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## The HIPC initiative and poverty reduction in Ghana: An assessment

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Discussion Paper No. 2001/119

## **The HIPC Initiative and Poverty Reduction in Ghana**

An Assessment

Robert Osei<sup>1</sup> and Peter Quartey<sup>2</sup>

November 2001

### **Abstract**

This paper presents a review of the current debt problem in Ghana and assesses whether debt relief under the HIPC initiative can be effectively translated into poverty reduction. The extent of the debt burden is jeopardizing Ghana's effort at poverty reduction. The evidence suggests that debt relief could have a positive effect on poverty reduction in Ghana, although the effect will be small relative to say, export growth. Ghana cannot achieve significant improvements in its human development indicators if all the savings from debt relief are redirected to only primary health and education, as these sub-sectors already absorb a significant proportion of their sectoral budgets. Rather, the resources saved must be directed towards an integrated programme for the education and health sectors as a whole. The effectiveness of debt relief for poverty reduction will be greatly enhanced if it is duly complemented with proper fiscal management.

Keywords: debt, poverty reduction, government expenditure

JEL classification: F34; O11; O55

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## 1 Introduction

The decision of the new Ghanaian government to seek relief under the heavily indebted poor country (HIPC) initiative has come under intense debate. The government's argument is that it can do very little in terms of poverty reduction and economic development with the country's current debt burden (GOG 2001). The international financial institutions (IFIs) and some of the major donors, particularly Britain, have applauded this decision. Not all share this view; members of the main opposition party in Ghana (National Democratic Congress, NDC) have criticized the government's decision. Their arguments range from 'it will deter private investments' to 'Ghanaians don't want to be tagged poor as it will mar their image' (excerpts from the *Ghana Review International*; March to July 2001).

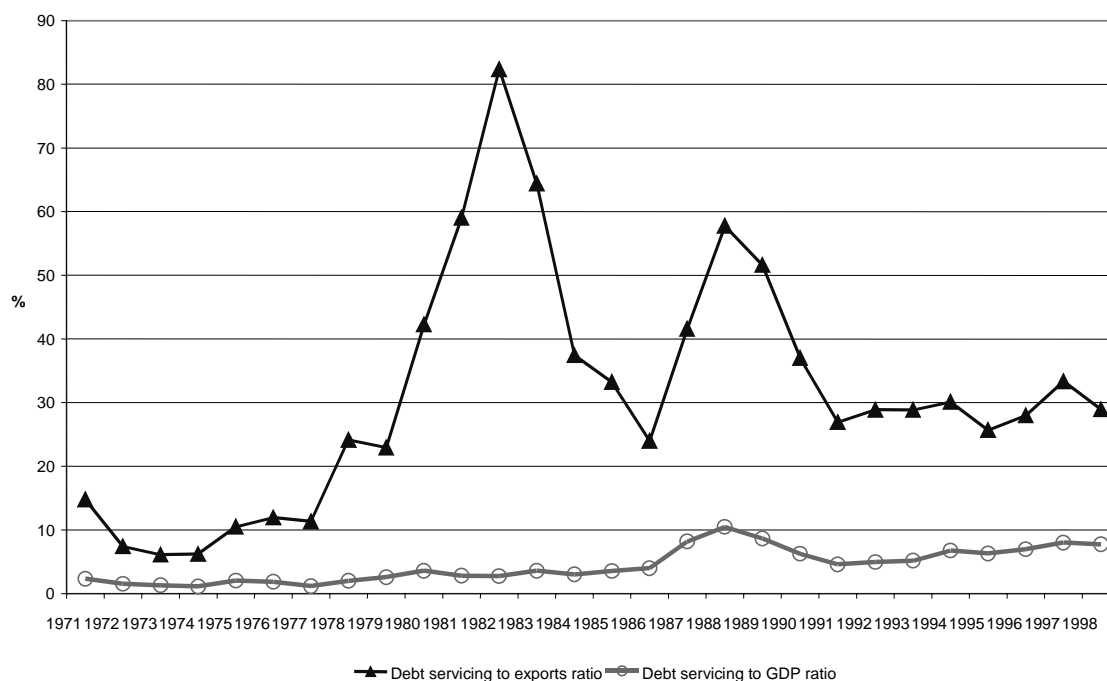
The NDC's criticism of the government's decision seems more of a political gimmick as it is difficult to rationalize which aspect of the HIPC initiative they criticize. The previous government (NDC) in 1995 prepared a medium-term development plan (MTDP) called the *Vision 2020*. An interim poverty reduction strategy paper (PRSP) based on the MTDP was also submitted to the IMF in June 2000. The main objective of the *Vision 2020* is that Ghana will achieve a balanced economy and middle-income country status and standard of living by the year 2020. This is to be achieved by pursuing sustained economic development with a focus on poverty reduction. These objectives are no different from those of debt relief under the HIPC initiative.

Japan's decision not to extend new loans to Ghana vindicates some of the arguments made by those who oppose the government's decision. Japan's adamant stance, however, does not seem to be related to the economic merits of debt relief under the HIPC initiative (at least in Ghana's favour). It has been suggested that debt relief may counteract Japan's use of aid to bribe governments and prise open markets in Africa where they have to compete with old colonial forces such as the United Kingdom, France and the US (Akoto Ampaw 2001).

The current debt situation has brought enormous cost on both developed and developing countries, creating a spiral of unforeseeable social and economic effects. The debt burden of HIPCs measured on any scale is outrageous. Debt servicing absorbs a significant proportion of developing countries' export earnings and domestic revenue in general. This seriously compromises growth and poverty reduction programmes of these countries. The enhanced HIPC initiative therefore seeks to deal with the external debt problem of developing countries in a comprehensive way to allow them exit from repeated debt rescheduling (Bangura, Kitabire and Powell 2000: 1).

The present value of long-term debt in Ghana was about US\$ 3.8 billion in 1998. This represented about 187 and 51 per cent of exports and GNP, respectively (World Bank 2000). Compared to the pre-1983 period debt servicing ratios have more than doubled in the 1990s with the trend stabilizing around 8 and 30 per cent of GDP and exports, respectively (Figure 1). Meanwhile extreme poverty continues to be high in Ghana especially in the rural areas despite a reduction in the overall poverty incidence from about 36 per cent in 1991/92 to about 29 per cent in 1998/99 (GOG 2000).

Figure 1  
Plot of debt servicing ratios for Ghana, 1971-98.



Source: World Bank (2000).

We present a preliminary assessment of debt relief under the HIPC initiative and its possible impact on poverty reduction in Ghana. To attain the international development targets of halving poverty by the year 2015, Ghana will have to increase its social sector spending especially in the rural areas where poverty is widespread. Debt relief is one way by which more resources can be made available for spending in key social sectors such as health and education. Building on recent debate, this paper addresses two main issues. First, it assesses whether there are justifications for the government’s decision to seek relief under the HIPC initiative. Second, the paper assesses the potential of debt relief in alleviating poverty and improving living standards in Ghana

Section 2 discusses the nature of the debt problem by examining the sustainability or otherwise of the debt burden and its implication for poverty reduction policies in Ghana. A discussion of the ways in which debt relief can be translated into significant poverty reduction in Ghana is presented in section 3. Section 4 concludes the study and draws implications for policy.

## 2 The nature of the debt problem in Ghana

### 2.1 The level of debt and debt servicing

Ghana suffered a debt crisis in the 1960s long before debt problems became common (Harrigan and Younger 2000: 201). However, it was only after the advent of the economic recovery programme (ERP) that the country’s debt started to increase substantially. In the early 1980s, Ghana suffered a debt crisis with accumulated external

payments reaching US\$ 577 million by the end of 1982. Between 1970 and 1983, debt to GDP ratio amounted to 30.2 per cent. The factors that precipitated this debt crisis were similar to what had created debt distress in many developing countries. These factors included the oil price hikes in 1979, sharp rises in international interest rates, recession in the west, inappropriate policies and domestic policy mismanagement.

The objectives of the ERP included improvements in debt repayment, restoring international creditworthiness, and attracting foreign capital to rehabilitate infrastructure. However, the country had very low creditworthiness during the initial phase of the ERP, and it was very difficult to attract concessionary long-term finance. Ghana resorted to short-term borrowing from the IMF in the form of three successive standby agreements. The share of short-term credit to total external debt rose from 20.1 per cent in 1982 to 40.7 per cent in 1985. The short-term IMF loans led to debt servicing problems between 1986 and 1988. Total debt service as a per cent of exports of goods and services increased from 23.56 per cent in 1985 to 28.29 per cent in 1986. By 1988 total debt service as a per cent of exports of goods and services had reached a record level of 56.57 per cent, but this declined to 36.95 per cent in 1990 (World Bank 1999).

It was against this background that the IMF under ERP II assisted with debt rescheduling to overcome the debt crisis. The IMF allowed Ghana access to its concessional facilities such as the extended fund facility (EFF), the structural adjustment facility (SAF) and a more favourable enhanced structural adjustment facility (ESAF) in 1988. These short-term IMF loans were worth SDR 506 million (US\$ 642 million) as at the end of 1988. Ironically, these aid and loans were used to refinance debt repayments rather than investment or consumption, a problem similar to what occurred in the 1960s (Killick 1995; Harrigan and Younger 2000). There was the fear that the debt situation might reach a level similar to the ‘Ponzi’ type game, where loans are used to meet debt service obligations rather than invest in directly productive ventures (Harrigan and Younger 2000). The situation was corrected (temporarily) through debt restructuring in the late 1980s. This led to a widening of the gap between net aid flows and debt servicing (Figure 2). However, the ‘Ponzi-type’ game scenario seems to have revisited Ghana in the late 1990s—debt servicing exceeded net aid in 1997. Although Ghana continued to service its debts without restructuring, by the end of 1994 its external debt outstanding, excluding IMF obligations, amounted to US\$ 4.8 billion, nearly 80 per cent of GDP (World Bank 1999).

The government’s over-reliance on external inflows during the ERP has had serious repercussions on the economy. During 1994-97, debt service as a per cent of export of goods and services averaged about 27 per cent. The World Bank (1995b) projected that between 1995 and 1997, debt service obligations, including reduction in arrears, will amount to US\$ 1.0 billion. Debt servicing has also had a negative impact on the government’s fiscal budget. As reported in Harrigan and Younger (2000), interest on public debt amounted to 17.8 per cent of government spending in 1993. The high interest rates restricted government spending on investment and other social sectors.

In per capita terms, external debt increased from an average of about US\$ 98 over the pre-1983 period to about US\$ 312 over the 1990s. Over the same period, GDP per capita increased from about US\$ 315 to about US\$ 388 (Table 1). These statistics are quite worrying. In 1983, the per capita debt was equivalent to about 31 per cent of the

average person's income, whereas by the 1990s this had risen to 80 per cent. In 1994 Ghana's external debt was more than its GDP.

Another cost of the debt problem in Ghana has been the high growth in money supply and the attendant macroeconomic instability. The major source of monetary growth was the domestic currency counterpart of Bank of Ghana repayments of foreign loans contracted by the government and some parastatals. This is normally recorded under the revaluation account and has been the greatest source of money supply (M2) growth in Ghana. The revaluation account represents the domestic currency loan by the central government to the public sector and it is a form of quasi-fiscal deficit.

Figure 2  
Per capita debt servicing and net foreign aid, 1971-97

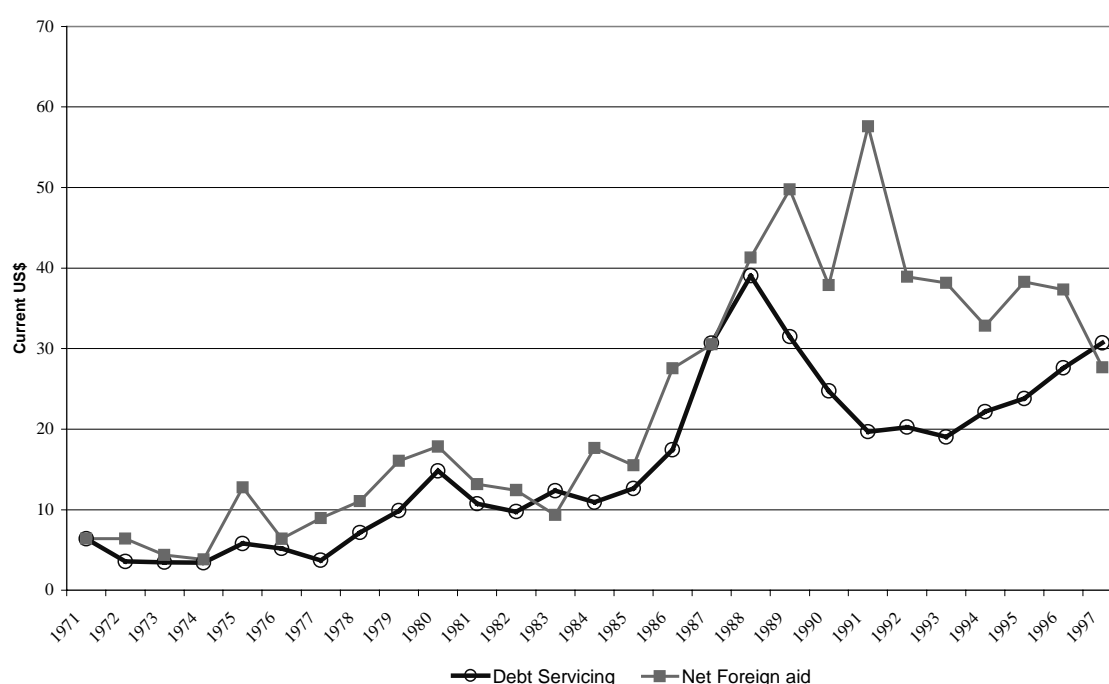


Table 1  
Debt and debt servicing in per capita US\$ (current prices), 1970-98

	1970-83	1983-89	1990-98
Total external debt	98.2	199.7	312.0
GDP	314.8	373.4	387.9
Debt servicing	6.9	22.1	24.4
Net foreign aid	9.7	27.4	38.6
Education expenditure	9.5	9.8	11.5
Health expenditures	na	na	5na
Total external debt	1.0	2.64	5.4

Source: World Bank (2000), and OECD (1999).

## 2.2 Public expenditure patterns and the implications for poverty reduction

Ghana has made little progress at shifting spending to development and/or pro-poor priorities. Government expenditures ratios (expressed as a per cent of GDP) increased over the post-ERP period; the most significant increase being in 1992 (the year Ghana returned to constitutional rule) when the expenditure/GDP ratio increased by more than 4 percentage points. Comparatively, the share of public expenditures in GDP was over 4 percentage points higher than the Sub-Saharan Africa average of about 23.2. Moreover, while the average for the sub-region seems to have declined in the 1990s, the same cannot be said for Ghana (Addison and Osei 2000).

A cursory look at the components of public expenditure shows that the public wage bill accounts for a sizeable proportion—it averaged over 27 per cent of the total in the pre-ERP period, reaching about 34 per cent in 1992 (Table 2). Although the share of wages in total expenditures has declined in more recent years, it is still higher than the pre-reform average. Interest payments have also become an important component of public spending especially during the 1990s, increasing from about 12 per cent of total expenditure in the late 1980s to about 32 per cent in 1997. This is a significant portion of government expenditures, and needs to be given serious attention if faster progress is to be made in reducing poverty.

The economic reform instituted in 1983 did change the pattern of public expenditures, although it still does not appear to be ‘pro-poor’—or at least it is no more pro-poor than it was in the pre-ERP era. Although there have been small increases in both health and education expenditures (as a per cent of GDP), their importance relative to other expenditure items has declined. The share of public health spending in total expenditures decreased from an average of about 9 per cent over 1984-91 to about 7 per cent in 1997. Public spending on education relative to total government expenditures also decreased from about 19 per cent in the pre-ERP era to about 15 per cent in 1997. This trend is particularly worrying, given that expenditures in Ghana have been traditionally biased towards the urban areas and also towards university education and tertiary health care. A poverty assessment on Ghana in 1995 noted that social spending was not well targeted to the poor. Public expenditure on health was too low and the existing spending was urban biased (World Bank 1995a: 2).

Table 2  
Trends and structure of public expenditures in Ghana, 1970-98

	Expenditure (% of GDP)	Various public expenditures as share of total expenditures:							Expenditures as % of GDP	
		Capital	Goods	Interest	Wages	Military	Health	Education	Health	Education
1970-83	16.2	18.5	49.9	12.4	27.8	–	–	19.1	–	2.9
1984-91	13.1	18.1	56.0	11.6	31.4	4.8	9.3	20.6	1.3	2.8
1992	17.8	19.7	48.2	12.3	34.3	4.6	7.9	16.6	1.4	3.0
1993-95	21.6	19.5	40.9	18.7	26.5	4.1	7.0	13.8	1.5	3.0
1996	22.2	26.0	34.0	23.0	24.4	3.0	7.0	13.6	1.5	3.0
1997	20.6	18.7	35.6	31.5	25.8	2.4	6.9	14.6	1.4	3.0
1998										3.0

Note: The ratios are in percentages.

Source: Reproduced from Addison and Osei (2000).



### 2.3 Debt sustainability in Ghana

Various indicators have been used in debt capacity analysis. These indicators include stock and debt service concepts relative to variables associated with a country's repayment capacity (World Bank 2001a). The debt to GDP and the debt service to GDP ratios are some of the broad indicators of debt sustainability. These indicators compare the debt burden to the ability of the economy as a whole to generate income. Indicators such as debt to exports ratios and the debt service to exports ratio link the levels of debt and its servicing to the availability of foreign exchange earnings in the economy. Whereas the debt to fiscal revenue and the debt service to fiscal revenue ratios link the debt burden to the ability of the public sector to generate income, the net present value of debt is used to capture the concessionality of the debt stock and compares debt among creditors with different repayment schedules.

Unfortunately, no single indicator captures all of the elements of debt sustainability. For instance, the debt to GDP, debt service to exports, and the debt service to government revenue ratios are not of the same relative importance across countries. The last two depend on the features of the economy (World Bank 2001a). Hence, in assessing long-term sustainability of public debt, the various debt indicators are usually considered simultaneously. The Catholic Agency for Overseas Development (CAFOD 1998), however, argues that the definition of what constitutes IMF and the World Bank debt sustainability is flawed.<sup>1</sup> Their argument is that these indicators fail to incorporate the ability of governments to meet urgent social needs whilst servicing debt. They propose the 'feasible net revenue' approach, which takes into account the fact that not all revenue potentially or actually raised by the government, should be used to service debt.

The thresholds for debt sustainability under the original HIPC initiative were defined as NPV of debt to exports ratio in the range of 200-250 per cent, and a debt service to export ratio ranging from 20 to 25 per cent. There were certain additional indicators for countries with large export base. In those cases, a revenue to GDP ratio above 20 per cent and an exports to GDP ratio above 40 per cent and a NPV of debt to revenues ratio of 280 per cent are required (World Bank 2001a). These targets were later reduced in the enhanced framework to free up resources for poverty reduction. The sustainability thresholds under the enhanced HIPC framework are 150 per cent NPV of debt to exports and a debt service to export ratio of 15-20 per cent. The fiscal threshold was reduced to 250 per cent NPV of debt to revenues, with the qualifying criteria lowered to 15 per cent of revenues to GDP ratio and 30 per cent of exports to GDP ratio (World Bank 2001a).

The above simple rules of thumb have been criticized extensively. Hjertholm (1997) proposes that the issue of debt capacity should be approached in terms of feasible or expected growth rates. Hjertholm approached the issue of debt capacity in three ways. First, is the output growth rate sufficient to meet debt servicing obligations? In other words, is the output growth rate adequate to meet interest on debt? This condition has rarely been met in developing countries in recent decades. Second, since interest on debt has to be paid in foreign exchange, it is export growth and not output growth that matters. Hence, is the rate of growth of export earnings at least equal to the interest rate? The poor export performance in developing countries is an indication that this condition

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<sup>1</sup> This point is also made in Sachs *et al.* (1999).

has not been met (Hjertholm 1997). The third condition is whether the rate of expansion of the tax base (or government revenue) is equal to the interest rate? Again, Hjertholm (1997) provides evidence that this condition has not been met in Sub-Saharan African countries. It is clear from the discussion that the various indicators in the HIPC framework only gives an 'idea' of whether a country's debt is sustainable. In this paper we merely use the various indicators to assess whether Ghana's debt is sustainable and whether there was justification for the current government to seek for debt relief under the HIPC initiative.

During 1970-83, Ghana's total external debt to exports ratio was 342.9 per cent, and this rose to 443.4 per cent between 1983-89 but declined to 385.9 per cent in the 1990s. Relative to GDP, total external debt averaged 30.22 per cent between the 1970-83 period, rising to 53.5 and 81.1 per cent in 1983-89 and the 1990s, respectively. In the same periods, debt servicing to GDP ratios were 2.09 per cent, 5.92 per cent and 6.3 per cent, respectively. Similarly, debt servicing was higher in the 1990s than it was during the pre-ERP period (Table 3). Debt servicing as a per cent of government revenue was 26.6 during the pre-1983 period but rose to 51.7 per cent between 1983 and 1989 before declining to 39.1 per cent in the 1990s. Prior to 1983, debt servicing as a per cent of government expenditure was only 14.4 per cent, rose sharply to 47.0 per cent between 1983 and 1989, then declined slightly to 32.5 per cent in the 1990s. This means that on average, about 28 and 37 per cent of government expenditure and domestic revenue respectively have been used to service debts over the period 1970-98. The feasible net revenue is computed for Ghana over the 1990s using CAFOD's approach and it is noted that the government was spending a period average of about 64 per cent of its feasible revenue on debt servicing (Table 3). These statistics clearly show that Ghana's debt was unsustainable and although eligible for debt relief, it opted not to take advantage of the HIPC initiative.

Table 3  
Debt and debt servicing ratios, 1970-98

	1970-83	1983-89	1990-98	Sustainability ratio	
				(Original)	(Enhanced)
Total external debt to exports	342.9	443.4	385.9	200-250	150
Total external debt to GDP	30.2	53.5	81.1	56	37.5
Total external debt to revenue	378.5	496.8	502.8	280	250
Debt servicing to GDP	2.1	5.9	6.3	-	-
Debt servicing to exports	24.9	44.3	29.8	20-25	15-20
Revenue to GDP	10.00	11.39	16.31	> 20	> 15
Exports to GDP	13.79	13.63	21.30	> 40	> 30
Debt servicing to revenue	26.6	51.7	39.1	-	-
Debt servicing to expenditure	14.4	47.1	32.5	-	-
Debt servicing to feasible revenue <sup>(a)</sup>	-	-	64.1	-	-

Notes: The ratios are in percentages.

(a) Authors' own computation using CAFOD approach.

(b) These are the implicit targets calculated as the product of the debt: revenue and revenue: GDP targets (Hjertholm 2001: 37).

Source: World Bank (2000).

## **2.4 Lessons to be drawn**

The statistics in section 2.2 indicate that Ghana spends a substantial proportion of its revenue on debt servicing, reducing the amount available to spend on health, education and in alleviating poverty. Heavy debt burdens bring additional problems that can affect a country's growth performance and the government's ability to commit resources to social priorities (WDR 2000). Debt service is financed partly with scarce domestic budgetary resources and thus competes with domestic recurrent spending, while concessional assistance goes to new investment projects. This usually results in a situation where there are resources for new health centres and roads but not for the training of doctors or the maintenance of roads.

Although Ghana has a good debt repayment record in recent years, its debt burden remains unsustainable and there is scope for considerable debt forgiveness. Cancellation of all non-concessional debt will make available between US\$ 30 to 40 million a year to the government and the cancellation of all non-concessional debt contracted before 1986 would save the country US\$ 50 million a year (Martin 1993). It has been projected that Ghana will save about US\$ 558 million in annual debt service payments between 2002 and 2004, through the HIPC debt relief initiative. According to estimates drawn up by the Institute of Statistical, Social and Economic Research (University of Ghana), US\$ 183 million could be saved in 2002, US\$ 179 million in 2003 and US\$ 183 million in 2004. In nominal terms, debt service payments of US\$ 397 million in 2000 would be reduced to US\$ 155 in 2002 after HIPC assistance (*Ghana Review International*, July 2001). The assumption of the delivery of assistance is based on the decision point to be reached in December 2001 and the completion point in December 2004, at which all creditors would deliver the rest of the debt relief. Besides, Ghana stands to benefit if creditor governments refinanced the debt service with additional grants or converted debts into equity.

Ghana's expenditure pattern shows that the public sector wage bill has been reduced but the resources freed up have gone into interest payments. Savings from debt relief will ease the budgetary pressures and free up resources for economic and human development. However, the effectiveness of this policy depends on whether the savings from debt relief are committed to proper and productive use.

Akoto Ampaw (2001) argues that the main shortcoming of the HIPC initiative is that it is premised on the economic policies of structural adjustment so that only countries that are ready to comply with the rigid conditionalities of the IMF are eligible. It is also noted in a previous section that the ratios used for debt sustainability do not take into account the developmental needs as well as its impact on the living conditions of the poor. This paper argues, however, that these points do not justify a rejection of debt relief under the HIPC initiative. The question then is whether debt relief under the HIPC initiative has the potential to impact positively on poverty reduction. The next section addresses this issue for Ghana.

## **3 Translating debt relief into poverty reduction in Ghana**

The issue of whether countries that gain relief from the HIPC initiative will be able to effectively translate the lessening of the debt problem into poverty reduction (or pro-

poor growth, for that matter) is very important. Donor countries agreed to the (enhanced) HIPC initiative with the intention that debt relief will be used in a way that is beneficial to the poor. The main argument made by those calling for total or partial debt cancellation, is that the servicing of debt seriously compromises the ability of governments to provide basic social amenities, especially for the poor in these countries. With debt relief, more resources can be made available for investment in both human and physical capital with the consequent result that HIPC countries can make significant inroads into achieving pro-poor growth targets as well as attain sustainable debts (Sachs *et al.* 1999). Not surprisingly, the preparation of a 'poverty reduction strategy paper' (PRSP) is a key condition for HIPC countries to qualify for relief under the enhanced (Cologne) initiative.

There is no doubt that the current debt problem as discussed in Section 2 of this paper is jeopardizing Ghana's effort at reducing poverty. Almost 30 per cent of the population are living on less than a US\$ 1 a day. Over 55 per cent of Ghanaians do not have access to essential drugs and an average of about 20 per cent of one-year olds are not fully immunized against tuberculosis and measles (UNDP 2001). The country spends about six times more on servicing debt than it does on the health sector as a whole. It is noted that public expenditures in Ghana have not been any more pro-poor in the 1990s than in the 1970s and this trend can only be reversed if the public debt problem is brought under control. Given these trends, there is clearly a case for the country to seek relief under the enhanced HIPC initiative especially if it is to come anywhere near its target of moving the country to middle-income status and standard of living by the year 2020.

This paper assesses two possible ways in which resource transfers under the HIPC initiative could lead to significant poverty reduction. The first makes use of the notion recently popularized by Dollar and Kraay (2001) that 'growth is good for the poor'. Although some may have challenged this generalization (see Ravallion 2001), there is no hiding from the fact that significant poverty reduction in Ghana cannot be achieved with the current growth rate of 3.7 per cent in 2000. With the population growing at about 2.1 per cent,<sup>2</sup> this figure translates to a 1.6 per cent per capita GDP growth rate. This is way off the projection of between 2.4 and 5.9 per cent under the 'broad-based growth' and 'no change' growth scenarios respectively, needed to halve poverty by 2015 in Sub-Saharan Africa countries (Hanmer and Naschold 2001: 15).<sup>3</sup> The second way to assess the potential of debt relief in reducing poverty is by looking at the possible impact of net resource inflows on government fiscal behaviour. Here the implicit assumption being made is that resource inflows can impact on poverty, at least in the short to medium term without increasing physical investment and therefore growth. For instance resources released under debt relief can impact positively on poverty if they are used to reduce domestic borrowing and consequently inflation, or say, to increase the incentive structure for teachers, nurses and doctors in rural areas. This could have a significant impact on poverty but not necessarily on medium-term growth.

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<sup>2</sup> This is the projected population growth rate for Ghana over the years 1999-2015 in UNDP (2001).

<sup>3</sup> Broader based growth scenario makes the following assumption; all regions become open by 2015, SSA ICOR reach the East Asian and Pacific 1990 ICOR by 2015, and incremental labour capital ratio improves by 25 per cent by 2015. No change scenario is when these conditions are not met.

One way in which debt relief could result in growth is when resources that become available are used to increase both the stock and efficiency of investment. To a large extent, these additional resources could be considered as an increase in net aid. This issue is, therefore, addressed by looking at the question of whether aid inflows to Ghana have had a positive impact on growth.

The only study that has empirically tested the effect of aid on growth in Ghana (to our knowledge) is that by Lloyd, Morrissey and Osei (2001). In that study a simple model in which aid impacts on growth through its effect on government spending is formulated. Implicitly the assumption made is that aid is intended to finance public investment, a proposition for which Lensink and Morrissey (2000) provide empirical support. The authors use private consumption growth as a proxy for output growth. This approximation is appropriate for our purposes, as private consumption is a better measure of welfare analysis than output.<sup>4</sup> They find evidence that aid impacts positively on both short- and long-run growth in private consumption. Admittedly, the long-run aid elasticity of about 0.05 reported in the study is quite low and only significant at about 10 per cent compared with the export elasticity of about 0.3. However, they show that the low elasticity is due to the fact that the efficiency of aid flows to Ghana over almost half of the sample period (1970-83)—the period preceding the start of the World Bank/IMF supported adjustment programme—was very low. Decomposition results<sup>5</sup> also showed that aid/government investment contributed more to growth over the period studied (1970-97) than did export growth. This, in no way, belittles the effect that exports have on private consumption and output growth in Ghana. It merely suggests that exports relative to aid/government investments did not increase by much over the period studied. The average annual growth in exports over the period was about 2 per cent.<sup>6</sup> This compares with aid and government investments which both grew at an annual average of about 14 per cent—suggesting that aid may have been allocated to investment.

The results from Lloyd, Morrissey and Osei (2001) provide support for the argument that the net resources transfers from relief under the HIPC initiative could have a positive effect on growth in Ghana. This is premised on the assumption that the savings are used in the same way as aid. This is a reasonable assumption to a large extent. However if all the savings is spent on social sectors, it may improve the welfare of the poor but may not have necessarily have a positive impact on growth<sup>7</sup> (i.e., it may not alter the income poverty measure). For instance, another way in which these transfers could be made available to the HIPCs is when donors give back the money from debt

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<sup>4</sup> However, the 2000/2001 *World Development Report* (World Bank 2001c) cites an UNCTAD study which warns against over-reliance on the short-term results of poverty reduction strategies in increasing consumption per capita of the poor since this may easily conflict with the need to increase savings, investment, efficiency and exports which are the basis for accelerated economic growth and long-term poverty reduction.

<sup>5</sup> Based on the long-run elasticities they compute the contribution of each variable to private consumption growth.

<sup>6</sup> Most of the growth in exports, government investment and aid occurred after 1983. In fact the average annual growth rates for exports and government investment before 1984 were negative.

<sup>7</sup> Increases in consumption per capita of the poor may easily conflict with the need to increase savings, investment, efficiency and exports which are the basis for accelerated economic growth and long-term poverty reduction.

servicing as aid. A 'poverty action fund' can then be created by the recipient country, which can later be earmarked for poverty eradication. The fund can be used to develop rural infrastructure, promote small businesses and micro-enterprises, create jobs, improve health services and education. Uganda is one of the few countries that have reaped target outcomes from such a scheme (World Bank 2001c).

The results from Lloyd, Morrissey and Osei (2000) have interesting implication for the whole HIPC debate in Ghana. Perhaps too much attention is being paid to the recent debate on debt relief. There is no doubt that resources released from debt relief could have a positive impact on growth in Ghana. However, debt relief cannot and should not be at the forefront of the fight against poverty. The potential of exports to reduce poverty in Ghana is far greater than any degree of debt relief. To put this in perspective, we present a very simple simulation exercise based on the long-run elasticities of export (0.25) and aid (0.05) from Lloyd, Morrissey and Osei (2001). We use the average annual growth rates of exports and total debt servicing over the 1990-97 period.<sup>8</sup> We also obtain average forecast values for growth rates in these variables based on a simple autoregressive model of order four.<sup>9</sup> These simulations are at best tentative and should be taken as such. Assuming that aid flows remain unchanged, then a 'blanket' debt relief will imply that changes in net resource inflows will be equal to the amount of debt servicing that is forgiven. In other words the average annual percentage change in debts servicing can be taken as the average annual percentage change in aid (or resource inflows). We observe that over the forecast years (1998-2002) average annual export growth is not very different from the average over the 1990-97 period (Table 4). However the average annual growth in debt servicing more than doubles and is in fact over four percentage points higher than that for exports in the forecast years. Therefore total (or blanket) debt relief could result in significant increases in resource inflows to Ghana, assuming aid flows remain unchanged. The implication of growth in the net resource inflows vis-à-vis export growth, may not be that great for private consumption and therefore output growth. Growth in private consumption, which will result from the forecast growth in exports, is about three and a half times that which will result from the growth in net resource inflows from total debt relief. Given that there will not be one hundred per cent debt relief under the HIPC initiative, its effect is likely to be even lower than the projections above. The results from these simulations are indeed very tentative, albeit indicative of a simple fact; the potential for debt relief to impact positively on growth exists although it is relatively small. Instead, a redirection of energies towards an aggressive export-oriented growth strategy may tackle the growth and poverty objectives that is sought under the HIPC initiative better. This should be addressed from two angles; the domestic front through export promotion and diversification and from the international angle through making markets accessible to HIPCs such as Ghana.

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<sup>8</sup> Even though one could have looked also at total external debt we feel it will add very little (if any at all) to the picture we want to portray from this analysis as the resource flows of total debt is captured by debt servicing.

<sup>9</sup> It must be pointed out that we did not undertake a rigorous analysis for the data generation process (DGP) of the series and so the AR(4) model is only an approximation. However we do check for the order of integration and find all the series to be stationary.

Table 4  
Simulated growth in private consumption likely to result from debt relief

	1990-97	1998-2002 <sup>(a)</sup>
Average annual growth rates		
Exports	9.21	9.1
Total debt servicing forgiven	5.2	13.5
Resultant private consumption growth calculated from the annual growth rates above <sup>(b)</sup>		
Exports	2.39	2.36
Total debt servicing forgiven	0.26	0.68

Notes: Growth rates for the period 1990–97 are calculated using data from World Bank data sources.

<sup>(a)</sup> These are forecast values obtained from a simple AR(4).

<sup>(b)</sup> The calculations are based on long-run elasticities of 0.26 and 0.05 for exports and aid respectively obtained in Lloyd, Morrissey and Osei (2001).

Debt relief under the HIPC initiative could also have an indirect effect on growth if it helps create an enabling environment for private investments. Krugman (1988) argues that an excessive debt overhang could deter private investment as it creates uncertainty about inflation and exchange rate movements. Although macroeconomic imbalances were reduced to some degree in Ghana during the reform period, domestic prices and the exchange rate have not been stable. According to Brownbridge, Gockel and Harrington (2000), the fluctuating inflation rate and rapid depreciation of the exchange rate must have exacerbated the risk for long-term investment. It is well documented that private investments in Ghana have been abysmal (see *inter alia* Osei 2001b; Killick, 2000). Private investment in Ghana during the ERP was 4.8 per cent of GDP, only slightly higher than it had been before the reforms and well below levels recorded in other parts of the world including Africa (Brownbridge, Gockel and Harrington 2000). Relief under the HIPC initiative cannot make private investments any worse. Iyoha is noted to have found evidence that debt accumulation over time has deterred investments in Sub-Saharan Africa (World Bank 2001b: 102). If the government is able, under HIPC, to restore the economic fundamentals—low inflation, low budget deficits, reduced money supply, stable exchange rates, and improve the institutional capacity—then it could signify an increase in efficiency and productivity of investment and therefore increase private investments to Ghana.

Dollar and Kraay (2001) find no evidence in support of the hypothesis that health and education expenditures have a significant effect on incomes of the poor. The reason they give is that education and health in developing countries often benefit primarily the middle class and the rich. This interpretation is only part of the story; a more complete perception is to look at what the trends in education and health expenditures are in both real and per capita terms. Per capita expenditure in education in Ghana increased by just about US\$ 2 (in current prices) when one compares the 1970-82 and the 1990s period averages—an increase of about 21 per cent. The GDP price deflator, on the other hand, increased by over 35 per cent which means in real terms education expenditures were

actually lower in the last decade than 20 years ago.<sup>10</sup> It is also noted in Addison and Osei (2000) that as a per cent of the total, these expenditure items have actually decreased over the 1990s. Thus, it will not be surprising if education and health expenditures have no significant effect on output growth in Ghana.

There is no doubt that attaining the Development Assistance Committee's (DAC) agreed international development targets (IDT) will require more attention and resources in primary education and healthcare. However, these targets will be difficult (if not impossible) to achieve if the expenditure on health and education sectors as a whole is not significantly increased. In the case of Ghana, it will certainly not be enough only to increase health posts in the rural areas. This has to be complemented by increased resources for the training of new doctors and nurses as well as the provision of incentives to attract these people to rural areas.<sup>11</sup> The same can be said of education. Sachs *et al.* (1999: 5) note that the French and German governments spend approximately US\$ 2,500 per head on public health. This compares with the astounding figure of about US\$ 6 for the average Ghanaian.

In the case of Ghana, the issue is not just the reallocation of resources within the health and education sectors but rather making these priority sectors within the national budget as a whole. In 1999 almost 70 and 65 per cent of the health and education sectors budgetary allocation were respectively devoted to primary health care and basic education. We do not intend to underplay the need to spend more on these sub-sectors. However it should be done in a more integrated framework that will result in a situation where the quantity as well as the quality of health and education provision is improved. As Birdsall, Pinckney and Sabot (2001: 66) argue human capital accumulation will occur when high *quality* education is provided to the poor. Relief under the HIPC initiative is certainly one way in which more resources can be made available to these sectors.

To assess the potential benefits that debt relief will have for poverty reduction in Ghana, it is important that one understands the likely uses that resources released under HIPC will be put to. In other words, the fact that the net resource transfer has the potential of impacting positively on output growth in Ghana is neither necessary (one can have poverty reduction without growth)<sup>12</sup> nor sufficient (growth does not automatically ensure poverty reduction)<sup>13</sup> for effective poverty reduction (and increasing human development indicators). Rather, growth is conducive for poverty reduction. 'Growth may be good for the poor' as Dollar and Kraay (2001) assert, but the effectiveness of poverty reduction will depend on the process that generates growth. Hanmer and Naschold (2001: 5) cite a 1999 study by Hanmer and White which finds that robust determinants of infant and under-five mortality rates are, in addition to per capita GDP, the availability of health services, immunization rates, education, and gender quality.

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<sup>10</sup> Health expenditure data for the pre-1990 period are not available for a comparative analysis. However there is little reason to expect that the trend in health expenditures was any different from that of education.

<sup>11</sup> One often reads of medical doctors leaving Ghana to seek 'greener pastures'.

<sup>12</sup> Taylor, Mehrotra and Delamonica (2000: 443) note that over the period 1960-70 low output growth in Cuba was accompanied by high poverty reduction and social development.

<sup>13</sup> Ravallion (2001: 20) argues that it is not the growth rate that matters for poverty reduction but rather the distribution corrected rate of growth.



One key issue is whether the resources to be realized from debt relief will lead to increases in government expenditure on basic needs in Ghana. Osei (2001b) analyses the impact of net resource flows (net ODA aid) on government fiscal behaviour in Ghana over the period 1966 to 1998. The theoretic basis for the analysis is fiscal response models. Evidence from the study suggests that net foreign aid has not had a direct effect on public expenditure patterns in Ghana. Rather, aid appears to have been used as an alternative to domestic borrowing. Given its expenditure plans, the government considers which sources of finance, in addition to tax revenue, it can use. An example used to support this point is when in the 1990s domestic borrowing was increased in response to an increase in government expenditures and a decline in foreign aid flows. Over the medium to long term, any induced expenditure effect of aid is matched by an increase in tax revenue so that aid is used to reduce domestic borrowing. In the short run, aid has no effect on government expenditures, but rather it induces increased tax effort and reduces domestic borrowing. Some evidence of categorical fungibility is found, although one has to be careful with that interpretation as a significant portion of aid was received under the structural adjustment facility (SAF)—about 18 per cent of total net aid was received under SAF between 1987 and 1991.

The findings of Osei (2001b) have interesting implications for the possible effects that relief under the HIPC initiative will have for poverty reduction in Ghana. First if net resource transfers have a negative impact on domestic borrowing, then debt relief could ensure more stable macroeconomic fundamentals, which will in turn improve the efficiency of investment and attract more private investment. Second, there is evidence that tax effort increases with net resource flows to Ghana. This increased tax revenue could release more resources for health, education and other social sectors which will in turn have the effect of reducing poverty. How the taxes are raised is equally important for poverty reduction. Addison and Osei (2000: 13) note that petroleum taxes in Ghana may be more regressive than a ‘first-order incidence’ analysis will suggest. They, therefore, caution that policy-makers in Ghana should take equity issues into account in their revenue generation considerations.

The fact that net resource inflows tend to decrease domestic borrowing and increase tax revenue in Ghana means it is likely to impact positively on poverty reduction. However that is not enough. Fiscal discipline is equally essential if any significant poverty reduction is to be realised with debt relief. This is particularly important, as there is no guarantee that foreign aid flows will remain at current levels. Japan, the major aid donor to Ghana, has stated that no new loans will be extended because of the government’s decision to seek relief under the HIPC initiative (Akoto Ampaw 2001). The average annual net aid from Japan to Ghana over 1990-97 period was about US\$ 97.4 million (OECD 1999). This is more than half the projected amount of US\$ 183 million to be saved under HIPC relief in 2002. If other donors do not compensate for Japan’s stance, then debt relief will have little positive effect on poverty reduction. In other words, if aid inflows decrease, it will seriously compromise Ghana’s effort at achieving significant improvements in pro-poor growth using relief got under the HIPC initiative.

#### **4 Conclusions**

This paper contributes to the HIPC debate by providing an assessment of Ghana’s decision to take advantage of debt relief under the enhanced initiative and its possible

effects on poverty reduction. In particular, it provides an assessment of two broad issues. First, the paper assesses the nature of the current debt situation in Ghana. Second, it assesses whether relief under the HIPC initiative can be effectively translated into poverty reduction. It makes the following observations:

It is inevitable that Ghana takes advantage of the HIPC initiative. The country's external debt soared to an all-time high of about US\$ 322 per head in 1998 (current prices). This was almost 79 per cent of GDP and over 5 times the 1971 level. The servicing of the debt has put considerable strain on the fiscal budget; in 1998 debt servicing per capita of over US\$ 31 (current prices) was about US\$ 12 more than the total expenditure in health and education. Relief under the HIPC initiative is just one way of getting resources to finance economic and human development. However, in Ghana's case, the other sources of revenue for the government were not growing fast enough to compensate for the increasing debt servicing; debt servicing to domestic revenue increased from about 10 per cent in 1972 to over 40 per cent in 1998. Net foreign aid inflows which formed a major component of the government revenue in the 1980s have been on the decline in the later part of the 1990s (Lloyd, Morrissey and Osei 2000). The decision of the government to take advantage of the HIPC initiative was a step in the right direction.

The current per capita growth in GDP of about 1.6 per cent in 2000 falls short of the 2.4-5.9 per cent estimates needed to halve poverty by 2015 (Hanmer and Naschold 2001: 15). Lloyd, Morrissey and Osei (2000) find evidence that net aid flows have had a positive impact on growth in Ghana. The results also show that the contribution of exports to output growth in Ghana have been modest, mainly because average export growth over the period was small. This can be interpreted to mean that resources released under HIPC could impact positively on growth. However, the potential growth benefits of debt relief will indeed be small when compared with that which could result from expanding exports. Therefore, an export-oriented development programme should be very high on the agenda of policy-makers and donors if the country is to make significant strides towards achieving the international development targets of halving poverty in the next two decades. On the domestic front increased export earnings will be greatly enhanced if the share of the world market price going to producers is increased, especially as one of the major export earner of the country is cocoa, an agriculture product. From the donor's end, more should be done to make markets more accessible for the country's export as this will more likely have a greater impact on long-term poverty reduction than debt relief under the current HIPC initiative.

Private investments have been very low in Ghana. Debt relief under the HIPC initiative could be a source of stabilization for the economy, which will in turn reduce the risk of investments (as well as increase efficiency of capital). By reducing the debt overhang, more private investment will be attracted and this will consequently lead to an increase in economic growth. Reducing domestic borrowing as a result of debt relief will also make more resources available for private sector development. This will be consistent with government's pledge to make the private sector the engine of growth in Ghana.

There is evidence that net resource inflows to Ghana do not impact directly on government expenditures. Rather, it is considered a cheaper means of financing budget deficits and so has the effect of reducing domestic borrowing. Tax effort also increases with net aid inflows. This is interpreted to mean that debt relief will have a positive effect on poverty reduction by reducing inflation and domestic interest rates as well as

stabilizing the currency. This will in turn give a positive signal to potential investors, attracting more private investment and consequently increasing output growth.

The study concludes with the following comments. First, increasing resources to the health and education sectors, particularly primary health and education, is crucial if Ghana is to make significant inroads towards meeting the international targets of halving poverty by 2015. Relief under the HIPC initiative is one way of getting more resources for these priority sectors. However, too much emphasis should not be placed on increasing primary health and basic education at the expense of other complementary sub-sectors. In other words, attempts should not be made at just increasing the number of school buildings and health posts in the rural areas, but also it should aim at increasing the number of teachers, nurses and doctors, etc. This will ensure an increase in not only the quantity of primary health and education that is provided, but also its quality.

Debt relief under the (enhanced) HIPC initiative is not a panacea for Ghana's problems. It can, to some degree, put the economy on a development track. It is, however, essential that government expenditures are more strictly controlled as well—an aim of the poverty action fund and the medium-term expenditure framework. This is very important, as there is no guarantee that aid flows will remain at their current levels. There is an extent to which government can mobilize resources through taxation, as very high taxes could be a disincentive to potential investors and could counteract any positive gains on growth and poverty reduction. Therefore, the need to maintain fiscal discipline in Ghana cannot be over-emphasized and must complement debt relief.

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