United States General Accounting Office
Washington, DC 20548

October 11, 2002

The Honorable Joseph R. Biden
United States Senate

The Honorable Rick Santorum
United States Senate

Subject: *Benefits and Costs of the Debt Relief Enhancement Act of 2002*

Despite years of effort to provide debt relief to the world's poorest countries, these countries' debt problems still have not been resolved. In response to this situation, you and other Members of Congress introduced Senate Bill 2210, the Debt Relief Enhancement Act of 2002, to reduce these countries' debt service payments to manageable levels. The act proposes that no qualified country[1] pay more than 10 percent of its revenue on external debt service or no more than 5 percent if the country suffers a public health crisis. You asked us to evaluate the financial implications of the Debt Relief Enhancement Act and compare the act with other debt relief proposals. We provided your staff and other interested parties a formal briefing on our findings on September 26, 2002. The briefing discussed prior debt relief efforts and their limitations, provided information on additional Paris Club debt relief, and compared three proposals to increase debt relief. A copy of our briefing is attached.

In summary, we found that the Debt Relief Enhancement Act would immediately lower the debt service of countries that qualify for relief. It would cost about $2.7 billion (present value) for 26 countries over the next 3 years and have no effect on long-term debt sustainability. If applied over a 20-year period, the act's provisions would address the long-term debt sustainability of these countries. However, the cost of the proposal would grow to between $7 billion and $12 billion (present value) for those 26 countries. An alternative debt relief proposal, promoted by the Bush administration, is to convert up to 50 percent of future multilateral concessional loans to grants.[2] This proposal does not address the short-term debt service

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[1]Qualified countries are those that are eligible to receive debt relief under the Heavily Indebted Poor Countries Initiative. Countries are eligible if existing means are not enough to make debt levels sustainable and creditors are willing to finance the additional relief. In making this determination, the World Bank decides whether (in most cases) the ratio of a country's debt (in present value terms) to the value of its exports is more than 150 percent.

[2]See U.S. General Accounting Office, *Developing Countries: Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens*, GAO-02-593 (Washington, D.C.: Apr. 19, 2002).

obligations of these countries. However, it substantially improves their prospects of achieving long-term debt sustainability. We estimate that the cost of implementing this proposal by the World Bank would be about $9.7 billion (present value) over 40 years and would lower the debt burdens of all 65 countries that are eligible to borrow only from the World Bank's concessional resources.

In reviewing the cost of the Debt Relief Enhancement Act, we focused on the 26 countries in the Heavily Indebted Poor Countries Initiative that have qualified for debt relief as of July 2002. The primary data for our analysis were the World Bank's and the International Monetary Fund's (IMF) country-specific economic forecasts and debt service projections for these 26 countries. Specifically, we compared the annual debt service that the countries would pay if the act's provisions were implemented with their projected debt service if the act were not implemented. We conducted this analysis for two time periods: the 3 years covered by the act and the 20 years covering the repayment period of more than 80 percent of the countries' existing debt stock. The cost of converting 50 percent of multilateral loans to grants was based on our prior analysis of that proposal, which calculated a 40-year cost horizon for the countries that are eligible to borrow concessional resources from the World Bank. The 40-year cost horizon is consistent with the time period covered by the World Bank's analysis.

We performed our work from August 2002 through September 2002 in accordance with generally accepted government auditing standards.

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We are sending copies of this report to appropriate congressional committees and to the Honorable Paul O'Neill, Secretary of the Treasury. We are also sending copies to the World Bank and the IMF. Copies will be made available to others on request. In addition, this report will be available at no charge on our Web site at http://www.gao.gov.

If you or your staff have questions about this report, please contact me at (202) 512-8979. Thomas Melito, Anthony Moran, Bruce Kutnick, R.G. Steinman, Ming Chen, Stephanie Robinson, and Janey Cohen made key contributions to this report.

Sincerely yours,

Joseph A. Christoff

Joseph A. Christoff
Director, International Affairs and Trade

Enclosure

The Financial Challenge of Debt Relief

Briefing for Senate Staff
September 26, 2002

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Overview

- Background on Debt Relief
- Limitations of the Enhanced HIPC Initiative
- Additional Paris Club Debt Relief
- Proposals to Further Enhance Debt Relief
- Summary

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Background:
The Scope of the Debt Problem

- 42 countries identified as heavily indebted and poor, ¾ of which are in sub-Saharan Africa
- In 1998, the debt service-to-revenue burden for 26 of these HIPC countries averaged 27 percent
- In 2002, the debt service-to-revenue burden for these 26 countries averaged 14 percent
- HIPC countries will still need large amounts of development assistance following debt relief, including substantial loans from multilaterals

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Background:
What Has Been Done to Address the Debt Problem?

- **Bilateral Debt Forgiveness**
  - Despite efforts of bilateral and commercial creditors to reduce debt of poor countries, total debt owed to external creditors increased by about $100 billion between mid-80s and mid-90s
- **HIPC Initiative**
  - Coordinated effort among bilateral and multilateral creditors provided over $7 billion in debt relief through a 2-stage process
- **Enhanced HIPC Initiative**
  - Intends to provide an additional $29 billion in deeper, broader, faster debt relief with central focus on reducing poverty in HIPC countries

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Limitations of the Enhanced HIPC Initiative

- **Enhanced HIPC is not fully funded**
  - GAO estimates the World Bank's unfunded liability at $4.4 billion (present value) for assistance under the Enhanced HIPC Initiative
- **Enhanced HIPC assumes overly optimistic growth rates**
  - Projects future export growth rates will be approximately double historical rates
  - Recent World Bank analysis acknowledges lower actual growth rates for both exports and government revenue
  - Recent "topping up" infusions due to lower growth

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Additional Paris Club Debt Relief

- Bilateral donors have agreed to provide about $5 billion in additional debt relief, beyond their commitments to finance the HIPC initiative

- Most bilateral donors are providing 100 percent forgiveness on concessional and pre-debt relief nonconcessional loans

- This will increase the proportion of total debt held by multilateral institutions, thereby potentially increasing the cost of additional debt relief to the United States

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Comparison of Proposals to Further Enhance Debt Relief

	Biden/Santorum	100 percent multilateral forgiveness	Switching 50-percent loans to grants
Impact time frame	2003-05	Near term	Medium-Long-term
Effect on debt service	Lowers immediately	Lowers immediately	No impact until second decade
Effect on long-term debt sustainability	No effect if for only 3 years	Delays, but does not preclude future debt sustainability problems	Probability for debt sustainability improved
Cost profile	Short run	Short run	Gradual/long run
Total cost (NPV)	$2.7 billion for 26 countries (3 years) $7-12 billion for 26 countries (20 years)	$14 billion for 26 countries	$9.7 billion for 65 IDA-only countries

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The Biden-Santorum Bill

- Uses debt service as criteria; proposes that no qualified country pay more than 10 percent of its revenue on external debt service; 5 percent if the country suffers a public health crisis
- Proposal would be costly during its 3-year window
  - 20 of 26 HIPCs are likely to fall in 5 percent category because of health crises in those countries
  - Cost of proposal over 3 years is about $3.4 billion before additional Paris Club debt relief and about $2.7 billion after, in addition to existing HIPC funding requirements
- Applying the Bill's criteria over a 20-year horizon escalates the cost
  - Cost would range from $7-12 billion for 26 countries depending on how the proposal is implemented and future country growth rates

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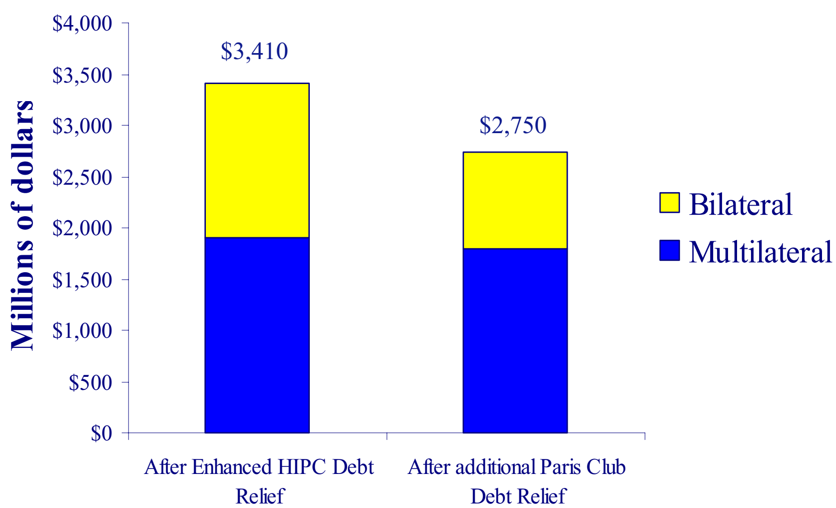
Present Value Cost of Biden-Santorum Bill (26 countries)



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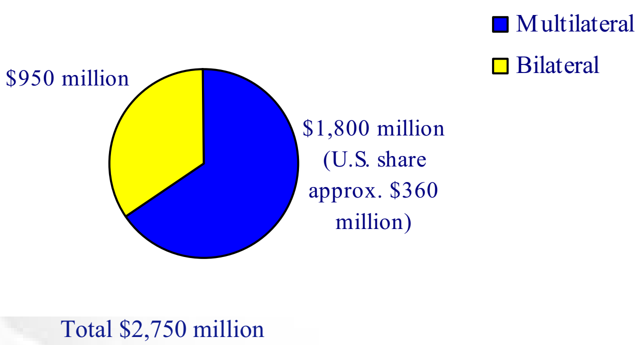
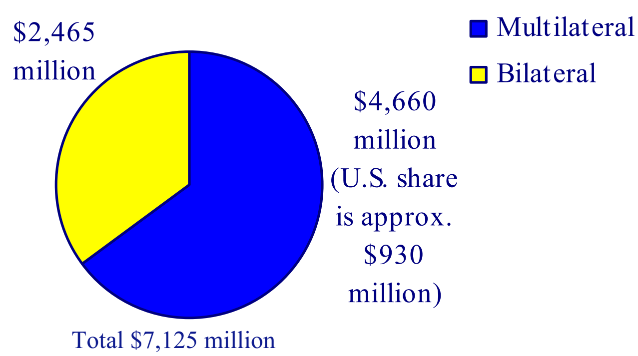
Sharing the Burden: Cost of Biden-Santorum Bill by Type of Creditor* (26 countries)

Present Value Cost of Biden-Santorum Bill by Creditor Type, 2003-2005



Present Value Cost of Biden-Santorum Bill by Creditor Type, 2003-2022 (lower estimate)



*After additional Paris Club debt relief

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Multilateral Debt Forgiveness

- NGOs and others have recommended that multilateral organizations forgive 100 percent of old debts owed by poor countries, as many bilateral creditors have done
- Cost would be about $14 billion for 26 HIPCs
- Significantly reduces current multilateral resources available for new lending; bilateral donors, including U.S., may be expected to fund shortfall
- Long-term debt sustainability concerns remain as countries accumulate substantial new debt after forgiveness, with debt burdens once again becoming unsustainable

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Loans-to-Grants Proposal

- Medium- to long-term approach to debt sustainability
- President's proposal was to replace 50 percent of future multilateral loans with grants
    - 18-21 percent grants for World Bank (IDA) ultimately agreed upon
    - GAO estimates the cost of 20 percent grants at $3.9 billion in present value 2002 dollars
- Increased grants improves debt sustainability by lowering future debt-to-export ratios from what they would otherwise be, but does not address short-term debt service burden
- Promotes long-term debt sustainability better than 100 percent forgiveness of old multilateral debt

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Summary

- Current debt relief efforts are insufficient to provide long-term debt sustainability
- Immediate efforts to increase debt relief result in substantial short-term budget costs, and don't address long-term problem
  - U.S. share of costs likely to be significant, given the growing proportion of total debt belonging to multilaterals
- Long-term debt relief efforts easier to finance, but do not address short-term debt service burden

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