democratic Republic of Congo (the former Zaire), Kenya, Nicaragua, Pakistan, and Uganda (four HIPCs and one country that some people have argued ought to be a HIPC) during recent decades.

All the case studies exhibit instances that might justify the appellation odious for a part of the debt. To begin with, none of the five countries could claim to have been a democracy consistently during the past two decades. But even when they did have ostensibly democratic governments, as in Pakistan between 1988 and 1999, some of the rulers seemed more intent on furthering their family interests than on promoting the national welfare.[6]

Capital flight was significant in the Democratic Republic of Congo (where capital flight is roughly equal to the increase in the country's debt stock during the past two decades), Nicaragua in the late 1980s (22.4 percent of GDP between 1985 and 1998), and Uganda in the early 1980s. There was actually modest repatriation of capital into Pakistan and Uganda in the 1990s. Estimates of the personal fortunes amassed during their presidencies by Joseph Desire Mobutu in Zaire, Daniel Toroitich arap Moi in Kenya, and Anastasio Somoza in Nicaragua are striking—in each case, roughly half the size of their country's total outstanding debt at the time they left, or will leave, office.

Arms expenditures were a major factor in the Democratic Republic of Congo, in Nicaragua under the Sandinistas, and in Pakistan, although in Pakistan it is not clear that this was done in defiance of the wishes of the public. Although we were able to identify clear cases of spending on white elephants in four of the countries, they did not account for a large percentage of borrowing during the past two decades. In sum, though

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6. One of the authors recalls a taxi ride in Washington the night before he entered the World Bank, inter alia to work on Pakistan. He happened to have a Pakistani taxi driver, who responded to a question about why he was so downbeat about the economic state of Pakistan: ''They [meaning Benazir Bhutto and her cronies] are looting the country.''

by no means can all the debts be considered odious according to all the criteria, it is not difficult to understand how history could be used to nurture popular indignation with forcing countries to service their debts.

Thus one can understand why a conviction that much of the debt was unjust, illegitimate, or odious may have contributed to political support for debt relief, while at the same time maintaining reservations about whether this principle could be applied in deciding exactly which debt, and thus what amount of total debt, to cancel.

Additionality

Debt campaigners assume that reducing debts will enable countries to spend less on debt service, and therefore more on other things, like education and health. Even at the level of the individual country, this proposition needs two qualifications. First, only the reduction of debt service that would have been paid releases resources; the reduction of debt service due that would have built up arrears just cleans up the books. Second, even a reduction of debt service that would have been paid results in increased resources only if other receipts, including aid receipts, remain constant.

Even if the aid inflow is unaffected for the individual country, might this come at the expense of a decrease in aid to other developing countries? We examine this latter possibility in the next section. In this section, we concentrate on asking whether there are reasons to expect that the grant of debt relief will lead to an increase in the total net flow of financial resources to all developing countries, which is what is meant by debt relief leading to additionality.

Assessment of the additionality (or not) of debt relief in the context of aid transfers faces two challenges. The first is that the underlying officially available data on grants, on the various kinds of subsidized loans, on interest payments—some paid, some reduced, some forgiven, and some owed but not paid—are difficult to unravel, particularly for individual debtor countries with many different lenders and donors. The accounting is perforce complicated. We discuss the issues in box 4.1.

At the end of the day, we judge the DAC accounting treatment to be appropriate, except in some relatively minor details. The way reduction of ODA debt increases measured ODA is not at the moment when the debt is forgiven but in the following years, when the country would have been due to repay the principal and does not have to. Because repayments of principal are counted as deductions from ODA, this means that a donor country that holds its disbursements constant in the future will register an increase in measured ODA.

The second challenge to measuring additionality is more fundamental and intractable, namely, that we can never know the counterfactual—

Box 4.1 Aid accounting and debt relief

The task of developing standard methods for counting aid is the responsibility of the Development Assistance Committee of the OECD. To qualify as official development assistance, a transaction must satisfy three criteria: it must emanate from the public sector in the donor country, it must have a minimum grant element of 25 percent, and it must have as its main objective the promotion of development in one or more relatively poor countries on an agreed list of recipients.[1]

ODA is measured net of principal repayments by borrowers on their ODA loans made in previous years. That is, borrowers' periodic repayments of principal (but not of interest[2]) are netted out of (and thus reduce) total transfers. The corollary is that when debt is forgiven, ODA in subsequent years is measured as higher than otherwise would have been the case by the amount of principal written off. This principle is correct.

When an ODA loan is forgiven, the donor reports the debt cancellation, but with an offsetting entry for a notional repayment of principal, which means that ODA does not increase in the year the debt is canceled. That also is appropriate treatment. Debt forgiveness is recorded, but does not add to ODA in the short run.

Are these procedures appropriate if the debt cancellation is not so much a voluntary act intended to benefit the debtor as an accounting recognition that the debt is uncollectible? Cohen (2000) argues that debt cancellation should be divided into two parts: the 90 percent (or whatever) that is uncollectible should be recorded as a loss on a bad loan, and the remainder should be recorded as debt forgiveness. That would make the uncollectible portion transparent, and it might create more healthy bureaucratic incentives for official creditors and guarantors to weigh carefully the risks that the loans they make may go bad, but it would not change the bottom line.

What about the flow accounts? The practice there is simply not to deduct from ODA repayments of principal that are not made. Certainly the contrary practice, to *deduct* repayments that are *not* made, would be nonsense! In principle, the right answer would be to count prior defensive lending as de facto debt relief that never built up a liability to be repaid. But after the fact, that is an analytic not an accounting exercise!

Where the conventional approach on the flow accounts does seem to give wrong answers is in relation to two second-order issues. The first concerns interest arrears. When ODA debt is canceled, interest arrears are canceled as well and are recorded—as an addition to ODA. Given that interest arrears are normally not paid because countries are unable to pay them, this is inconsistent with the principle that forgiving uncollectible debt is simply recognizing reality.

The second issue concerns the treatment of other forms of debt cancellation, of which the important one is cancellation of export credits extended to eligible countries. The DAC permits donor countries to count this as ODA, even if those loans would not have been serviced in the absence of debt forgiveness. This means that a donor country that holds its measured ODA constant when it forgives export credits that would not have been serviced in the absence of debt relief will actually be providing *fewer* financial resources than it would have done in the absence of debt relief. Additionality would actually be negative!

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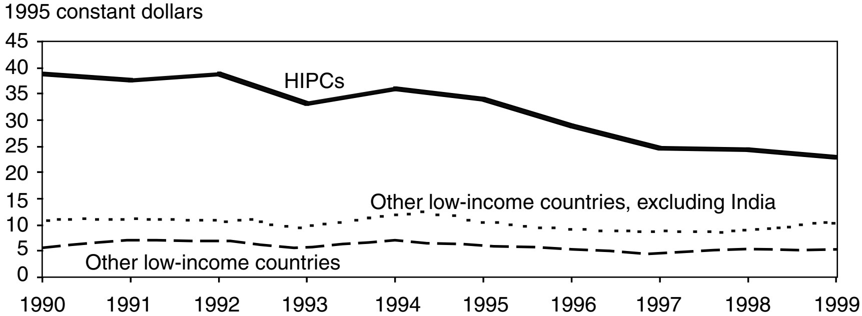
1. See http://www.oecd.org/dac/htm/dacdir.htm.

2. Had interest payments also been deducted from ODA, as is done in measuring resource transfer, and had loans all been serviced on the original terms, measured ODA might have become negative.

Figure 4.1 Aid to low-income countries in per capita terms, 1990-99



Note: Figures are population-weighted averages.

Source: World Bank, *World Development Indicators*, 2001.

what would have happened in the absence of debt relief. We can only compare future aid flows with debt relief to past aid flows without the same relief.

The donor countries have pledged that debt relief provided under the enhanced HIPC Initiative will be additional to the aid they are already giving.[7] But good intentions do not always translate into action, and increased aid appropriations often have to run the gauntlet of legislators facing competing domestic needs and anyway suspicious of foreign ''give-aways.'' Is there any way of knowing whether the current and additional proposed debt relief under the enhanced initiative will in fact add to the total resources available to developing countries?

During the past 5 or 6 years, as debt relief programs have intensified, total ODA has been declining (see figure 2.1 and table 2.1). A cynic would note that that decline coincides with a period when the benefits of the earlier rounds of debt cancellation should have been showing up in increased ODA. Figure 4.1 compares the course of aid per capita during the 1990s in all low-income countries and in those countries that benefited from the HIPC Initiative. Until 1997, aid declined in a more or less parallel way in both groups of countries. Had the initiative been additional, one would have expected to see the HIPCs facing a slower decline, or even registering an increase, after countries began receiving HIPC assistance in 1997. In fact, it is the non-HIPCs that registered a small increase after 1997, whereas the decline continued in the HIPCs. Although this is hardly decisive, it does suggest that any positive effect there may have been was very muted.

Conversely, if we examine the recent parliamentary processes in some of the donor countries, we might find a measure of comfort. For example,

7. ''G-7 Finance Ministers Report on the Debt Initiative,'' presented at the Cologne Economic Summit, 18-20 June 1999.

Senator Jesse Helms, in his final days as chairman of the Senate Foreign Affairs Committee, persuaded the committee to approve a $435 million appropriation for the HIPC Initiative, which was almost certainly an addition to the funds that Congress would otherwise have approved for development aid. And other countries have also pledged funds for the HIPC Trust Fund, as well as forgiven bilateral debts. Perhaps the visibility of the HIPC Initiative secured more additionality than in the past. Of course, new aid appropriations are not the same as disbursements, and there is no way of being sure of what would have happened in the absence of debt relief. But the enhanced HIPC Initiative does seem to be inducing some, if only modest, additionality in comparison with the earlier record.

This modest additionality has come in the context of donor governments' allocations for their own programs of bilateral debt relief. We doubt, however, that more debt relief by the World Bank would be additional. Most debt owed by the HIPCs is owed to IDA rather than the World Bank itself, but it has been argued that the Bank could nonetheless draw on its accumulated reserves to write off those loans. Indeed, Drop the Debt (2001) argued that the Bank could do this without reducing its lending or threatening its triple-A credit rating, and a reputable accounting firm (Chantrey Vellacott) concluded that the claim was justified.

Even if this is correct, however, that does not settle the question. Entities with a triple-A credit rating pay a premium over the US Treasury to borrow that ranges from a few basis points up to about 75 basis points. The World Bank has recently been paying a premium of about 8 basis points over the US Treasury when it borrows. There is no question but that the sharp reduction in the Bank's capital and in its future operating profits that would result from the proposal to forgive all IDA and World Bank debts would increase that premium; the only question is by how much. If it were to rise by 50 basis points, which is easily within the range consistent with maintenance of a triple-A rating, that would increase the Bank's borrowing cost by about $75 million in the first year and some $550 million a year in the new steady state. The Bank would either have to pass that on to its non-HIPC borrowers in higher loan interest rates or progressively curtail its operations.

In either event, it is non-HIPC developing countries that would pay. In the new steady state, for example, Mexico would pay about an extra $50 million a year if the World Bank chose to pass the cost on, and India would pay an extra $36 million a year (on the basis of their present borrowing levels). Additionality would be achieved for all developing countries only if the loss to the non-HIPCs was less than the gain to the HIPCs. The latter have been quantified by Drop the Debt (2001, 4) as $215 million a year for the first 22 countries and $353 million for all the HIPCs.

Because our figure of $550 million a year for the extra steady-state borrowing cost is merely illustrative, this comparison does not establish whether or not additionality is to be expected. However, additionality would materialize only if the World Bank was previously being irrationally conservative in holding more reserves than could be justified. Conversely, the losses could exceed the benefits if reserves were forced down far below the optimal level. Perhaps the Bank is being too conservative in its practices, but we doubt very much whether it is so far from the optimum as to permit anything like a full funding of debt relief from its reserves without harming the interests of other developing countries by more than the benefit to the HIPCs.[8]

The African Development Bank (AfDB) is even less able to write off the debts it is owed without undermining its financial position than is the World Bank. The cost of the HIPC Initiative (in NPV terms) represents 102 percent of the AfDB's reserves and loan loss provisions. Comparable figures are 23 percent for the World Bank, 13 percent for the Inter-American Development Bank, and 20 percent for the IMF. Financing the HIPC Initiative is even more problematic for some of the small subregional development banks (see box 4.2).

The IMF is in a different situation, because it still has substantial holdings of gold on its books that are valued at the old official price of SDR 35 per ounce (currently about $45), in comparison with the market price of about $290 per ounce. It mobilized some of its holdings to finance the enhanced HIPC Initiative. The obvious approach would have been to sell gold on the open market and then use enough of the proceeds to keep the balance sheet whole and the remainder to forgive HIPC debt. But this proposal encountered objections, on the ground that selling gold would depress the market price. This would of course have been a correct reflection of the fact that part of a sterile stockpile of gold would have been released for productive use, making the world better off. But both gold producers and gold bugs were distressed at the prospect of a lower gold price and succeeded in blocking it.

Hence, in the event, the IMF devised an elaborate procedure that enabled it to tap some of the profits without selling gold on the market.[9]

8. To the extent that the debt is uncollectible, the World Bank's real reserves have already declined; what is at stake is whether the donors or the borrowers (or neither) should recapitalize it.

9. ''In December 1999, the Executive Board of the IMF authorized off-market transactions in gold of up to 14 million ounces to help finance IMF participation in the HIPC Initiative. Between December 1999 and April 2000, separate but closely linked transactions involving a total of 12.9 million ounces of gold were carried out between the IMF and two members (Brazil and Mexico) that had financial obligations falling due to the IMF. In the first step, the IMF sold gold to the member at the prevailing market price and the profits were placed in a special account and then invested for the benefit of the HIPC Initiative. In the second step, the IMF immediately accepted back, at the same market price, the same amount of gold from the member in settlement of that member's financial obligations falling due to the Fund. The net effect of these transactions was to leave the balance of the IMF's holdings of physical gold unchanged.'' See from http://www.imf.org/external/np/exr/facts/gold.htm.

Box 4.2 The Central American Bank for Economic Integration

The example of the Central American Bank for Economic Integration (CABEI) highlights the distributive challenges of offering debt relief to a limited number of countries. CABEI has been operating since 1960, and it is the second largest source of financing for the countries of Central America. In 1999, when the enhanced HIPC Initiative was announced, it became clear that it posed a significant problem for CABEI. Two of CABEI's five members (Honduras and Nicaragua) were eligible for relief. Under HIPC terms, the burden of debt relief imposed was equivalent to half of CABEI's net worth.

For CABEI to have financed this effort without help from the international community would have threatened its solvency. Furthermore, it would have involved a transfer of resources from some poor countries to others, negating the underlying rationale for the HIPC Initiative. Thus the leadership of CABEI appealed to the World Bank and the international community for assistance in covering their share of debt reduction in Honduras and Nicaragua. An agreement was reached with the G-7, European Union, World Bank, and IMF for more than half of CABEI's share to be paid out of the World Bank's HIPC Trust Fund. Nevertheless, CABEI committed significant resources of its own to the HIPC Initiative, becoming the first institution to grant debt relief to Honduras ($252 million) in April 2000 (it subsequently wrote off $435 million of Nicaragua's debt).

Looking to the future, CABEI is constrained in its ability to lend to Honduras and Nicaragua, because under the HIPC arrangement it is not permitted to lend to these countries on nonconcessional terms, and it has not traditionally had a fund with resources for concessional loans. CABEI has created a new Special Trust Fund for Social Transformation in Central America to finance loans on concessional terms, but this facility has received only $9 million in commitments.

The profit from the operation was invested in an interest-earning account, and the interest on that investment is used to provide debt relief to the HIPCs.

The 1999 operation to mobilize gold involved only 14 percent of the IMF's 103 million ounces of gold. Hence there is plenty of scope for further actions of the same type, or for variants such as simply selling gold on the market. At the current price, this would yield more than $20 billion if the whole of the IMF's undervalued gold were to be mobilized. The IMF thinks that holding a lot of undervalued gold ''provides fundamental strength to [its] balance sheet'' and ''provides the IMF operational maneuverability.''[10]

More specifically, the IMF argues that its gold holdings matter in allowing even conservative central bankers to treat quota increases as an asset swap rather than a donation, because they know that if necessary the IMF could sell some gold to keep its balance sheet whole if some of its loans to distressed debtors were to sour. Though the IMF does indeed lend

10. See http://www.imf.org/external/np/exr/facts/gold.htm.

to countries with major macroeconomic problems, its record in recovering debts on its own balance sheet (as opposed to that of the PRGF, which has a separate balance sheet) is sufficiently sound to make it perfectly sensible for its members to treat quota increases as asset swaps, with or without the IMF's extra ''gold'' security.[11]

However, one should recognize that a likely consequence of forgiving the $5.6 billion of the IMF's claims on the HIPCs is that this might jeopardize the future of the Poverty Reduction and Growth Facility, the IMF's special fund for highly concessional lending to the poorest countries that cannot afford to borrow on its regular terms. The major industrial countries that control the IMF would be likely to conclude that they would be inviting new claims for debt reduction in the future if they were to maintain the facility. If the PRGF were therefore closed, it would eliminate loans now running at about $700 million a year gross and $100-150 million net, of which about 75 percent are to the HIPCs.[12] That would leave precious little additionality, even for the HIPCs, and would reduce transfers to other developing countries.

A report published in 2000, to which both authors of this study were signatories (Overseas Development Council 2000), urged that the PRGF be transferred from the IMF to the World Bank. The logic was that the development issues to which the PRGF is supposed to be directed are primarily the responsibility of the World Bank rather than the IMF (see box 4.3). Now that the World Bank has established Poverty Reduction Support Credits as a parallel to the loans of the PRGF, also directed to enabling low-income countries to implement their Poverty Reduction Strategy Papers, the bureaucratic obstacles to such a transfer are even less than they were then.

The report envisaged transferring the PRGF's assets, including its outstanding loans, as well as its liabilities. This could be done after the IMF had used a part of its gold stock to write off some or all of the (uncollectible) outstanding debts of the HIPCs to the PRGF, in effect ''recapitalizing'' the PRGF and providing a PRGF dowry to the World Bank. One would then not need to worry about the IMF abolishing the PRGF, because it would no longer have a PRGF to abolish. Reduction of any portion of the outstanding debts to the IMF would then be unambiguously additional, and the amount of resources available for concessional credits (or grants) from the World Bank would be increased.

Redistribution

The logic of the preceding section is that any additionality provided to an individual country by the enhanced HIPC Initiative will come at the

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11. Lerrick (2000) makes this point.

12. Estimates based on 5-year annual averages (1997-2001); $500 of the $630 million in PRGF lending in 2000 went to HIPCs (IMF *Annual Report*, appendix 2, table II.6).

Box 4.3 The IMF's future role in development

A task force commissioned by the Overseas Development Council (2000) recommended that the IMF's Poverty Reduction and Growth Facility be moved to the World Bank. It argued that the IMF had an important continuing role in the poorest countries in macroeconomic surveillance and policy discussions, but that these need not be based on continuous lending and the associated conditionality. IMF loans should be made available only when countries encountered crises. Then countries could borrow under the IMF's traditional standby facilities. The task force suggested that some PRGF funds (now drawn from the World Bank) should be used to subsidize the interest costs of otherwise conventional standby loans for very poor countries.

The task force concluded that it was inappropriate to have the IMF in charge of a facility whose fundamental purpose is to provide development finance, the provision of which should be conditioned on the adoption of policies that will promote development. It is perfectly true that development requires prudent macroeconomic policies that will minimize the danger of crises and provide a supportive environment for growth. But it is also true that development policy has many other dimensions. These include governance and institution building, social policies in such areas as health and education, the banking system and corporate governance, policies toward trade and competition and privatization, and rural and urban policy. Except for the financial sector, where both institutions are involved, these are all areas in which the World Bank rather than the IMF has a mandate to develop a measure of expertise. It accordingly was deemed logical to concentrate medium-term, noncrisis lending in the World Bank.

The task force did not wish to see such a concentration lead to a reduction in financial flows to low-income countries. Hence, it recommended that the Poverty Reduction and Growth Facility be transferred from the IMF to the World Bank, complete with its financial assets, rather than simply closed. It envisaged continuing cooperation between the World Bank and IMF after the transfer, so as to bring the IMF's expertise to bear in assessing the macroeconomic policies being pursued by countries wishing to borrow. But the loans would come from the World Bank, with the IMF providing inputs to the policy assessment, rather than vice versa.

expense of other developing countries unless it is financed by additional ODA or by the mobilization of IMF gold. Through what channels can this occur, who is likely to suffer, and what are the consequences likely to be in terms of the reduction in global poverty?

The easy channel to understand concerns the redirection of bilateral aid. If a donor keeps its ODA constant in the years following debt reduction, when it is receiving fewer repayments than it would have, then some countries must receive fewer grants or new loans. In principle, it is possible that the donor could concentrate its ODA reduction on the countries whose debt was forgiven, in such a way as to leave the financial position of each recipient unaffected.[13] But the presumption is that the

13. Except that the recipients of debt relief would benefit from lower interest payments, which are not counted as part of ODA.

countries which benefit from debt reduction will not see their ODA allocations cut equivalently, and they will therefore benefit more than from the interest payments they no longer have to make. That benefit will come at the expense of those developing countries that receive reduced ODA.

Can anything be said about the likely consequences of such a redistribution? Yes, inasmuch as one of the key characteristics of HIPCs is that they are poorer than most other developing countries. Thus there is a presumption—no more—that debt relief will tend to redistribute aid toward poorer countries. However, if aid is to be effective, it should be concentrated in countries with particularly good institutions and policies, and these are not only or necessarily the HIPCs. There may in fact be a trade-off between the two Burnside-Dollar criteria: aiding poor countries and aiding countries with effective institutions and good policies (see box 4.4). That would leave one agnostic as to the net effect on poverty of redistributing aid toward HIPCs.

Consider next the case in which debts are forgiven by the multilateral institutions. Let us take IDA first, because it is the most important creditor of the HIPCs. Drop the Debt (2001), Lerrick (2000), Oxfam (2001), and Roodman (2001) all argue that the World Bank should draw on its reserves to forgive HIPC debt owed to the Bank itself and to IDA. As was noted above, Drop the Debt argues that this would not involve the Bank sacrificing its triple-A credit rating, which may be true but is nonetheless misleading, in that one would still have to expect its borrowing costs to rise. This would make it more expensive to borrow from the Bank, so the burden would fall on such borrowers, which means primarily the middle-income developing countries but also relatively low-income countries such as China, India, and Indonesia. It would be possible to make this cost transitional by rebuilding the Bank's reserves over time, but that would imply either cutting back the Bank's lending or else adding further to the cost of borrowing.

In either event, it is the World Bank's regular borrowers who would pay. The idea that the World Bank (let alone any of the other development banks) sits on a heap of functionless cash in the way that the IMF sits on a pile of sterile gold is just wrong. Tapping the World Bank's reserves would not be a free lunch, or impose financial penalties on the president or staff of the Bank, but (except to the extent that the Bank may hold higher than optimal reserves) would be paid for by its borrowers. Debt campaigners concerned with the plight of the world's poor need to be aware of the risk that the United States and other Bank shareholders will succumb to the pressure to use the Bank's reserves, because it has no financial cost to them—leaving the middle-income and non-HIPC Initiative poor countries to pay the tab.

How would the World Bank Group adjust if IDA's HIPC assets were to be wiped out? For the partial write-off under the enhanced HIPC

Box 4.4 Aid does work—if . . .

It is not surprising that the effectiveness of aid depends on conditions in the recipient country—and that aid provided to incompetent or corrupt governments is unlikely to generate growth or reduce poverty. It is easy to specify when aid does not work (Zaire in the past), but awfully hard to specify when it does. What do we mean by the conditions of ''good governance'' and ''good policy'' under which aid seems most effective? And might not some aid, though less effective, still be better than no aid at all (in improving people's lives), even when government is mediocre and policy unreliable (the way many citizens of the United States and European countries might describe their own governments!)? After all, most countries that need aid fall into that middling category.

On the basis of statistical analysis across countries and over time, Burnside and Dollar (2000) report that foreign aid is effective (encourages more economic growth) only where fiscal deficits are small enough, inflation is low enough, and the trade regime is sufficiently ''open.'' For countries that are just average on these characteristics, aid accomplishes nothing in terms of growth. They conclude that aid works only where ''policy'' is adequate (essentially assuming that these macroeconomic conditions reflect good policy). They also conclude that aid does not in itself influence policy for the good. So they argue for aid based on ''selectivity'' across countries—that is, donors should channel aid only to those select countries that are already behaving well, with ''good enough'' policies and adequate institutions.

Other analysts question Burnside and Dollar's findings, arguing that their statistical results are too fragile to warrant a dramatic switch to such selectivity by donors (Hansen and Tarp 2001). Different samples and variables produce different findings. Aid seems to have diminishing returns, for example, and taking that into account reduces the apparent relevance of policy. Aid tends to be highest (relative to their GDP) in the poorest countries—a good thing in itself, because aid is meant to reduce poverty—but those may also be the countries where aid is most likely to have diminishing returns, because absorptive capacity is limited.

Cross-country statistical analysis can raise questions more effectively than dispose of them. Better understanding of exactly what and how certain policies and institutions at the country level make aid more selective is likely to come in the end from understanding specific country cases. Meanwhile, there is evidence that policies in the poorest countries, including the HIPCs, were better on average in the 1990s than in the 1980s (Birdsall, Claessens, and Diwan 2001; Burnside and Dollar 2001). So selectivity in aid transfers would actively benefit more countries today than it would have a decade ago. In addition, multilateral institutions have consistently been more selective than bilateral donors, probably because they are less vulnerable to immediate political pressures, and through such mechanisms as the Consultative Group of donors, the entire aid process has become more multilateral (Birdsall, Claessens, and Diwan 2001).

Finally, of course, even where some aid does not instantly ''produce'' growth, it can improve people's lives directly, if it contributes to reducing infant deaths, helping children stay in school, empowering disenfranchised women, and building local community organizations. If these outcomes also eventually help generate growth, all the better.

Initiative, the approach incorporated in present plans is to draw on a trust fund, which is funded partially by donors and partially by contributions from World Bank profits (the latter already a slight tax on non-HIPC borrowers). But even now donor contributions to the trust fund are not adequate to fully finance the enhanced HIPC Initiative (the money now in the trust fund will last only until 2005), let alone full debt cancellation. If the Bank's reserves are in fact higher than optimal, then it should certainly contribute more of its profits and use less of them to accumulate reserves. But we doubt whether this could be more than a marginal additional contribution. It would therefore be necessary to employ one of the three alternative approaches that have been suggested:

- Raise charges to the World Bank's regular borrowers (above the marginal increases that already reflect periodic contributions from the World Bank's profits to IDA and to the debt relief trust fund).
- Reduce future lending to IDA countries to match the reduced reflow of IDA funds.
- Invest World Bank funds in income-earning assets and use the interest earned to make grants to poor countries (Meltzer Commission 2000; Lerrick 2000).

We have already analyzed how the first approach would impose the burden on the Bank's regular borrowers, except to the extent that the Bank may currently be holding higher than optimal reserves.[14]

The second approach requires that other IDA borrowers bear the cost of forgiving HIPC debts. It is true that the fall in lending would be exactly equal to the reduction in amortization payments due from the HIPCs, so that there would be no collective benefit or cost to IDA's clients.[15] But though there would be no cost to IDA borrowers taken collectively, one again needs to ask whether there would be distributional effects. Perhaps the Bank could arrange for its IDA lending to each borrowing country to contract by the amount of the country's reduced repayment obligations, although one may suspect that this would provoke furious criticism that it was deliberately denying countries the benefits of debt relief.[16] Other-

14. The size of reserves is set according to policies periodically reviewed by the member governments, and is intended to optimize the trade-off between financial risk to the World Bank and borrowers' costs.

15. The reduction in amortization payments seems to have been overlooked by World Bank spokespersons, who have sometimes argued that IDA's inability to maintain the same level of new lending would be damaging collectively to the countries that borrow from IDA.

16. One could expect many more comments like these: "In an almost cynical game of bait and switch, countries like Mozambique have seen the benefits of debt relief canceled out by corresponding reductions in aid, resulting in no net gain for social development activities in the national budget" (Edmund Cain, "Helping Poor Nations Lift All Boats," *Atlanta Constitution*, 23 August 2001).

wise, the presumption has to be that loans to non-HIPC IDA borrowers would contract, so that they would be the ones paying for HIPC! That means IDA-only borrowers like Bangladesh and blend borrowers like India and Indonesia. Given that IDA has based its lending quite consciously on the Burnside-Dollar criteria, there is a strong likelihood that such a redistribution would have a perverse effect on the global fight against poverty.

The Meltzer-Lerrick plan is to have reflows into IDA invested in income-earning assets, and then use the income generated to make grants. The disadvantage of this is that, unless IDA reflows were to be supplemented by large additional donor contributions, the initial effect would be a severe reduction in the flow of IDA money. (If the assets in which IDA invested yielded 7 percent, then the flow would initially decline by 93 percent in the absence of additional donor funding.) The issues with respect to the regional development banks are similar, but more acute (remember box 4.2 on CABEI).

There are two morals to this discussion. The first is that additionality matters. The second is that it is wrong to think of the World Bank's reserves as a substitute for IMF gold or additional ODA in providing additionality. The Bank already uses any excess reserves to fund "worthy" purposes, of which the HIPC Initiative is only one. "Success" in raiding the Bank's reserves to forgive HIPC debt would come at the expense of other developing countries, perhaps ones that are equally poor and that have been making better headway in combating poverty. The result could well be a reduction rather than an increase in the rate at which global poverty declines and a further threat to achievement of the Millennium Development Goals.

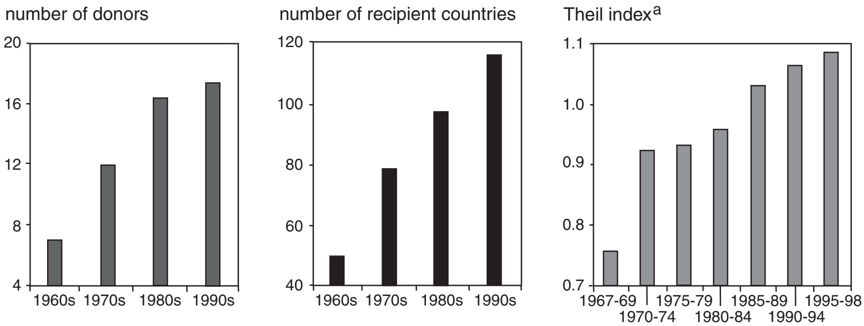
Efficiency

Suppose that there were no additionality or redistribution whatsoever, but that other aid decreased just enough to offset debt relief and the reduction in interest payments, leaving each HIPC neither better nor worse off in terms of resource transfers. The HIPC Initiative might still be worthwhile, because for several reasons it might increase the efficiency of aid, meaning its effectiveness in generating development per dollar transferred. In this section, we trace five mechanisms by which debt relief might be expected to increase aid efficiency: ownership, reduced transaction costs, project-based aid, tied aid, and effects on private investment.

Ownership

In recent years, aid donors have begun to emphasize the need for recipient countries to take charge of the design of development strategy, to be "in

Figure 4.2 The increasing aid coordination challenge



a. The Theil index is a statistical measure of the extent of concentration of aid by sector. Higher values of the index indicate that aid is spread over a greater number of sectors.

Source: World Bank, *Global Development Finance*, 2001.

the driver's seat,'' to ''own'' their development programs and priorities, rather than these being largely dependent on and set by donor decisions about development assistance. The fact is, of course, that the poorer a country and the more dependent it is on external funds, the larger and more complicated its task and the less likely it is to have the administrative capacity and the political wherewithal to cope. Country size is also a factor. China and India are much better able to manage the donor process, despite their low per capita income, than are small, somewhat richer countries like Congo and Honduras.

However, these well-meaning efforts are flying in the face of a basic trend during the past two decades—which for the HIPCs and most other low-income countries has been the reality of the donors' ever-increasing presence, measured both in terms of the number of donors and their annual inflows of new money. Behind the continuing if diminishing annual positive net transfers to most low-income countries, there has been a combination of gradual increases in gross transfers offset by gradual increases in debt service payments. The increases in gross transfers of donors and creditors meant that their involvement in the development programs of recipient countries was constantly increasing. Perhaps even more important, there has been a continuing increase in the number of donors operating in each country, and in the number of sectors over which each spreads its aid (see figure 4.2).

The increasing financial presence of donors reduces the space for governments to ''own'' their development programs. Government officials, constrained by high debt service obligations and by the need to keep the aid flowing, find their choices severely limited by donor preferences. To the extent that ownership matters, and the evidence is that it does (Collier and Dollar 2001), it would be much better to forgive the debt and cut new inflows. Even if there were no increase in net transfers, the country would regain the ability to decide for itself what it thought was worth doing, and governments would become more accountable to their citizens for consistent and coherent management of their own aid resources. In some objective sense, the decisions might be no better than those that result from present arrangements; but if they resulted in the government and public believing in what was being done, the end results could be expected to improve.

Reduced Transaction Costs

It is difficult to argue that the business of development assistance has in the past been conducted efficiently. The HIPCs and other low-income countries highly dependent on external assistance cope with dozens of donors and creditors, proposing hundreds of projects and programs, negotiating and monitoring elaborate and often different procurement and disbursement procedures as well as policy and program conditions. Donors make constant efforts to coordinate their activities, including through the Consultative Group process of annual meetings of all donors with officials of recipient countries, but that has not resolved the problem. In addition, until the beginning of the HIPC process, these meetings ran in parallel with repeated rounds of debt negotiations for most countries (see box 2.2 above).

Government officials of aid-dependent countries as a result often spend much of their time dealing with donors and managing within their own governments the interministerial and intergovernmental decisions about donor-financed programs. The World Bank alone might have half a dozen different missions visiting a country at the same time. In any week the minister of finance or of planning may expect to meet with some of these missions, as well as missions from the European Union, IMF, United Nations Development Program, United Nations Children's Fund (UNICEF), and several national aid ministries. They might discuss new financing, renegotiate existing programs, and consider reports on ongoing projects. In some cases, country officials would be coping with competing missions—from the World Bank and the Dutch with different approaches to agriculture, or from UNICEF and the European Union with different approaches to health or childcare.

Country officials might also, at least implicitly, have to adjudicate between the conflicting priorities of different donors and creditors, for example, between IMF demands for reduced government spending and World Bank pressures to sustain the government's prior commitment to an ongoing road maintenance program. The recent explosion of NGO-based aid, though still modest in volume, is highly management intensive, and adds further to the burden for governments.

A second benefit of a transfer-neutral reduction in debt is that it would reduce these transaction costs of obtaining aid. At present, one of the principal tasks of some government officials is to keep the donors happy and the aid flowing—aid that is then recycled back to the donors. It would free up the time of key personnel in the main economic ministries to focus on longer-term issues if they could be relieved of this task.

Project-Based Aid

Donors display a strong preference for supporting predefined discrete projects that they can describe to their taxpayers' representatives and claim credit for with the public of the recipient country. This is especially true of bilateral donors, who have been the largest providers of aid to HIPCs and sub-Saharan African countries in the past two decades. Thus most of their support has come in the form of ''projects'' as opposed to more fungible policy-based budget support or debt relief. The World Bank and African Development Bank also provide the bulk of their support in the form of projects, although multilaterals they are one step removed from the political pressures of donor-country legislatures, they are somewhat more able to provide program support.

Project support is relatively nonfungible, meaning that countries cannot easily shift resources earmarked by donors for a specific health project to infrastructure investment or vice versa. Of course, to the extent that project support is earmarked for an activity that the recipient government would otherwise have funded itself, the project is indirectly supporting some other activity the government chooses. If a government manages the donors effectively, it can thus create the kind of fungibility that is potentially more consistent with sustained, coherent planning. We have here, however, a chicken-and-egg problem. The more a government depends on immediate support, the less easy it is for it to manage the donors and seize ownership of its program—even when each donor in principle strongly supports that ownership.

Table 4.1 shows a breakdown of bilateral donor assistance to the HIPCs during the past 20 years, by 5-year period, into project support, program support, technical assistance, debt relief, and a category including food, emergency, and unallocated aid. These data do not show much increase in the share of bilateral assistance going to nonproject budget support, even if one aggregates debt relief with program support. In the past few years, however, donors have made efforts to support broader programs through the budget—for example, to supplement the health-sector budget once an overall health plan has been agreed on with the recipient government, rather than supporting the construction of clinics or the purchase of hospital equipment. The available data make it difficult to distinguish these newer broader ''projects'' from traditional ones, and so the situation may be somewhat less dire than is suggested by the table.

Table 4.1 Project versus nonproject activity: Commitments of bilateral ODA to the HIPCs, 1973-99 (percent)

Commitment	1973-79	1980-84	1985-89	1990-94	1995-99
Total program	17	17	18	15	8
Total project	35	36	41	40	44
Technical cooperation grants	33	31	27	28	24
Debt relief	3	4	4	9	13
Food, emergency, and unallocated aid	12	12	10	8	11
Total with food aid and technical cooperation	100	100	100	100	100

Note: Project aid includes the following sectors: social infrastructure and services, economic infrastructure and services, production sectors, and multisector.

Source: Organization for Economic Cooperation and Development, Development Assistance Committee creditor reporting system, *International Development Statistics* CD-ROM (various years).

In the absence of budget support, the governments' domestic budgets must finance debt service. In the case of HIPCs in 1999, gross disbursements from bilateral and multilateral donors were about $15 billion, of which not more than $3 billion was clearly in the form of general budget support.[17] Debt service paid from the budget was slightly more than $5 billion. Thus HIPC governments were financing a net negative transfer from their budgets of about $2 billion, despite receiving a large positive resource transfer.

Of course, if all the projects financed were in fact a high priority for the governments, there would be no harm done. The problem arises if the projects in fact reflect donor priorities more than country priorities. This is the case not only among investment options (health vs. roads) but also between spending on new investments versus spending to operate and maintain existing investments. Donors traditionally emphasize the importance of maintenance, but in fact they find it easier to finance new construction, which tends to reinforce rather than counter the incentives operating in countries where corruption is rampant. Building new preschool classrooms is more visible and more politically attractive than keeping schools in decent condition—not only for officials who manage to take a cut of new construction, but also for donors reporting to their legislatures on their development assistance programs.

In sub-Saharan Africa, the donors' involvement in new investments has been so great that the bulk of all public investment has been externally financed. Perhaps reflecting this dominance of donors in public invest-

17. By general budget support, we mean the $1.1 billion in bilateral budget support reported in table 4.1 and the $1.7 billion in IMF loans and World Bank structural and sectoral adjustment loans to HIPCs in 1999.

ment projects, public investment as a share of total investment is higher in Africa than in other developing regions, given income. Public investment is also high relative to the central government budget (one third and more) and to GDP, at 5 to 10 percent (World Bank 2000b). If the marginal return to public investment is low (Devarajan, Swaroop, and Zou 1996)—as appears to be the case in many countries in Africa, given their low growth despite substantial investment rates—a shift of resources from investment to budget support would probably generate higher overall development effectiveness.

Tied Aid

Aid is said to be tied when the donor requires purchase of the goods or services used in the project from providers based in that donor country. Collectively, donors have made efforts to reduce the tying of aid, and they have recently pledged to end the practice.[18] Unfortunately, this pledge exempted the two areas where tying is most costly to recipient countries: food aid and technical assistance. Loans from multilateral institutions are untied—or at least are tied only to suppliers based in a country belonging to the lending bank, which is not very restrictive for World Bank loans but may have more of an effect for loans from regional development banks. Debt relief is by its nature untied.

According to conventional estimates, tying reduces the value of aid to the recipient by 15 to 30 percent (Chinnock 1998). Because about 30 percent of the $22 billion in annual bilateral assistance other than technical assistance has been tied, this means that donors were choosing to waste something like $2 billion a year on lending other than technical assistance. The waste is far greater in technical assistance, now running at about $13 billion a year. (Technical assistance refers to support for advice and training, usually by consultants, and to manning the project implementation units that are set up to oversee projects.) This is virtually all tied to the donors' own professionals, who are often 10 or 20 times as expensive as those who could be hired on the world market from other developing countries.

If we conservatively assume that the efficiency loss of tying is 50 percent in the case of technical assistance, then tying costs about $6.5 billion a year. That will remain even after the OECD countries have implemented their pledge to abolish tying. In addition, tying may cost 30 percent of the yearly $1 billion in food aid. Even after tying has been ''abolished''

18. At the annual meeting of the OECD's Development Assistance Committee in April 2001, the 23 DAC countries agreed to end the longstanding practice of tying aid to procurement in the donor country. The decision was billed, alongside continuing rounds of bilateral debt relief, as a sign of the donor community's commitment to strengthening the effectiveness of aid and increasing countries' ownership of their reform programs. (Even now, however, US Agency for International Development consultants must fly on US carriers.)

per the DAC pledge, therefore, total waste will probably be more than \$7 billion a year.[19]

Tying—in addition to lowering the real impact of aid on development—has a less easily measured cost in loss of control and ownership by aid recipients. Tied aid eliminates incentives to minimize costs by establishing efficient purchasing systems, by maintaining processes of competitive bidding, and so forth. It also constitutes a form of protection for firms based in donor countries that may throttle any potential local supply.

Effects on Private Investment

Krugman (1988) and Sachs (1990) argued in the context of Latin America that a debt overhang implied that a substantial part of the benefit of future exports would accrue to creditors, because more export receipts would enable the debtors to service their debt more fully. This expectation diminishes the incentive for private investors, who may fear that their profits will be heavily taxed so that government can pay its debt service. Others (Addison and Rahman 2001) argue that the general uncertainty created by a high debt stock discourages investment in tradables with high returns but long gestation periods (e.g., coffee for export or garment factories), in comparison with less risky quick-return nontradables such as retail sales and construction—or perhaps simply discourages private investment relative to consumption.

These arguments suggest that a sufficiently large and visible reduction in a country's debt will sharpen the incentive to invest in a way that new aid transfers will not. The question is whether such a mechanism is operating among the HIPCs, so that reducing their high debt might play some role in releasing them from a poverty trap.

For poorer countries receiving publicly sponsored development loans, other, more fundamental, constraints may be more important in discouraging private investment. But the question, in the end, is an empirical one, which several recent studies have addressed. Two papers presented to a recent conference in Helsinki found such an effect (Dijkstra and Hermes 2001; Were 2001), whereas a third identified a positive effect for debt relief but estimated that it was mainly the result of reducing debt service rather than debt stock (Serieux and Samy 2001). We conclude that debt relief is more likely than an equally large but highly uncertain flow of new aid to reassure private investors about a country's economic potential. In other words, an assured dollar of debt relief is probably more efficient in generating development than a promise of a dollar of new aid.

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19. All figures are aggregates from the OECD DAC *Handbook*. One restriction in assessing the effects of tied aid in HIPCs is in the reporting, because tied aid statistics are only presented in the aggregate.

With all these potential advantages of debt relief over new aid, why have donors and creditors been reluctant to reduce debt? One reason may be a desire to avoid undermining the principle that debt contracts should be considered sacrosanct. Another may be their own political and bureaucratic constraints, such as pressures on bilateral donors to tie their aid, which is possible only with new lending or grants. But perhaps the major factor is donors' lack of confidence in the capacity and accountability of recipient governments. The poorer the country and the weaker its institutions, the more likely is it to need assistance and the less likely is it to be a good user of that assistance.

In contrast to assistance earmarked for specific projects and programs, debt reduction has the property of releasing resources that might be used for programs the donors would not endorse—a military buildup instead of education, to take the classic example. Even if it is possible to monitor an increase in social spending (a characteristic goal of HIPC programs), it is not easy to monitor changes in other uses of government revenues. In particular, it is not easy to know the counterfactual; for example, whether, in the absence of the debt reduction, a government might have increased its revenue effort—including raising money from those who, though capable of paying taxes, have heretofore managed to avoid them. Debt relief, and particularly a one-time large debt reduction, also has the disadvantage of releasing the creditworthiness constraint, opening the door for impatient (or badly managed or corrupt) governments to accumulate official debt all over again (Easterly 2001), unless the donors are much more disciplined and accountable than they were in the past.

That project aid is also at least partly fungible—to the extent it allows governments to divert their own resources from projects they would have financed anyway to activities donors might not endorse—has not traditionally worried the donor community. The thinking goes, apparently (and reasonably), that some projects appealing to donors are not priorities for recipient governments and would not have been financed without donor help. In addition, donors, including the World Bank and the other multilaterals, are less vulnerable to accusations of ineffectiveness in the case of projects. They are accountable to their own legislatures or boards in a fiduciary sense for the projects they finance, and they can report on project outcomes.[20] Accountability for the programs they may ''indirectly''

20. E.g., the World Bank management reports regularly to its board on the effectiveness of its projects. Even special reports, such as the Wappenhans Report of 1992, focused on the Bank's performance in terms of projects, i.e., on the number of projects deemed satisfactory in terms of rates of return and staff judgments of ''development effectiveness.'' The Bank's fundamental effectiveness in terms of the effects of its support on overall development is much more difficult to assess. Only in the past few years has the Bank undertaken systematic research on this larger question of effectiveness at the country level. The results of some of those studies are cited in box 4.4.

finance, and for the overall performance of the countries they assist, does not exist in the same bureaucratic sense, and indeed cannot be easily surmised given the difficulties of inference.

Even where there is confidence in a current government administration, donors face the constant risk of a future deterioration in governance. Again, the poorer and less capable a country, the greater is this risk. The World Bank and the other multilateral donors can build in conditions for new loans, but they cannot in the same way link debt relief to future actions of a recipient government. Government commitments to a process of privatization of state-owned banking monopolies, or elimination of onerous regulations on small business, or increases in the proportion of total spending going to social investments, can be linked to releases of loan tranches; that is not possible in the case of a one-time reduction of debt stock, as is foreseen at the completion point in the HIPC program. Even if the debt stock reduction is actually financed over time, the donor commitment is made up front, and some of the expected benefits of the one-time reduction (especially greater confidence in the private investment community, and more control and ownership of medium-term programs by the government) are associated with its being treated as completely irreversible.

For these reasons, official debt relief in the 1990s was always a negotiated process, in which the official creditors tried to lock in future commitments about the use of the ''freed'' resources. The HIPC and enhanced HIPC debt reduction programs continued this approach. There was a new emphasis on the need for debtor countries to take the lead (the ''driver's seat'') in developing their own programs of poverty reduction. Conversely, the fact that the strategy to be developed is for poverty reduction—and that there are clear guidelines for the kinds of information and programs such a strategy is likely to entail—certainly reflects donor interests and priorities. (This is not to say that these guidelines may not also reflect recipient government priorities as well, only to highlight that they do reflect donor priorities.)

The bottom line is that countries can benefit from debt relief, especially outright debt stock reduction, even if it is not additional at all, that is, even if it is financed completely by reducing future new transfers. In part, that is because the value of new transfers is overstated to the extent they are tied, or constrained to expenditure on projects that generate lower returns than are available elsewhere.

Less measurable but also important is that debt reduction compared with new aid involves reduced donor presence and greatly reduced transaction costs of receiving aid. By releasing the budget constraint that debt service represents on fully fungible tax revenues, it increases the ability of debtor governments to control their own destinies, at least with respect to government policies and programs. It thus enhances ownership and automatically puts recipient governments in the driver's seat—the very objectives of the new approach to development assistance the HIPC Initiative is meant to embody. Finally, there is the evidence that sufficiently large and certain debt reduction is likely to reassure private investors more than the promise of future new aid.

Conversely, from the point of view of donors and creditors, debt reduction undermines their ability to withhold resources in the future from governments they judge to have become wasteful or corrupt, or that renege on earlier policy or program commitments. (To the extent that the debt is uncollectible, this ability is overstated but apparently still comforting.) The efficiency advantage of debt relief will be captured only in countries that are able to exploit the greater flexibility and improved capacity to plan and manage. In countries where politics go bad or even well-meaning leaders are not backed up by functioning institutions, debt relief has no real advantage over donor-driven and -managed projects. This brings us to our next issue: country selectivity.

Country Selectivity

Following the work of Burnside and Dollar (2000), it is more and more accepted that the reason that aid did so little to stimulate development in the past is that it was often given to the wrong countries (though even on this point there is still some debate; see box 4.4). Too often, it was directed to strategic or commercial ends, to corrupt dictators and countries on the verge of civil conflict, rather than where it could do the most good to promote development and reduce poverty. Burnside and Dollar showed that aid "works," in the sense of being effective in reducing poverty, if two conditions are satisfied. First, it must be directed to countries that have a lot of poverty, which is hardly surprising. Second—and much more difficult—it must be directed to countries that have capable institutions and policies.[21]

By country selectivity, we mean the ability and willingness of donors to channel resources to recipient countries on the basis of these two criteria: need, and the ability to use funds effectively. These criteria of course can conflict: poor countries are usually those with weaker institutions, and often policies. No one claims to know exactly how to pick optimally when faced with a clash of that sort. Nevertheless, just focusing on these two criteria and keeping strategic and commercial considerations out of the decision-making process would be an excellent start.

One of the less-appreciated consequences of the debt buildup since the 1970s has been the erosion of donors' ability to follow this principle. At

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21. In chapter 6, we outline this problem further and suggest some benchmarks that could guide country selectivity by donors (see also box 6.2).

first, the main accumulation was of bilateral debt. Because donors feared the consequences of stopping the flow of finance, they progressively forgave the debt owed to them through Paris Club arrangements, and they began shifting their aid from loans to grants. But the multilaterals did not have those options. If they were to maintain a positive net transfer, they had to lend ever more. In consequence, a growing portion of the debt of today's poorest countries became debt owed to the multilateral institutions. For the HIPC Initiative countries, 42 percent of all official debt was owed to the multilaterals by 1998 (World Bank 2001b).

The consequence was that multilateral lenders came to receive an increasing share of debt service paid by these countries, while providing a declining share of net transfers to them (figure 4.3). This became a problem not only for the multilaterals themselves, but for donor governments. Because multilaterals are the preferred creditors, bilateral donors were anxious to avoid any of the poor countries falling into arrears to multilaterals. Moreover, bilaterals' switch in the 1980s from loans to grants was a short-term solution, in that this reduced their need to service bilateral debt and thus indirectly helped finance countries' debt service to multilaterals. Indeed, for several countries, donors contributed to special country trust funds that financed debt service to the World Bank.[22]

However, donors began losing their ability to be selective toward borrowing countries with high multilateral debt and high servicing costs for that debt. Birdsall, Claessens, and Diwan (2001) show that, in a sample of African countries, donors and creditors generally provided more transfers to poorer countries that scored better on the World Bank's internal measure of country policy and institutional capacity. This is especially true for IDA and the IMF. However, this was not the case for a subgroup of countries with unusually high multilateral debt.[23] For that group, donors (with the important exception of IDA[24]) collectively appear to have channeled resources independent of country capability.

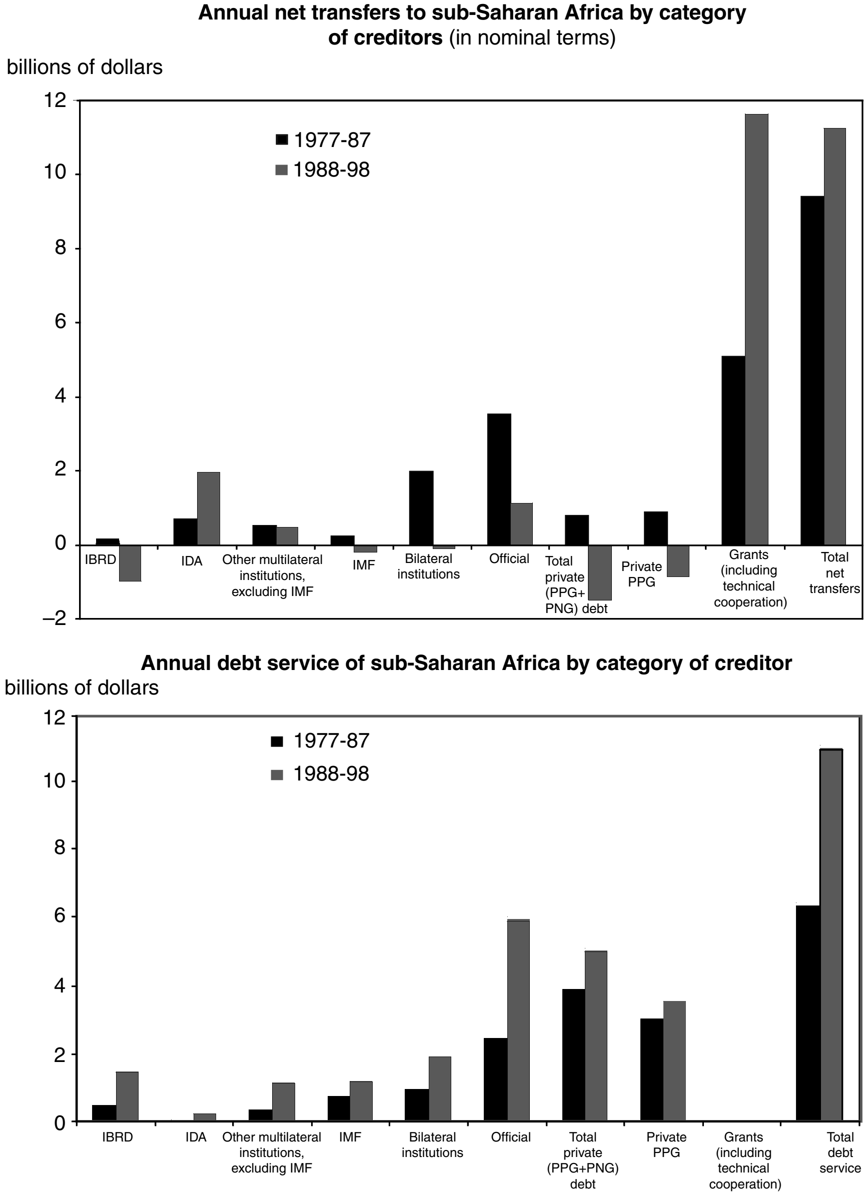
The results of this study thus suggest that donors are not only aiming at development, by channeling more resources to poorer countries, but are also engaged in what might be called ''forced'' lending to countries that have accumulated high levels of multilateral debt. Even as they successfully encouraged multilaterals to be selective—avoiding lending to countries

22. An example is IDA's ''Fifth Dimension,'' which consisted of funds allocated to IDA recipients to cover interest payments due on their IBRD debts. Another is the Tanzanian Multilateral Debt Fund, which was supported by bilateral donors and used to help service Tanzania's debts to the multilaterals, thus allowing Tanzania to stay out of arrears and be eligible for the HIPC Initiative.

23. Unusually high multilateral debt was defined as above the median of the group's debt-GDP and multilateral-debt ratios. The study refers to net transfers, as it should.

24. The Country Policy and Institutional Assessment (CPIA) scores were designed to guide IDA lending, so the result is not too surprising—but is nonetheless gratifying.

Figure 4.3 Aid and debt, sub-Saharan Africa, 1977-87 and 1988-98



IBRD = International Bank for Reconstruction and Development
IDA = International Development Association
PNG = private, nonguaranteed
PPG = public or publicly guaranteed

Source: Birdsall, Claessens, and Diwan (2001).

unlikely to use the money well—they ended up using bilateral loans and grants to keep countries from defaulting on their official multilateral debt.

Thus the debt relief resulting from the HIPC Initiative may benefit donors as well as the HIPCs themselves. It may liberate donors that were previously locked into forced lending and permit them to restore country selectivity. This could lead to additional resources being provided to countries with more adequate policies and institutions, and thus increase the average efficiency of aid. And that in turn could help to restore the political will in donor countries to increase aid programs.

Summary

A large stock of accumulated debt can be an obstacle to growth and poverty reduction. Government officials have their freedom severely constrained by the need to keep aid flowing so as to be able to meet their debt-service obligations. They are forced to deal with dozens of creditors and donors proposing new projects involving new resource flows, and they are therefore likely to have difficulty planning and implementing the kind of sustained public investment programs in roads, schools, and other key sectors that would promote private investment, fuel growth, and address the needs of the poor.

Job-generating investment may be low because potential investors fear the future tax burden that high public debt implies in the absence of secure permanent net positive transfers from outside donors to government, or simply fear future economic and political uncertainty. Meanwhile, donors and creditors—to help governments avoid arrears on their high debt-service obligations, and to maintain the credibility and potential benefits of their favored programs—resort to a combination of debt rescheduling and fresh loans and grants that in fact represent few truly additional resources. The resulting process is not conducive to sustained development initiatives truly owned and managed by recipient governments.

Quite apart from the case for supplying these countries with more real resources, there is a case for thinking that transfer-neutral debt reduction could help get development moving again. And then there is the apparent political fact that it is easier for donors to muster political support to help countries in this way than through the more traditional channel of increasing the aid budget. No wonder we got an enhanced HIPC Initiative. The question to which we turn next is whether and how that initiative should be extended as a part of a program to revive the momentum of development.