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Rebalancing ODA and debt relief

Following the Monterrey Consensus of 2002, most bilateral donors set ambitious targets for increasing their official development assistance (ODA) as part of efforts to meet the Millennium Development Goals (MDGs). Over the last few years, aggregate ODA has indeed risen considerably. However, most donors are not on track to meet their ODA commitments, and there is still a considerable gap between actual ODA flows and the aid needed for implementing measures to achieve the MDGs. For a realistic chance of meeting the MDGs, annual ODA flows need to be stepped up by $50 to $60 billion.

Moreover, much of the recent increase in ODA has involved greater debt relief, which accounted for almost two thirds of the ODA surge in 2005, when total aggregate ODA reached a historic peak (Figure 1). In subsequent years, this increase in total ODA has been reversed as unusually large debt relief exercises in the Paris Club for some non-HIPCs have been completed, and debt write-offs under the HIPC Initiative are set to decline. Meanwhile, other categories of ODA have increased at much lower rate while the share of ODA for social expenditure has increased at the expense of aid provided for infrastructure and the productive sectors. The share of the latter fell from 69% in the early 1990s to 55% in 2002–2006 (Figure 2).

Figure 1

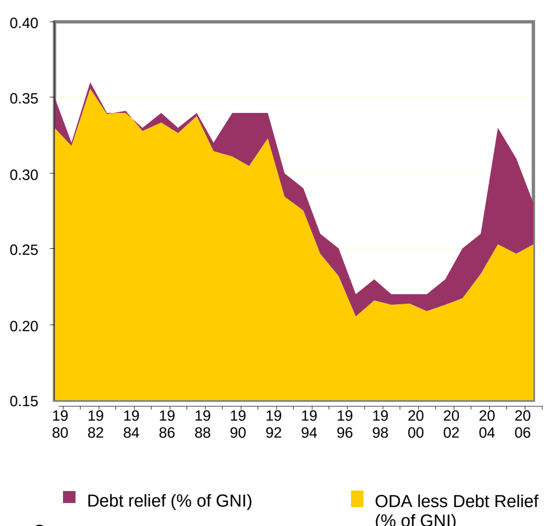


Figure 2

Sustained poverty reduction requires growth and job creation

It is not only the amount of ODA that matters, but also how effectively funds are used. Improved aid effectiveness has been increasingly associated with better institutions and policies. Although views differ as to what constitutes good institutions and policies, the provision of ODA has become increasingly conditional on fulfilling numerous good governance criteria despite weak evidence that such a correlation actually exists. Aid effectiveness is often also seen in terms of aid delivery procedures.

However, the development effectiveness of aid is at least as important. In determining a yardstick for development effectiveness, it is necessary to clarify the objectives of ODA. Traditionally, the main criteria have been per capita income growth and its effects on human development. With the Millennium Declaration, human development objectives have come to the forefront. Meanwhile, growth and structural change have lost prominence as explicit objectives of development policy as the intellectual and policy environment in recent years has assumed that growth and structural change are generated automatically by market forces in a liberalized globalizing economy. ODA has come to be viewed almost exclusively in terms of its contribution to reaching the MDGs, while faster growth is not an explicit MDG.

A larger proportion of ODA is being spent on health, education and for other social purposes. However, for poverty reduction to be sustainable, it cannot rely exclusively on redistribution, but also depends on increases in domestic value added and per capita income. Unless ODA helps boost output growth, it is unlikely to contribute to reducing poverty in the long term, beyond the MDG target year of 2015. ODA for infrastructure and the productive sectors is essential to support domestic efforts to raise levels of real income and employment, thereby shifting income distribution in favour of the poor.

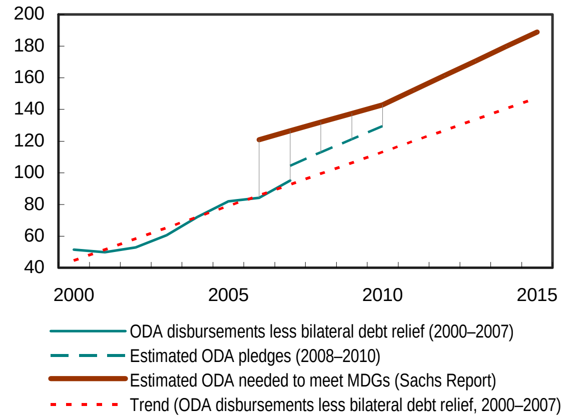
Debt relief: the need for additionality

The Monterrey Consensus stipulated that debt relief should be "fully financed through additional resources" (para. 49) and that donors need to ensure that "resources provided for debt relief do not detract from ODA resources" (para. 51). Such additionality is indispensable, because debt reduction has a limited effect on the capacity of governments to increase expenditure in the period for which it is granted. Full additionality would not only improve the chances for beneficiary countries to meet their growth and social objectives without later encountering unsustainable debt situation.

Although the HIPC Initiative for debt relief was conceived on the understanding that the debt relief provided would be a net addition to the total volume of ODA, the first five years following its launch saw a sharp fall in total net ODA transfers.

Of course, such a change is not proof that debt relief was not additional. Assessing the additionality of specific debt relief requires comparison with a counterfactual scenario (i.e. the amount of ODA that would have been provided in the absence of debt relief). One way to do so would be to consider the pledges made by major donor countries to increase their ODA up to certain level within a certain time frame (G-8, 2005). In 2005, the OECD estimated that, on the basis of these donor commitments and other relevant factors, ODA from the G-8 and other donors to all developing countries would be $50 billion higher in 2010 compared to its 2004 level. If this estimate is translated into annual increases along a trend line, and if these are compared to actual disbursements, *total ODA*, excluding debt relief, has been *considerably lower than the presumed trend based on donor commitments* (figure3).

Figure 3



An alternative is econometric analysis looking at how debt relief affects other ODA, keeping all other things equal. The main finding of such an analysis is that an extra dollar of debt relief sees a reduction of $0.22–$0.28 in other forms of ODA.

Moreover, the reasoning behind debt relief initiatives is that they free up fiscal space previously allocated to servicing debt, thus enabling reallocation of budgetary resources for social expenditure. This assumes that the forgiven debt would have been serviced, but in many cases, such debt was 'non-performing' at the time of its cancellation; thus, the amount of financial resources freed by debt relief is actually well below its book value

Past debt relief efforts have largely ignored the considerable development needs of low-income countries that have relatively low debt levels, either due to prudent external financing strategies or because they have not undertaken essential public sector investments. In order not to discriminate against such countries, it would be appropriate to allow all poor countries to benefit from the Multilateral Debt Relief Initiative, including those with sustainable levels of indebtedness. It may also be desirable to provide debt relief to developing countries that have an unsustainable level of debt, but are not eligible under the Highly Indebted Poor Countries (HIPC) initiative.

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