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## HIPC debt relief and policy reform incentives

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Discussion Paper No. 2001/105

## **HIPC Debt Relief and Policy Reform Incentives**

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October 2001

### **Abstract**

In this paper, I discuss the incentives that the HIPC Initiative could create in debtor countries in favour of economic adjustment and reform. The usual debt-overhang argument, stating that debt relief will increase the net benefits of reforms, needs to be revisited in this context. First, the HIPC Initiative does not provide pure debt relief, but also creates new public spending obligations on poverty reduction programmes. Second, not all HIPCs can be considered as enjoying good economic governance, while the debt-overhang argument assumes a welfare-maximizing government. I show that standard positive incentives can be obtained only in good economic governance instances. I suggest that, in other instances, the outcome of HIPC programmes could be improved if external shocks were taken into account in their design.

Keywords: debt overhang, incentives, social expenditure, investment

JEL classification: F34

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## 1 Introduction

Towards the end of the debt crisis decade, a vast literature on the issue of debt overhang emerged, which significantly influenced policy thinking and decisions concerning debt relief programmes in favour of developing countries. In a nutshell, the argument of this literature was that too heavy a debt burden was creating disincentives in the indebted countries, which in turn impeded adjustment and reform policies. According to this analysis, debt service obligations acted as an implicit taxation on all future returns on investments and reforms, therefore limiting the willingness of governments to implement the appropriate policies needed to promote economic growth. As a consequence, high debt implied low growth and, in the absence of a major debt relief initiative, heavily indebted countries were meant to stay trapped in a low equilibrium.

Only in 1996, the G7, the IMF and the World Bank proposed a comprehensive debt relief approach in favour of highly indebted poor countries (HIPCs), known as the first phase HIPC Initiative. It was then enhanced in 1999 at the G7 summit in Cologne. Its enhancement not only increased its size and coverage, but also changed its nature somewhat, because of the strong emphasis put on poverty reduction policies rather than on debt relief only.

The question of this paper is the following: Will the HIPC Initiative provide incentives to implement the reform policies that are necessary to improve development perspectives in highly indebted poor countries? To answer this question, I first focus on the incentive effects of pure debt relief, but it is also necessary to take into account the fact that the HIPC Initiative now includes two components: debt relief, and obligations for the debtor to implement a poverty reduction programme.

Despite the emphasis put on the issue of debt overhang by the G7 in Cologne in 1999, there are some negative answers to our question. Birdsall, Claessens and Diwan (2001), in particular, argue that the assumption of an implicit taxation effect due to debt overhang is not relevant for HIPCs, because very often these countries have received positive net transfers from creditors, rather than negative ones. Consequently, they propose a different perspective, stating that the initiative would not provide direct incentives to invest and implement reform policies in HIPCs, but would introduce favourable incentives on the creditor side. More precisely, the HIPC Initiative, after debt relief, would permit a more efficient aid policy by donors, because aid agencies could concentrate on selective financial assistance to countries implementing 'good' policies. In their words, the HIPC would end the 'debt game'.

This suggests that it is necessary to introduce into our analysis a discussion of the interaction between debt relief and good economic governance. Therefore, our question has two dimensions; whether, for example, the programmes proposed in the context of the HIPC Initiative can, for a given governance, improve incentives towards better adjustment and reform policies, as was explained earlier in the debt-overhang literature. The answer to this first question depends on the initial quality of governance. The second dimension concerns the influence of HIPC programmes on governance. On this side, notwithstanding the indirect impact through aid selectivity considered by Birdsall, Claessens and Diwan, I suggest that HIPC programmes contain a number of elements that may improve governance and policy-making.

Section 2 provides a brief discussion of the initial literature on the adverse incentives introduced by debt overhang. Section 3 describes the main features of the HIPC Initiative, and discusses the differences between this initiative and pure debt relief. Section 4 elaborates on previous discussions and provides an analysis of the likely outcomes of HIPC programmes, with some emphasis on their impact on social expenditure.

## **2 The ‘old’ debt-overhang literature revisited**

Sachs introduced in 1986 the notion that debt reduction could create favourable incentives in an indebted country (Sachs 1989). His theory was based on the idea that too heavy a debt service burden would imply that all efforts to improve future revenues through investment and reforms would only increase future payments to the creditors, thus creating a bias towards immediate consumption of all available income and against adjustment efforts.

Several analytical models of the debt-overhang effect have been proposed, in particular by Corden (1988) and Helpman (1989). Corden (1988) considers the impact of debt and debt relief on adjustment efforts by a government, supposed to be able to make welfare-maximizing decisions on domestic allocation of resources. Implementing an adjustment policy implies immediate costs such as public consumption reductions and only uncertain future benefits. Consider a two-period framework, in which an adjustment or reform policy defined in a broad sense as policies implying short-term sacrifices leading to longer-term benefits, is considered in first period. The cost of adjustment is equivalent to investment, which increases future (second-period) output. With very high debt service obligations, such an improvement of future output will only result in increased debt service payments rather than in more income available for consumption in the second period. Conversely, in the absence of adjustment, second-period output will remain low, which means only more arrears (or rescheduling) on debt service obligations.

Under such circumstances, debt service obligations act as an implicit tax on the proceeds of the first-period investments, collected by creditors. Consequently, no adjustment policy is implemented or it is delayed for a long time, and the economy stays trapped in a high debt/low growth equilibrium. However, if debt service obligations are reduced, at least part of the new income generated by first-period investments will be available for second-period consumption. This means that debt relief may create positive incentives to implement adjustment and reform policies. The implicit marginal taxation on proceeds of first-period investment efforts falls to zero. This outcome, favourable to the debtor country, may be beneficial to the creditors as well if adjustment policies improve growth performances and then the future debt service capacity of the debtor.

Following Corden, this framework can easily be expanded by introducing stochastic shocks on available income. For instance, one may assume that in good states of nature, the debtor country may be able to fully pay its debt service, while in bad states of nature it is not. If the country invests in the first period and if the second-period state of nature is favourable, then it can keep all the benefits generated by its investment. Conversely, if the second-period state of nature is unfavourable, such benefits will accrue to its

creditors. Therefore, the expected implicit marginal rate of taxation of investment proceeds in favour of creditors is somewhere between 0 and 1. It goes down to zero only when debt service obligations, even in bad states of nature, are equal or below payment capacity. Conversely, under good states of nature, creditors get fewer payments after debt relief than the maximum debt service capacity available.

This discussion of outcomes of debt relief in the presence of external shocks suggests that an once-for-all debt reduction, without indexation on the future state of nature, is sub-optimal. It would be preferable to provide higher debt relief under bad states of nature when the creditors in any event cannot collect much debt service, and smaller under good states of nature. I will come back to this issue of the consequences of external shocks for the design of a debt relief programme in my discussion of the HIPC Initiative outcomes.

The previous framework assumes that the government can control domestic resource allocation, which is a strong assumption. However, similar properties are obtained in a framework where the private sector makes strategic decisions on resource allocation through its investment. For instance, Helpman (1989) proposed a framework where private investment is negatively influenced by future income taxation, which in turn depends on future debt service obligations.

This amounts to expanding the previous framework by considering a second-best world, where government policy instruments are minimal (the rate of taxation on private sector income). Under such circumstances, the implicit taxation effect considered by Corden becomes an explicit taxation of the private sector. When government debt service obligations are high, private sector income is heavily taxed. This leads to low investment.

In this framework, the consequences of a debt overhang will depend on the structure of the tax system. Economic activities that are highly taxed will be the most affected. In the case of usual African HIPCs, these are the formal sector firms and, in some cases, primary export activities. As a consequence, the debt overhang in such countries may particularly discourage economic modernization as well as outward orientation.

Some authors (e.g., Borensztein [1990] in the case of the Philippines, or Cohen [1993] for a cross-section study) have attempted successfully to test the impact of debt stock on private investment performance by introducing a debt-overhang effect in an econometric investment equation. However, few significant and robust results have been obtained this way. Results may depend on the tax system structure, which is usually not stable over time, and this may affect estimations. Moreover, it is usually extremely difficult to estimate accurate private investment equations in developing countries where basic information, such as the actual cost of capital, is not available.

Reduced form-estimates of the debt-overhang effect have been also attempted, which relate indirect observations of debt service capacity to the debt burden borne by debtors. In this vein, Krugman (1989) has proposed to consider a debt relief 'Laffer' curve, as shown in Figure 1. In this figure the actual value of the debt stock owed by a country, defined as the present value of expected future debt service payments, becomes smaller when debts (i.e., the net present value of future debt service actually due to creditors) increase after a certain threshold. This threshold, which defines the debt overhang, corresponds to the point where adjustment/investment disincentives created by more

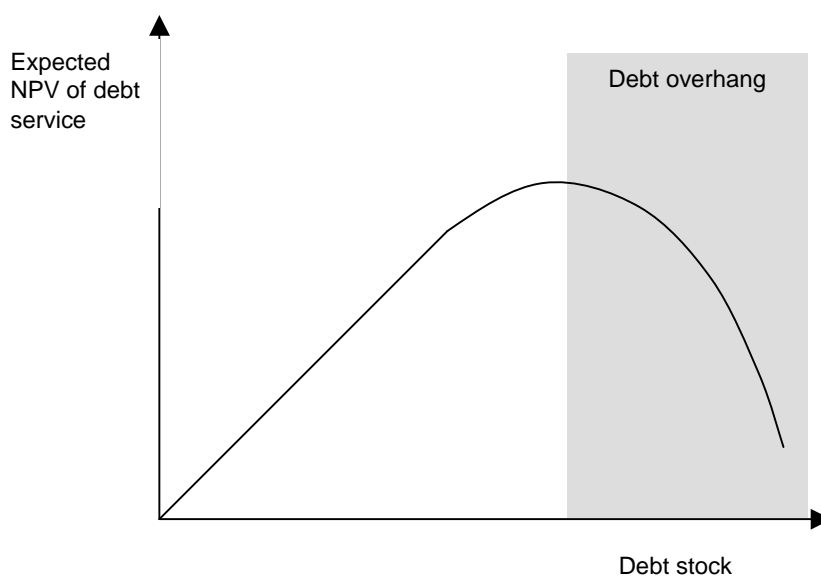
debt service obligations are high enough to reduce future expected debt service payments.

The emergence of a secondary market for commercial debts owed by intermediate income countries in the 1980s has provided information to test such a curve. Several authors (e.g., Cohen 1990) have estimated equations where the secondary market price of debt (which is equivalent to the slope between the origin and any point of the debt relief 'Laffer' curve) is declining with debt indicators such as the debt-to-export ratio. It depends also on the country's rescheduling and arrears history. However, the data on which such equations have been estimated are very fragile, because the secondary market liquidity was in several cases very low, with only few actual deals. Moreover, by definition, such tests can be performed only for countries owing significant debts to commercial creditors, while highly indebted poor countries are principally, when not exclusively, indebted vis-à-vis official creditors.

Notwithstanding these practical issues, Cohen (2000) has applied his previous secondary market price equation to an analysis of the possible outcomes of the HIPC Initiative. To this end he has computed 'notional' secondary market debt prices for countries eligible to the HIPC Initiative by simulating his equation based on pre-Brady plan Latin American debt prices. His point is that at the current level of HIPC's debt ratios, their notional debt prices are very low. He concludes that the significance of the HIPC Initiative should to a large extent be scaled down in the sense that the actual cost for creditors will be very small: they will forgive debts that would have not been repaid anyhow.

Nevertheless, Cohen's computations also suggest that the HIPC Initiative should be very significant in terms of incentives for the individual debtor countries: low implicit debt prices are equivalent to a very high debt overhang. Under such circumstances, the incentive impact of debt relief should be maximal.

Figure 1  
The debt relief 'Laffer' curve



This view is somewhat contrary to the one proposed by Birdsall, Claessens and Diwan (2001), who argued that HIPCs, which receive on average positive net transfers from creditors, cannot suffer an implicit taxation due to their debt obligations. However, their argument is not entirely convincing. The matter of the fact is that even though HIPCs enjoy positive net transfers, this is because they receive new aid flows corresponding to projects financed by donor agencies. In the previous analytical framework borrowed from Corden and Helpman, what counts is the amount of resources that the government can discretionarily allocate, and not the total aggregate resources that it receives. The central issue is whether projects financed by the donors are truly 'owned' by the debtor government, i.e. whether this government would have decided on such an expenditure in the absence of aid flow. Recent discussions on the necessity to improve the ownership of reforms and development policies by governments in African countries suggest that the answer to this question is negative too often. As a consequence, project aid does not always add resources to the budget that debtor governments can discretionarily allocate. This implies that, notwithstanding project aid flows which have reversed net transfers in favour of HIPCs, their debt service obligations may have actually created a taxation effect as assumed in earlier literature.

The Birdsall, Claessens and Diwan analysis points to another major issue, namely whether the government in place tries to implement 'good' economic policies. In the initial debt-overhang literature, it was assumed that the government objective was to maximize the nation's welfare. Within this framework, only the debt-overhang disincentives can prevent implementation of the right economic policies. If the government has different objectives (e.g., protecting vested interests), the policies it implements may be the wrong ones, whatever its debt obligations. This discussion suggests that the impact of HIPC debt relief programmes cannot be assessed independently of the quality of economic governance in the debtor countries.

### **3 The HIPC Initiative**

The current HIPC Initiative takes stock of previous developments of the debt relief and growth literature in acknowledging that unsustainable debt and debt service obligations are counter-productive. It builds also on the experience gained in the early 1990s with the Brady initiative, which proposed an ambitious debt relief plan in favour of heavily indebted middle income countries and had been instrumental in the resolution of the Latin American debt crisis.

The Brady approach of the early 1990s was not adapted to HIPCs, because their debts were principally due to multilateral and bilateral official creditors, and could not be handled the same way as commercial debts. The Paris Club provided more and more generous debt relief on bilateral official debts, but this—for lack of a comprehensive treatment of debt obligations—was not sufficient to eliminate their debt overhang. A large part of HIPCs debts had been contracted after the Paris Club cutoff dates and in several countries most of the debts were due to multilateral rather than to bilateral institutions. By comparison, resolving the commercial debt issue in the Brady plan countries was very close to providing a comprehensive debt relief programme.



Only in 1996, the G7, the IMF and the World Bank proposed a comprehensive debt relief approach, known as the first phase HIPC Initiative. The initiative was then reinforced and accelerated in 1999 at the G7 summit in Cologne.

The objective of the current HIPC Initiative is to cut the total debt stock (in net present value) owed by eligible countries to 150 per cent of their exports. Using a ratio of debt to export instead of debt to GDP or fiscal receipts may create a bias: this amounts to assuming that the debt issue is principally one of foreign exchange transfer, although it also has a public finance dimension. For this reason, a second threshold is considered for economies that are very open to external trade, where the maximum sustainable debt is considered equivalent (in net present value) to 250 per cent of fiscal revenue.

These thresholds are defined at the decision point, and determine the amount of debt relief received during an interim period and at the completion point, whatever the future evolution of export and fiscal incomes of the beneficiary country. By comparison, in a few instances, debt relief programmes proposed in the early 1990s in the context of the Brady initiative introduced a somewhat more sophisticated approach, which made the final size of debt relief conditional on future exogenous events. This was the case for Mexico, whose debt reduction plan contained a 'recapture clause', stating that Mexico would have to increase payments to its former creditors in the event of a future improvement in oil prices. This kind of recapture clause may play a useful role in adapting the post-relief debt service to future external shocks. By comparison, under the HIPC Initiative, the existence of future external shocks is ignored, while eligible countries are usually subject to very wide variations in their terms of trade, and in their agricultural primary export volumes as well.

Under the enhanced HIPC Initiative, an HIPC programme means not only debt reduction, it also implies that the beneficiary government must agree to allocate the amount of money saved on debt service to well-specified projects. With this obligation, the HIPC Initiative directly imposes the issue of good economic governance: before granting debt relief to a specific country, one first wants to ensure that the country in question will use the proceeds of debt relief for the 'right' objectives. Such a concern was already present in the first phase of the HIPC Initiative, insofar as countries had (and still have) to show a good track record before reaching the decision point, as well as the completion point. However, it now plays a much greater role.

This policy conditionality is specified in the PRSP (Poverty Reduction Strategy Paper) that the government has to prepare in consultation with the various stakeholders before reaching the completion point of a HIPC debt reduction programme (and a preliminary PRSP is required before the decision point). In some countries (e.g., Uganda, Chad), the proceeds of debt relief are registered in a 'virtual account', which finances commitments specified in the PRSP. These expenditures cover usually education, health services and basic infrastructure.

At this stage, two particular features of the current HIPC Initiative need to be stressed. First, it introduces specifically distributional policy objectives that go beyond mere conditioning of the decision and completion points on good economic governance. This point must not be overdone, however, insofar as investment for the future will, in many cases, create positive outcomes for the poor. In analytical terms, such conditionality on a poverty reduction programme is not much different from a condition on good economic policy-making. As a matter of fact, many PRSPs mention strong economic

growth as a necessary condition for poverty reduction. It has, however, practical consequences in focusing public spending programmes on social expenditure and other policy measures aimed at fighting poverty.

In this sense, the HIPC Initiative is comparable more to the ‘debt for development’ swaps introduced, usually by NGOs, in the 1990s than to pure debt relief. In such deals, debt was repurchased to private or official creditors (at a price below its face value) and then cancelled in exchange for government expenditure commitments to favour identified development goals (such as environment protection projects). The major difference, however, is that the HIPC Initiative is comprehensive, while debt swaps were implemented on a small scale and thus could not be considered as possible solutions to debt overhang.

Second, HIPC programmes may, particularly through the preparation of PRSPs, have a positive institutional development impact. In several countries, the PRSP has created the first opportunity for dialogue between the government and citizens on development objectives. They may also facilitate time-consistent efforts towards development objectives, insofar as they represent irreversible long-term aid commitments, and stronger ownership of the development policies by debtor governments. They play also a useful role in capacity-building. In some cases, the budgetary procedures set up to allocate debt service relief proceeds have a positive influence on a government’s fiscal rules and procedures. Another example of the capacity-building content of the HIPC programmes is that preparing the PRSP has, in many instances, led to new initiatives to launch poverty surveys, which had been overlooked for a long time.

To sum up, the HIPC Initiative is not simply a comprehensive debt relief programme, it also creates new development policy commitments and, occasionally, new budgetary rules for beneficiary governments.

#### **4 Will the HIPC Initiative create the right incentives?**

The answer to this question depends critically on the government initial policy stance. If a government was already committed to poverty reduction or to good economic governance before the HIPC programme, poverty alleviation expenditures had already been budgeted. In these ‘virtuous’ countries, HIPC programmes would release resources for free utilization in the government budget because poverty reduction projects in any event would have been implemented. Thus, the consequences of HIPC programmes can be analysed along the lines of our previous discussion of policy incentive impacts of a pure debt relief.

In these cases, one may predict the consequences of debt relief on the structure of public expenditure to be minimal, or at least less dramatic than in countries not initially committed to poverty alleviation. In view of the poverty reduction emphasis of the HIPC programmes, looking at their expected impact on social expenditure may provide a relevant proximate indicator of such consequences.<sup>1</sup>

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<sup>1</sup> As shown by IMF/WB (2001a), tracking the impact of HIPC programmes on public spending policies within the existing budget management systems is almost impossible, and one has to rely on crude approximations to get an idea of this impact.

To test the hypothesis that the impact of HIPC programmes will depend on the quality of initial economic governance also requires identifying the ‘virtuous’ countries, which is not straightforward task. However, a good proxy can be found in the dates when the different countries reached their HIPC decision point. Early programmes were granted to countries implementing good policies, while lengthy negotiations before reaching the decision point can be related mostly to situations where economic governance initially was not considered entirely satisfactory.<sup>2</sup>

In Figure 2, I have grouped countries that reached the decision point before April 2001 in three subsets: (i) first-phase countries, i.e. countries entering the HIPC Initiative in its first phase before the 1999 enhancement decision;<sup>3</sup> (ii) countries reaching their decision point between January and June 2000;<sup>4</sup> and (iii) other countries.<sup>5</sup> Figure 2 shows clearly that on average late-comers are committed—or at least are expected by the IMF and the World Bank—to increase their social expenditure much more than others. For the three groups of countries, the average rate of change in social expenditure is 37, 45 and 63 per cent, respectively.

Moreover, as suggested by Figure 3, the implicit elasticity of social expenditure to debt service reduction is expected to be much higher in late-comers than in other countries. On average, debt service will decline by 34, 26 and 19 per cent in the first, second and third group of countries, while the ranking of their social expenditure rates of growth will be the other way round. This confirms that a higher proportion of debt relief proceeds will be earmarked to social expenditure in countries with initially worse economic governance.<sup>6</sup>

These observations tend to confirm our expectation that the impact of HIPC programmes on public spending depends on the quality of initial economic governance, with ‘virtuous’ countries having much greater free will. This suggests that our standard debt-overhang theory may apply only to these countries.

But precisely put, ‘virtuous’ cases are those where adjustment incentive issues are perhaps the least serious. The fact remains, however, that in such countries, the debt burden is still, or was before debt relief, a drag on investment and growth, be it through the government budgetary constraint or through indirect negative incentives on private investments. Private investment rates are still very low in several of these countries; between 12.5 and 13 per cent for Mali, Mozambique and Uganda in 2000 (and below 11 per cent in Burkina Faso), while the average rate of private investment for Africa as a

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<sup>2</sup> A counter example is Ghana, because this country decided only lately to apply to an HIPC debt relief. Since Ghana has not yet reached the decision point, this does not affect results shown.

<sup>3</sup> Bolivia, Burkina Faso, Guyana, Mali, Mozambique and Uganda. Côte d’Ivoire is excluded because after having reached an early decision point in the first phase of the HIPC initiative, it has been unable to reach either a completion point in the first phase or a decision point in the second phase.

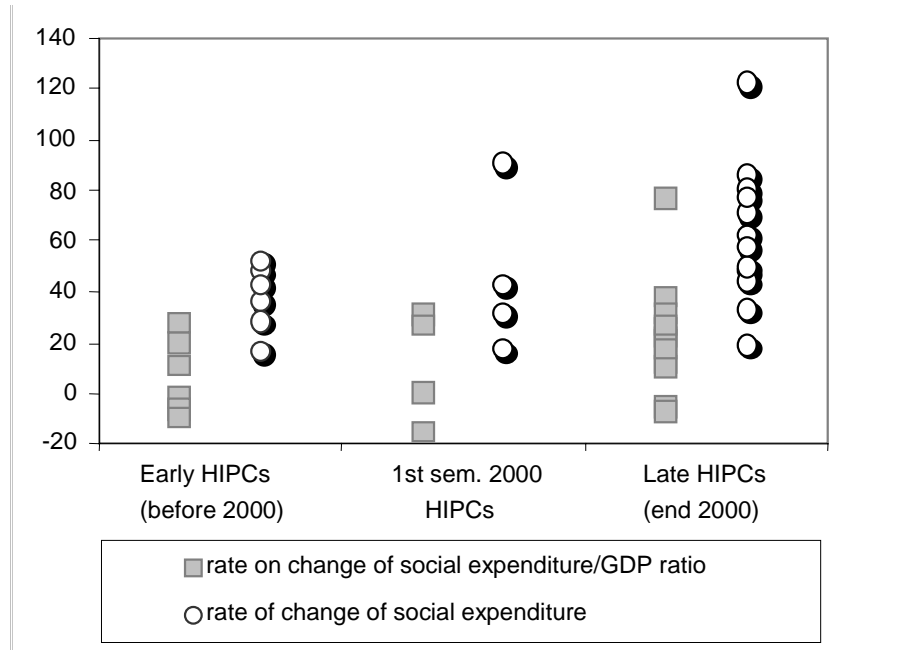
<sup>4</sup> Honduras, Mauritania, Senegal and Tanzania.

<sup>5</sup> Benin, Cameroon, Gambia, Guinea, Guinea Bissau, Madagascar, Malawi, Nicaragua, Niger, Rwanda, Sao Tome and Zimbabwe.

<sup>6</sup> Only an elasticity approach, rather than a direct comparison of debt relief and social expenditure increase is relevant since (i) the definition of social expenditure differs among countries and (ii) the new priority given to poverty reduction implies that social expenditure increases more than the debt relief proceeds.

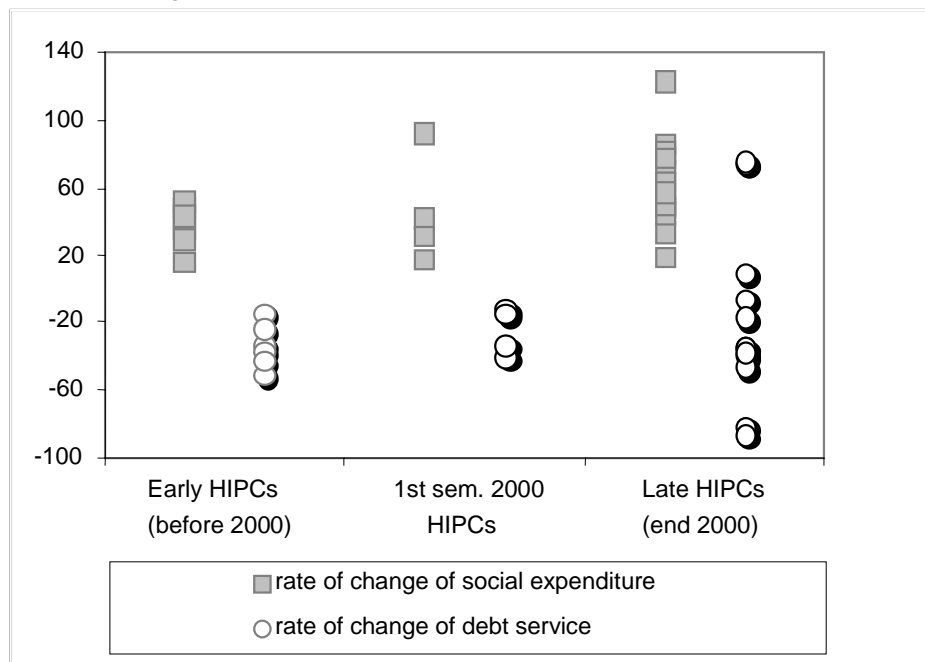
whole was close to 14 per cent. This suggests that these countries should be able to reap some indirect benefits from the HIPC Initiative in the future.

Figure 2  
Expected growth of social expenditure, 1999-2002



Source: based on IMF/WB (2001b).

Figure 3  
Expected growth of social expenditure vs. decline of debt service, 1999-2002



Source: based on IMF/WB (2001b).

Conversely, in countries lacking a previous political commitment to good economic governance and poverty reduction, no adjustment and reform incentives will be created by the HIPC debt relief as such. Moreover, no reduction of taxes on the formal sector will be feasible in the short to medium term (the poor are usually outside the formal sector), which means that it will continue to bear a heavy tax load. This may create future disillusion, which will later impact negatively on private sector behaviour. In Chad, for instance, private sector representatives expected the principal outcome of the HIPC programme to be a reduction in taxation, but this is very unlikely, given that it will not ease the budget constraint of the government.

If these countries were exempt from external shocks, this would not be a big issue. In any event, be it through debt relief incentives or through the PRSP implementation, development expenditure would be realized more readily after HIPC programmes than before.

However, the existence of external shocks will affect the outcome of the HIPC programmes. This issue, already mentioned in section 2, will be particularly sensitive for countries with poor initial economic governance. In bad states of nature, the government will have to continue to spend debt relief proceeds on projects identified in the PRSP, even though the country will be in no better position to pay its remaining debt service—no more than prior to the HIPC programme, it was able to pay its full debt service in bad states of nature. Temporary fiscal difficulties leading to high risks of domestic or external arrears will re-emerge, and the debtor government will need some form of exceptional financial assistance. Therefore, in many instances, aid agencies may be faced with the obligation of providing new finance again or rescheduling at concessional conditions to avoid failure of the HIPC programme.

In good states of nature, policy-makers will have money available for investments and adjustment measures that could protect them later on during occurrences of bad states of nature. But if they do not implement such policies and simply consume their windfall gains, they may receive more exceptional financing in bad states of nature. Again, for all practical purposes, the return on investment and fiscal adjustment measures will be implicitly taxed during future occurrences of bad states of nature.

One solution to solve this issue would be to make the HIPC debt reduction conditional on the state of nature; during bad states, debt service obligations should be reduced or cancelled, or increased during good states of nature, or both. This would require, however, advance definition of the circumstances, which would constitute good or bad states of nature. For oil-exporting countries, a proxy could be based on the evolution of oil prices (and possibly oil output), similar to the recapture clause of the Mexican Brady deal. But it would be impossible to foresee all possible circumstances for all countries that could be considered as good or bad states of nature. Furthermore, such clauses would be politically difficult to implement, because they could be interpreted by public opinion as a sort of confiscation of windfall gains by the donors to the detriment of poor debtors.

Another, albeit second best, solution would be to earmark windfall gains obtained during good states of nature to PRSP projects, in order ascertain that such incomes are not wasted. Therefore, the PRSP virtual account or its equivalent would receive more than the mere proceeds of debt relief in good states of nature, and it could receive less in bad states of nature. This kind of scheme can be found partially in the case of Chad,

where in the context of its negotiations to reach the HIPC decision point at the end of 2000, the government agreed to earmark all its future income generated by oil production<sup>7</sup> to poverty reduction projects identified in the PRSP. More specifically, the HIPC decision point was reached only after the creation of the 'Collège de Contrôle et de Surveillance des Revenus Pétroliers', which was given the authority to control that all Chad's future oil income (and not only debt service relief proceeds) be spent on poverty eradication as specified in the PRSP.

## 5 Conclusion

The HIPC Initiative is a major improvement in the treatment of debt issues in poor countries. It recognizes that a comprehensive debt reduction is a necessary condition for economic and social progress in highly indebted poor countries.

The HIPC Initiative also recognizes that not all debtor governments are initially committed to good economic governance. If for this reason only, pure debt relief is far from being the panacea for the countries concerned. Taking this into account, a major feature of the HIPC Initiative is that it combines debt relief with conditionality on poverty reduction policies.

In countries with good economic governance, the HIPC programme will work more or less as expected in the debt-overhang theory, so that debt relief creates positive incentives for more investment and reform. But these are the good cases, not the countries where such positive changes are needed the most.

In countries with dismal economic governance, poverty reduction conditions linked to the HIPC Initiative change its nature. It will work much less as a debt relief than as a multi-year programme of aid flows targeted to poverty reduction projects. This may have favourable outcomes, because this will avoid debt relief proceeds being wasted, and will increase social expenditure. However, the indirect incentive gains of HIPC programmes will be minimal in such countries. To solve this issue at least partially, more attention should be paid to the treatment of external shocks: debt service and public expenditure obligations of the debtor governments should be made conditional on the state of nature. Original and politically feasible institutional arrangements that would mimic this could be founded in procedures set up to earmark windfall gains enjoyed in good states of nature to the PRSP virtual account.

The HIPC programmes also contain a number of elements that may strengthen, through the preparation and implementation of PRSPs, institutional-building. Such institutional improvements should be a major long-term positive outcome of HIPC programmes, beyond the medium-term adjustment and investment consequences considered in this paper.

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<sup>7</sup> Due to start in 2003, thanks to the development of the Doba oil field.

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