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DEVELOPING COUNTRIES

The United States Has
Not Fully Funded Its
Share of Debt Relief,
and the Impact of Debt
Relief on Countries'
Poverty-Reducing
Spending Is Unknown



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Highlights of [GAO-09-162](#), a report to congressional requesters

Why GAO Did This Study

In 1996, the Heavily Indebted Poor Countries (HIPC) Initiative was created to provide debt relief to poor countries that had reached unsustainable levels of debt. In 2005, the Multilateral Debt Relief Initiative (MDRI) expanded upon the HIPC Initiative by eliminating additional debt owed to four international financial institutions (IFI): the International Monetary Fund (IMF), World Bank's International Development Association (IDA), African Development Fund (ADF), and Inter-American Development Bank (IaDB). These four IFIs are projected to provide \$58 billion in total debt relief to 41 countries. GAO (1) analyzed the U.S. financing approach for debt relief efforts; (2) reviewed the extent to which MDRI might affect resources available to countries for poverty-reducing activities; and (3) assessed revisions to the analyses conducted by the World Bank and IMF to review and promote future debt sustainability. GAO analyzed Treasury, IFI, and country documents and data, and interviewed officials at Treasury and the four IFIs.

What GAO Recommends

To address limitations in the U.S. approach for financing MDRI, GAO recommends that the Secretary of the Treasury consider the use of different funding options, such as requesting separate appropriations from Congress. Treasury responded that it is open to considering alternative MDRI funding approaches in the future.

To view the full product, including the scope and methodology, click on [GAO-09-162](#). For more information, contact Thomas Melito at (202) 512-9601 or MelitoT@gao.gov.

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The United States Has Not Fully Funded Its Share of Debt Relief, and the Impact of Debt Relief on Countries' Poverty-Reducing Spending Is Unknown

What GAO Found

Treasury's approach to financing MDRI, known as early encashment, does not fully fund current and future U.S. commitments. The approach does not fully fund the current U.S. MDRI commitment because the United States is in arrears on its IDA replenishment. These arrears are due to requirements under U.S. law for withholdings and across-the-board rescissions. Under early encashment, the World Bank requires that the U.S. commitment to the IDA replenishment be paid in full before early encashment income can be used to fund MDRI. The World Bank deducts the U.S. arrears to IDA from any early encashment income before applying this income toward the U.S. MDRI commitment, resulting in a current MDRI shortfall of \$149 million. Treasury officials said that if the United States ultimately pays its arrears to the IDA replenishment, early encashment income will then fully fund the U.S. MDRI commitment. However, to fully fund the U.S. MDRI commitment, (1) Treasury will need to release a withholding of \$94 million by reporting to Congress that the World Bank has accomplished transparency reforms required under U.S. law, and (2) Congress will need to appropriate approximately \$49 million to compensate for the rescissions. Moreover, GAO estimates that the early encashment approach will be insufficient to fully finance future U.S. MDRI commitments even if U.S. payments are made on time and in full because these commitments exceed projected early encashment income.

GAO estimates that the HIPC Initiative and MDRI debt relief from the four IFIs combined may provide countries for which data are available with nearly \$44 billion in additional resources over the next 50 years, but the extent to which countries spend these resources on activities to reduce poverty is unknown. In addition to providing debt relief, the MDRI program for IDA and ADF provides for a reallocation of assistance, based in part on a consideration of the strength of country policies and institutions. The estimated amount of this MDRI assistance individual countries receive will vary. Although IFIs and the U.S. government encourage recipient countries to spend resources generated from debt relief on efforts to reduce poverty, the extent to which such spending occurs is unknown for two reasons. First, debt relief resources are difficult to track, because these resources cannot easily be separated from other types of financial flows such as international assistance and fiscal revenues. Second, country data on poverty-reducing expenditures are not comparable across countries and also may not be reliable.

The World Bank and IMF have improved their country debt sustainability analyses (DSA) since 2005, including by addressing weaknesses GAO previously reported. DSAs now consider the strength of a country's policies and institutions in determining sustainable debt loads and assess future debt sustainability under multiple scenarios that adjust economic assumptions. Furthermore, IDA and ADF now structure their assistance based on a country's risk of debt distress. While the new DSAs have identified numerous ambitious actions countries should take to avoid eroding their debt sustainability, implementing these actions could prove difficult.

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Abbreviations

ADF	African Development Fund
CBO	Congressional Budget Office
CPIA	Country Policy and Institutional Assessment
DRF	Debt Reduction Facility
DSA	debt sustainability analysis
DSF	Debt Sustainability Framework
GAAP	generally accepted accounting principles
HIPC	Heavily Indebted Poor Country
IaDB	Inter-American Development Bank
IDA	International Development Association
IFI	International Financial Institution
IMF	International Monetary Fund
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MTDS	Medium-Term Debt Management Strategies
NPV	net present value
OECD	Organization for Economic Coordination and Development
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PV	present value
UN	United Nations

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United States Government Accountability Office
Washington, DC 20548

January 26, 2009

Congressional Requesters

A buildup of foreign debt throughout the 1970s and 1980s—combined with low growth, falling commodity prices, and other economic difficulties—left many poor countries with significantly more debt than they could repay. In order to address this problem, the international community has provided increasing amounts of debt relief to 41 such heavily indebted poor countries over the last decade. These efforts include the Heavily Indebted Poor Country (HIPC) Initiative, which was launched in 1996 as an approach for international financial institutions (IFI), commercial creditors, and individual nations to lower the debt levels of the world’s poorest and most indebted nations to “sustainable” levels. “Sustainable” means that a country can make its future debt payments on time and without rescheduling.

Multilateral debt relief efforts culminated in the Multilateral Debt Relief Initiative (MDRI), which was announced in 2005. MDRI involves fewer creditors than the HIPC Initiative, eliminating additional eligible debt that countries owe to four IFIs—the World Bank’s International Development Association (IDA), the International Monetary Fund (IMF), the African Development Bank’s African Development Fund (ADF), and the Inter-American Development Bank (IaDB).¹ MDRI was created to assist countries in increasing their funding for poverty-reducing activities and accelerating progress toward achieving the United Nations (UN) Millennium Development Goals (MDG).² Countries must complete the HIPC Initiative before they can receive MDRI debt relief. Of the 41 countries that may benefit from both programs, 23 have received irrevocable HIPC Initiative and MDRI debt relief and another 11 have

¹IaDB was not included in MDRI but decided in 2007 to provide equivalent debt relief under a similar initiative. IaDB’s Fund for Special Operations is the entity responsible for providing debt relief. For the purpose of this report, references to MDRI also include the IaDB initiative. IMF, ADF, and IaDB plan to cancel all eligible debt countries owed them as of the end of 2004. IDA plans to cancel all eligible outstanding debt as of the end of 2003.

²The UN MDGs, which have a target completion date of 2015, are to (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote gender equality and empower women; (4) reduce child mortality; (5) improve maternal health; (6) combat HIV/AIDS, malaria, and other diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development.

begun receiving debt relief under the HIPC Initiative. Another seven countries are potentially eligible for debt relief but have not yet met the requirements for such relief.

We estimate that IDA, IMF, ADF, and IaDB will provide about \$58 billion in debt relief under the HIPC and MDRI Initiatives to 41 countries over the next several decades.³ Donor governments (including the U.S. government) have agreed to help fund multilateral debt relief. Donor governments have provided funding to IFIs to support the HIPC Initiative through means such as a trust fund established at the World Bank. To fund MDRI, governments may (1) provide funding in addition to their regular contributions or replenishments to the institutions,⁴ (2) provide their regular contributions early and generate credits through an approach known as early encashment, or (3) do both. The U.S. Department of the Treasury (Treasury) is currently using early encashment to fund the U.S. MDRI commitment. In July 2008, we reported that even if the U.S. government provides full funding for IDA, this early encashment approach results in a U.S. funding shortfall for MDRI by 2014.⁵

In response to your request, we (1) analyzed the U.S. financing approach for debt relief efforts; (2) reviewed the extent to which MDRI might affect resources available to countries for poverty-reducing activities;⁶ and (3) assessed revisions to the analyses conducted by the World Bank and IMF to review and promote future debt sustainability. In addition, you asked us to review strategies for addressing legal actions brought by companies to

³This estimate is in end-2008 present value dollars. The present value of debt is a measure that takes into account the concessional, or below-market, terms that underlie most of these countries' loans. Present value debt is defined as the sum of all debt-service obligations (interest and principal) on existing debt, discounted at the market interest rate. The nominal value of the debt relief, estimated at more than \$122 billion (more than \$68 billion for the HIPC Initiative, not including predecision point countries for whom data are unavailable, and \$54 billion for MDRI), is greater than the present value. These nominal dollar amounts do not take into consideration the time value of money.

⁴Replenishment refers to periodic contributions by member countries that are agreed upon by the institution's board of governors to fund concessional lending operations over a specified period of time, normally every 3 years. IDA14 covers the period 2006 through 2008, and IDA15 covers the period 2009 through 2011.

⁵GAO, *Developing Countries: U.S. Financing for Multilateral Debt Relief Initiative Currently Experiencing a Shortfall*, [GAO-08-888R](#) (Washington, D.C.: July 24, 2008).

⁶Countries describe their poverty-reducing spending as targeted toward activities, categories, sectors, clusters, programs, and ministries that we refer to in this report as activities, areas, or categories.

collect outstanding claims from countries receiving HIPC and MDRI debt relief. These strategies are discussed in appendix II. We have previously reviewed debt-related issues, including the HIPC Initiative and MDRI.⁷

To address these objectives, we reviewed documents and analyzed data provided by Treasury, the World Bank, IMF, ADF, and IaDB, and spoke with officials at Treasury and these four institutions. We also examined poverty reduction strategy papers, country budget documents, and debt sustainability analyses. We prepared our own estimates regarding the sufficiency of the U.S. funding approach for MDRI as well as the amount of assistance that will be provided to beneficiary countries by the HIPC Initiative and MDRI. Our calculations reflect relevant data for debt relief countries as of November 21, 2008. All figures provided in this report are expressed in end-2008 present value dollars unless otherwise noted. To illustrate the impact of debt relief on individual countries, we selected five countries (Ethiopia, Ghana, Nicaragua, Rwanda, and Tanzania) as case studies based on several criteria, including geographic diversity and dispersion of country ranking in terms of the percentage of total HIPC and MDRI debt relief they received from the four institutions. In terms of percentage of debt relief received, we selected countries at or near the top, middle, and bottom of the ranking as examples of how the program works. Our choice of countries is meant to be illustrative, not representative. We assessed the reliability of the data analyzed and found the data to be sufficiently reliable for the purposes of this report.

We conducted this performance audit from December 2007 through January 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. (See app. I for more detailed information regarding our scope and methodology.)

Results in Brief

Treasury's approach to financing MDRI, known as early encashment, does not fully fund current and future U.S. commitments. The approach does not fully fund the current U.S. MDRI commitment because the United States is in arrears to the World Bank on its IDA replenishment. These arrears are

⁷See related GAO products at the end of this report.

due to requirements under U.S. law for withholdings and across-the-board rescissions. Under early encashment, the World Bank requires that the U.S. commitment to the IDA replenishment be paid in full before early encashment income can be used to fund MDRI. The World Bank deducts the U.S. arrears to IDA from any early encashment income before applying this income toward the U.S. MDRI commitment, resulting in a current MDRI shortfall of \$149 million. Treasury officials said that if the United States ultimately pays its arrears to the IDA replenishment, early encashment income will then fully fund the U.S. MDRI commitment. However, to fully fund the U.S. MDRI commitment, (1) Treasury will need to release a withholding of \$94 million from the IDA14 replenishment, by reporting to Congress that the World Bank has accomplished transparency reforms required under U.S. law, and (2) Congress will need to appropriate approximately \$49 million in funds to compensate for the rescissions. Both actions will need to be completed by June 30, 2009. Moreover, we estimate that the early encashment approach will be insufficient to fully finance future U.S. MDRI commitments even if U.S. payments are made on time and in full because these commitments exceed projected early encashment income.

We estimate that HIPC Initiative and MDRI debt relief from the four IFIs combined may provide beneficiary countries for which data are available with a total of nearly \$44 billion in additional resources over the next 50 years, but the extent to which countries spend these additional resources on activities to reduce poverty is unknown. According to our projections, HIPC assistance may provide over \$21 billion in debt relief to recipient countries, while MDRI may generate over \$22 billion in additional resources. In addition to providing debt relief, the MDRI program for IDA and ADF provides for a reallocation of assistance, based in part on a consideration of the strength of country policies and institutions. The estimated amount of this MDRI assistance individual countries receive will vary as countries realize increases or decreases in their assistance from IDA and ADF. Although IFIs and the U.S. government encourage recipient countries to spend resources generated from debt relief on efforts to reduce poverty, the extent to which such spending occurs is unknown. IMF and World Bank documents suggest an association between increased debt relief and increased poverty-reducing expenditures, but it is difficult to demonstrate that debt relief has led directly to increased poverty-reducing expenditures for two reasons. First, debt relief resources are difficult to track, because the resources generated by debt relief cannot easily be separated from other types of financial flows such as international assistance and fiscal revenues. Second, country data on

poverty-reducing expenditures are not comparable across countries and also may not be reliable.

The World Bank and IMF have improved their country debt sustainability analyses (DSA) since 2005, including by addressing weaknesses that GAO previously identified, and these new DSAs have identified numerous ambitious actions countries should take in order to avoid future unsustainable debt levels. The new DSAs differ from other analyses by considering country performance in determining sustainable debt loads, and assessing debt sustainability under several scenarios that include varying assumptions of future economic growth. This approach addresses past GAO concerns that DSAs contained only one scenario, which may have been based on overly optimistic economic assumptions. Furthermore, IDA and ADF now structure their future assistance to countries based on a country's risk of future debt distress. Countries with a high risk of debt distress receive grant assistance, while countries with a low risk of debt distress receive concessional loans. This approach is aligned with our past reporting that the increased use of grant assistance would have a positive impact on poor country debt sustainability. The new DSAs have identified numerous actions countries should take in order to avoid future unsustainable debt levels. For example, for the 13 countries with a moderate or high risk of future debt distress, DSAs note that projected debt sustainability could be further eroded if countries do not take actions such as implementing sound macroeconomic policies or realizing sustained national income or export growth. Achieving such ambitious objectives could prove difficult for these poor countries over the course of the 20-year projection period.

To address limitations in the U.S. approach for financing MDRI, we recommend that the Secretary of the Treasury consider the use of different funding options that clarify the priority between paying U.S. arrears owed to IDA and paying MDRI obligations, such as requesting separate appropriations from Congress.

The Department of the Treasury, the World Bank, and IMF provided written comments on a draft of this report, which are reprinted in appendixes IX, X, and XI. Treasury stated that it is open to our recommendation that alternative U.S. funding approaches for MDRI be considered in the future. Treasury emphasized its objective to fully meet its current IDA and MDRI funding commitments while also noting that a lack of full funding would jeopardize this objective. Similarly, the World Bank stressed the importance of full funding for IDA and a sustainable U.S. funding approach to cover debt relief costs. IMF noted its

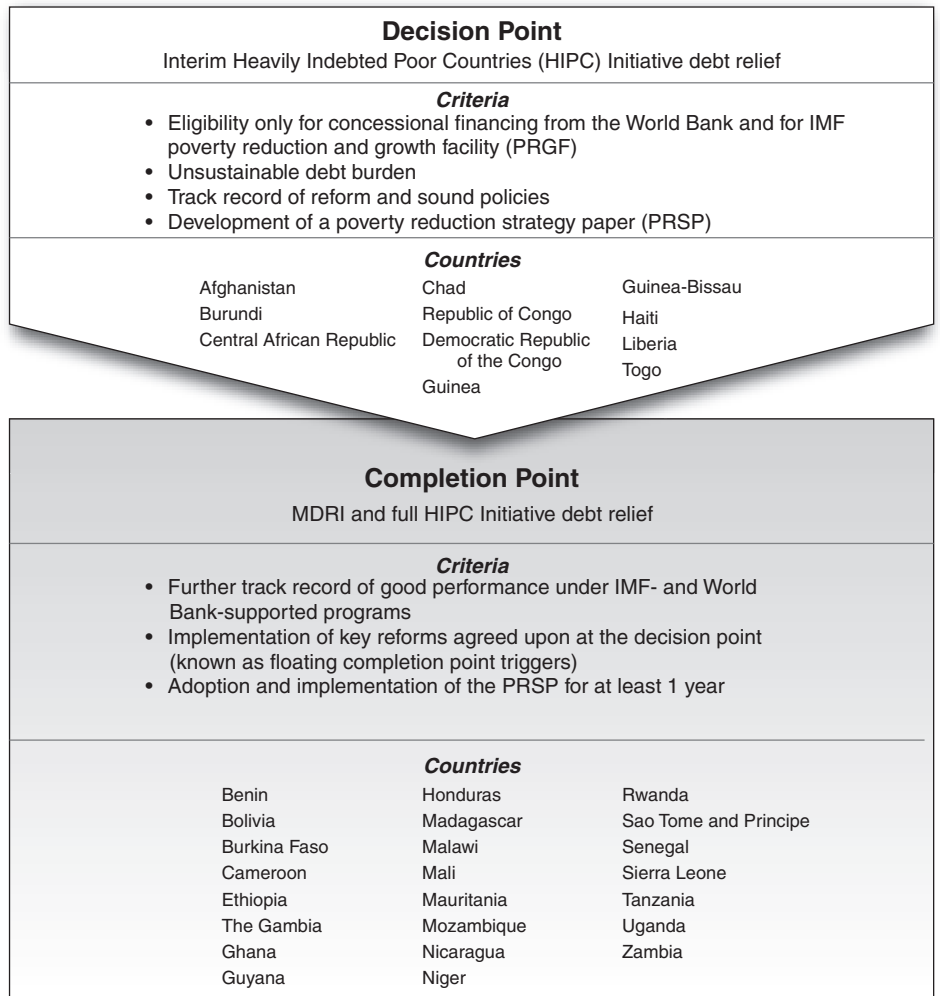
disagreement with our position that the impact of debt relief on poverty-reducing spending is unknown. We maintain that our position is accurate since, while data compiled by IMF report that poverty-reducing spending has increased in countries receiving debt relief, it is not possible to link such increases to debt relief. Treasury, the World Bank, IMF, and the African Development Bank provided technical comments on a draft of this report, which we have incorporated as appropriate. We requested comments from IaDB, but none were provided.

Background

Bilateral creditors and IFIs created the HIPC Initiative in 1996 to address concerns that certain poor countries had accumulated unsustainable debt burdens, despite receiving debt relief from bilateral creditors. In response to concerns over the continuing vulnerability of poor countries, the World Bank and IMF enhanced the initiative in 1999 by reducing the qualifying thresholds and increasing the number of potentially eligible countries. Countries must meet numerous criteria in order to qualify for HIPC Initiative debt relief, such as establishing a track record of reform and sound policies. To fully benefit from HIPC debt relief, countries must progress through different phases of the initiative (see fig. 1). At a country's "decision point," IDA and IMF use certain criteria to determine whether a country qualifies to receive HIPC Initiative debt relief. If a country is determined to qualify, it can begin to receive interim HIPC debt relief. Subsequently, at the "completion point," IDA and IMF determine whether the country meets additional criteria and can receive full and irrevocable HIPC debt relief. As of November 2008, of the 41 countries that may benefit from debt relief efforts, 23 had reached the completion point and 11 more had reached the decision point. An additional seven countries are considered "pre-decision point" countries and have not yet qualified for debt relief.⁸ MDRI expands upon the HIPC Initiative and represents the most recent effort to provide debt relief to heavily indebted poor countries. To receive MDRI debt relief, countries must first complete the HIPC Initiative.

⁸Pre-decision point countries are Comoros, Cote d'Ivoire, Eritrea, Kyrgyz Republic, Nepal, Somalia, and Sudan.

Figure 1: Process for Receiving HIPC Initiative and MDRI Debt Relief



Source: IMF and World Bank documents.

Note: Countries develop a poverty reduction strategy paper (PRSP), which outlines the goals and objectives for reducing poverty, every 3 years through a participatory process involving domestic stakeholders as well as external development partners, including the World Bank and IMF.

In addition, IMF has determined that it will provide MDRI debt relief to member countries with debt outstanding to IMF and a per capita income at

or below \$380 at end-2004 that do not otherwise qualify for debt relief.⁹ While the HIPC Initiative provides for a reduction in the debt levels of eligible countries, the process associated with MDRI debt relief requires IDA and ADF to take additional actions that provide resources to poor countries beyond those countries benefiting from debt relief.¹⁰

We estimate that IDA, IMF, ADF, and IaDB will provide, in present value dollars, about \$58 billion in debt relief (in end-2008 present value dollars) under the HIPC and MDRI Initiatives to 41 countries over the next several decades.¹¹ The amount of total debt relief provided under each initiative will be about equal, with over \$28 billion provided under the HIPC Initiative and about \$30 billion provided under MDRI. IDA is to provide the greatest level of debt relief at \$34 billion (almost 60 percent of the total). IMF is to provide \$10.6 billion, while ADF and IaDB are to provide \$9.1 billion and \$4.1 billion, respectively. Table 1 provides data on the amount of funding each institution will provide for each program.

Table 1: Total HIPC Initiative and MDRI Debt Relief by International Financial Institution for 41 Countries (In billions of end-2008 present value dollars)

	IDA	IMF	ADF	IaDB	Total
HIPC	\$15.0	\$6.4	\$5.3	\$1.7	\$28.4
MDRI	19.2	4.2	3.8	2.4	29.6
Total	\$34.2	\$10.6	\$9.1	\$4.1	\$58.0

Source: GAO analysis of IMF and World Bank documents.

⁹Using this criterion, IMF has identified two non-HIPC Initiative countries, Cambodia and Tajikistan, as eligible for MDRI debt relief. As of the end of September 2007, IMF had provided \$82 million and \$100 million in MDRI debt relief to these two countries, respectively.

¹⁰Countries eligible for these additional actions are low-income countries that receive only concessional loans from IDA and ADF. While some of these countries receive debt relief under the HIPC Initiative and MDRI, others do not.

¹¹While other creditors, including other IFIs and individual countries, also provide debt relief under the HIPC Initiative, our report focuses solely on debt relief provided by IDA, IMF, ADF, and IaDB. Total HIPC Initiative debt relief from all creditors is estimated at \$74.5 billion.

For the 33 countries¹² currently receiving debt relief under both programs, IDA has secured about \$8.6 billion for the HIPC Initiative and \$4.4 billion for MDRI (for more detailed information, see app. III). This total of \$13.1 billion represents 47 percent of the total required IDA financing of almost \$27.8 billion for these countries under both debt relief initiatives. ADF will provide about \$7.5 billion in HIPC Initiative and MDRI debt relief and has secured about \$5.7 billion, about 76 percent of this amount. IMF and IaDB have fully financed their \$8 billion and \$3.8 billion of HIPC Initiative and MDRI debt relief for the countries currently receiving such relief, respectively, using internal resources and donor-provided funds. Because these two institutions have fully funded their HIPC Initiative and MDRI debt relief, almost 65 percent of total debt relief costs for all four IFIs has been secured.

Based on our projections, the United States has committed to provide a total of about \$8.4 billion to the four IFIs to finance the total costs of their HIPC Initiative and MDRI debt relief (see table 2).

Table 2: Estimated U.S. Financing of Multilateral Debt Relief by International Financial Institution (In billions of end-2008 present value dollars)

	IDA		IMF		ADF		IaDB		Total	
	Estimate	Paid	Estimate	Paid	Estimate	Paid	Estimate	Paid	Estimate	Paid
HIPC	\$2.3	0.3	0.7	0.7	0.9	0.9	0.1	0.1	4.0	2.0
MDRI	3.9	0.2	0.1	0.1	0.4	0.02	0	0	4.4	0.3
Total	6.2	0.5	0.8	0.8	1.3	0.9	0.1	0.1	8.4	2.3

Source: GAO analysis of Treasury, IADB, IMF, ADF, and IDA documents.

Note: Estimated U.S. financing for IMF includes transfers of the U.S. share of \$0.47 billion from the PRGF-HIPC Trust fund for HIPC, \$0.10 billion from the PRGF-ESF Trust Subsidy account for MDRI, and a commitment of \$0.20 billion for HIPC debt relief to Liberia.

We estimate that the U.S. government is to provide \$6.2 billion, or 74 percent, of its debt relief financing to IDA and \$1.3 billion, or 16 percent, to ADF. The U.S. government has already provided \$0.5 billion to IDA and \$0.9 billion to ADF, leaving the majority of these costs (\$5.7 billion for IDA and \$0.4 billion for ADF) to be paid in the future. The U.S. government has provided \$0.8 billion to IMF and \$0.1 billion to IaDB. Of the \$2.3 billion that the United States has already provided, \$2.0 billion was for the HIPC

¹²We did not include Togo in our calculations of debt relief costs because it reached the decision point on November 25, 2008, which is outside the scope of this review.

Initiative and \$0.3 billion was for MDRI. (App. IV provides information on bilateral debt relief that the United States has provided to countries under the HIPC Initiative.)

U.S. Approach to Financing MDRI Does Not Fully Fund Current and Future U.S. Commitments

Treasury, IDA, and ADF have agreed to a financing approach for MDRI called early encashment, under which the U.S. government earns income for early replenishment payments to IDA and ADF. Since the U.S. government is currently in arrears on its replenishment payments to IDA14, early encashment does not fully fund the current U.S. MDRI commitment. We also estimate that U.S. early encashment income will be insufficient to fully finance future MDRI debt relief. Furthermore, the U.S. financing approach is more costly than other options.

Treasury Uses Early Encashment to Generate Income

The U.S. government currently uses an early encashment approach to fund U.S. MDRI obligations at both IDA and ADF.¹³ Early encashment income is earned by IDA and ADF when the United States allows the IFI to draw funds on, or encash, its replenishment commitment early, rather than according to a standard encashment schedule that spans 9 years for IDA and 10 years for ADF. The standard encashment schedule represents the IFI's expected disbursement pattern of the funds committed during the 3-year replenishment period. Treasury has agreed to allow IDA and ADF to encash the U.S. replenishment commitment over an accelerated 4-year period. Since the early encashments exceed amounts required during the first 4 years under the regular 9-year or 10-year encashment schedule, IDA and ADF can invest these funds and earn income (see app. V). IDA and ADF guarantee fixed discount rates that determine the amount of income countries using the early encashment approach will receive for full and timely encashments according to the accelerated schedule, regardless of IDA's and ADF's actual earnings on early encashments over the period.

¹³Early encashment is an existing World Bank financing approach that Treasury chose to use in a new way. Previously, donors were allowed, if they so chose, to pay their nominal replenishment commitment at a discount and earn early encashment income to meet the full value of their obligations. Donors could also pay their commitment in full and the early encashment income would add to IDA's liquid assets. Treasury instead chose to use the early encashment income to finance the U.S. MDRI commitment. For more information on the use of early encashment to finance U.S. MDRI obligations, see *Developing Countries: U.S. Financing for Multilateral Debt Relief Initiative Currently Experiencing a Shortfall*, GAO-08-888R (Washington, D.C.: July 24, 2008).

These amounts are then credited to the U.S. government and can be used toward paying the U.S. MDRI commitment. Treasury has separate agreements with IDA and ADF regarding the methodology used to estimate the amount of early encashment income that the United States will earn.

United States in Arrears on Its IDA14 Replenishment Commitment

The World Bank requires that the U.S. IDA14 replenishment be paid in full before early encashment income can be earned and used to fund MDRI; however, the United States is currently in arrears on its replenishment commitment. In recent years, Congress has withheld a portion of the U.S. replenishment contribution to encourage the World Bank to undertake specified reforms such as strengthened efforts to enhance transparency and combat corruption.¹⁴ In fiscal year 2006, Congress required that 20 percent of the funds appropriated to IDA be withheld from disbursement until the Secretary of the Treasury reported to Congress that the World Bank had undertaken certain anticorruption reforms.¹⁵ In fiscal year 2006, most of these funds were eventually disbursed pursuant to the requirements in the law; however, there was a shortfall in fiscal year 2006 of approximately \$41 million due to both the anti-corruption withholding provision and an across-the-board rescission. In fiscal year 2007 there was an additional rescission of about \$9.5 million. In fiscal year 2008, Congress rescinded \$7.7 million and required that 10 percent, or \$94 million, of IDA funds be withheld until Treasury reported that the World Bank had undertaken anticorruption reforms, and that another 10 percent be withheld until Treasury reported that the World Bank had enacted certain transparency reforms.¹⁶ As of July 2008, Treasury had reported to Congress that the World Bank had enacted anti-corruption reforms called for in the fiscal year 2008 appropriations law and had disbursed the corresponding funds. However, Treasury still had not reported to Congress that the World Bank had accomplished all of the 2008 transparency reforms and continued to withhold funds. Treasury has complied with its legal

¹⁴Pub. L. No. 109-102, §599D (Nov. 14, 2005); Pub. L. No. 110-161, §668(c) (Dec. 26, 2007).

¹⁵Pub. L. No. 109-102, §599D (Nov. 14, 2005), as amended by §20407 of Pub. L. No. 110-5, Div. B (Feb. 15, 2007).

¹⁶Pub. L. No. 110-161, §668(c) (Dec. 26, 2007).

obligation to withhold these funds that have created arrears.¹⁷ When funds are rescinded or withheld from IDA, the shortfall amounts become arrears of the United States that remain until the appropriated funds are released from Treasury. We estimate that the U.S. government has arrears to the IDA14 replenishment of about \$152 million, since the U.S. nominal contribution of \$2,698 million is less than the U.S. commitment of \$2,850 million.¹⁸

U.S. Early Encashment Income Insufficient to Fully Finance Current MDRI Debt Relief Due to Arrears

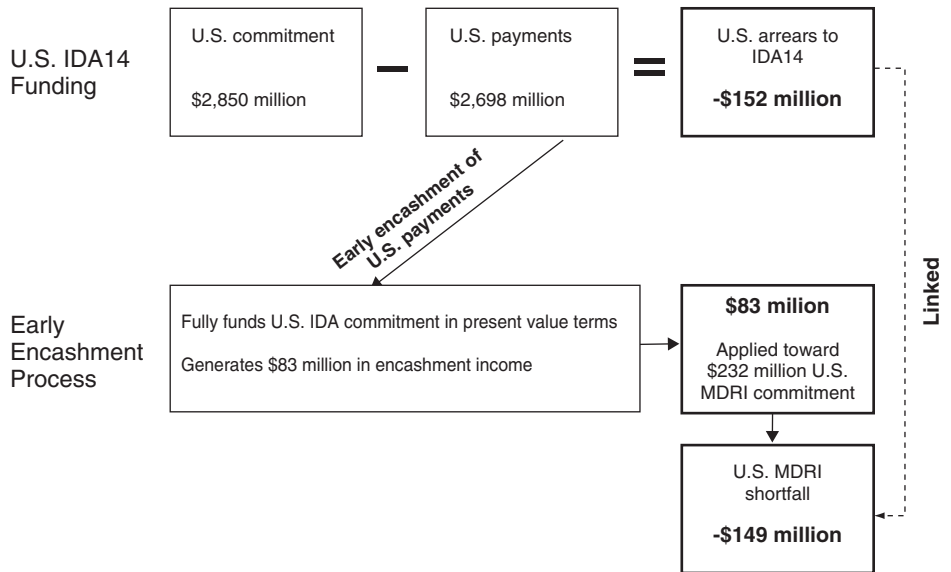
Because the United States is currently in arrears on its IDA14 replenishment commitment, the early encashment income the United States earns does not fully finance the current U.S. MDRI commitment. Under the early encashment process, the World Bank first uses early encashment income to fund the present value of the shortfall in the U.S. IDA replenishment before applying early encashment income to the U.S. MDRI commitment. As such, the present value of the U.S. replenishment to IDA14 will be fully funded before the MDRI obligation begins to be paid. As shown in figure 2, based on current U.S. payments, we estimate that the United States will generate sufficient early encashment income to fully fund the U.S. IDA14 replenishment commitment in present value dollars, with \$83 million in encashment income applied toward the \$232 million U.S. MDRI commitment. After applying its earned encashment income of \$83 million, the United States will have a shortfall of \$149 million in its MDRI commitment.¹⁹

¹⁷Some shortfalls in IDA funding are due to across-the-board funding rescissions reducing overall U.S. government funding levels, rather than withholdings specifically targeted at the World Bank to encourage reforms.

¹⁸The outstanding U.S. arrears to IDA are in nominal terms, which is the basis for U.S. commitments to IDA. Treasury officials emphasized that the nominal U.S. commitment to IDA is the required amount that must be paid. Early encashment has more than fully funded IDA on a present value basis.

¹⁹In 2008, the World Bank reported that the United States had a MDRI credit of \$232 million. This assumes that the United States will meet most of its obligations to the U.S. IDA14 replenishment under the early encashment schedule by June 30, 2009. *Debt Relief Provided by IDA under MDRI and HIPC Initiative: Update on Costs and Donor Financing, as of June 30, 2008*, International Development Association (Washington, D.C.: Oct. 1, 2008).

Figure 2: U.S. Replenishment, MDRI Commitment and Payments for IDA 14 (2006 through 2008, in millions of nominal dollars)



Source: GAO analysis of Treasury and IDA data.

Note: U.S. payments of \$2,698 million include a payment of \$47 million that will be encashed by June 30, 2009.

Treasury officials noted that if the United States ultimately pays its arrears to the IDA14 replenishment, early encashment income will then fund the U.S. MDRI commitment. However, to fully fund the U.S. MDRI commitment, (1) Treasury will need to release a withholding of \$94 million from the IDA14 replenishment, by reporting to Congress that the World Bank has accomplished transparency reforms required under U.S. law, and (2) Congress will need to appropriate approximately \$49 million in funds to compensate for the rescissions. Both actions will need to be completed by June 30, 2009. We estimate that the additional encashment income generated from releasing the \$94 million will amount to \$97 million and the shortfall in the U.S. MDRI commitment will decrease from \$149 million to \$52 million. A congressional appropriation of approximately \$49 million

by June 30, 2009 would generate enough early encashment income to finance the remaining \$52 million U.S. MDRI commitment.²⁰

Although it is unknown whether there will be any future shortfalls in U.S. replenishment payments, we assessed the impact of a shortfall on U.S. financing of MDRI similar to those that have occurred in recent years. The U.S. replenishment obligation for IDA for 2009 through 2011 is \$3.7 billion, which includes \$375 million for IDA's HIPC Initiative costs. In addition, the United States has agreed to pay \$356 million for its MDRI commitment, which Treasury plans to finance using early encashment. We assumed a 5 percent across-the-board shortfall, slightly less than the current 5.3 percent shortfall during the 2006 through 2008 period. (See app. V for further information on this simulation.) Under this scenario, the U.S. government would make payments of \$3.52 billion, leaving a shortfall of \$185 million. U.S. early payments would generate investment income of \$308 million. After first financing the replenishment shortfall, the remaining early encashment income of \$146 million would be used to pay the U.S. MDRI commitment of \$356 million, leaving a MDRI shortfall of \$210 million.²¹

ADF and Treasury have agreed to a different approach to calculate early encashment income that does not prioritize paying replenishment shortfalls before funding MDRI. All encashment income is solely used to pay the U.S. MDRI commitment. Excess encashment income is used to pay future U.S. MDRI commitments when needed. Any arrears or shortfalls in U.S. replenishment payments reduce encashment income proportionately. None of the early encashment income is used to offset regular replenishment shortfalls.

²⁰The amount of encashment income earned will depend on when IDA receives the \$94 million and \$49 million. If IDA receives this funding between July 1, 2009, and June 30, 2010, then encashment income credited to MDRI will be \$228 million, leaving a shortfall of \$4 million.

²¹The sum of MDRI encashment income (\$146 million) and replenishment shortfall (\$185 million) does not equal the amount of investment income (\$308 million). Different methods are used to estimate these nominal dollar amounts. Investment income is the sum of simple and not compound interest income. MDRI encashment income is estimated by using a present value methodology and then converting the figure to nominal dollars. In July 2007, IDA moved to a new accounting framework using U.S. generally accepted accounting principles (GAAP). Under U.S. GAAP, the IDA balance sheet will show that the U.S. government paid \$3.52 billion and will not count the \$185 million of earned investment income under this scenario. However, the IDA replenishment process will still allow countries to use encashment income to meet their replenishment obligations.

U.S. Early Encashment Income Insufficient to Fully Finance Future MDRI Debt Relief

The approach of funding the U.S. share of MDRI through early encashment income will not generate sufficient funding to meet the future U.S. commitment under the projected growth rate for future IDA replenishments.²² As we reported in our July 2008 correspondence, even if the United States pays its replenishments on time and in full, early encashment credits will be insufficient to finance U.S. MDRI obligations by 2014 for IDA and ADF.²³ Table 3 shows the relationship between the U.S. replenishments and the use of early encashment to finance U.S. obligations to MDRI under the World Bank’s projected average 7 percent growth rate for IDA replenishments.

Table 3: Projected U.S. MDRI Shortfalls under Projected Growth Rates in U.S. IDA Replenishments for IDA13 through IDA19 (In millions of nominal dollars)

	IDA13 (2003-2005)	IDA14 (2006-2008)	IDA15 (2009-2011)	IDA16 (2012-2014)	IDA17 (2015-2017)	IDA18 (2018-2020)	IDA19 (2021-2023)
U.S. MDRI obligation	N/A	232	356	529	636	726	1,024
	Actual			Projection period			
U.S. replenishment	2,850	2,850	3,705	3,992	4,263	4,541	4,921
U.S. replenishment growth rate	18%	0%	30%	8%	7%	7%	8%
U.S. MDRI shortfall	N/A	-149	0	-145	-225	-289	-550

Source: GAO analysis of Treasury and IDA data.

Notes:

The U.S. projected replenishment level is based on the World Bank’s projected growth rate in total IDA resources and assumes full and timely payment. IDA14 funding, which was reduced because the U.S. government paid only \$2,698 million due to withholdings and rescissions in U.S. law, is an exception. This circumstance has resulted in a shortfall in the U.S. MDRI obligation of \$149 million. For IDA12, the U.S. replenishment amount was \$2,410 million.

N/A – The U.S. government did not implement MDRI until July 2006.

The first row in table 3 shows the U.S. MDRI commitment from 2006 through 2023 in nominal dollars. Under this scenario, even if the U.S.

²²In contrast, the U.S. government has agreed to an approach that will result in full funding for the HIPC Initiative for IDA. As part of its regular replenishment, the United States will pay its share of IDA’s HIPC debt relief on a pay-as-you-go basis. The HIPC cost share of donors’ replenishments is paid over a 3-year period.

²³As we reported in July 2008, encashment income generated during ADF-12 is insufficient to cover U.S. MDRI costs for that period. However, in January 2009 ADF officials told us that accumulated surpluses from previous replenishment periods could offset the shortfall. Nonetheless, the shortfalls would increase during subsequent replenishment periods, rising to almost \$19 million by 2025.

government pays the replenishments on time and in full, there will be funding shortfalls for each replenishment period that will increase over time. We found that the U.S. government would need to increase its future replenishments to IDA by an average of 31 percent over the next 15 years, in order to fully fund its MDRI obligation using early encashment.

Early Encashment Is More Costly Than Other Options

Treasury's use of an early encashment approach to finance the U.S. share of MDRI debt relief has been more costly than paying U.S. MDRI costs directly because U.S. costs to borrow funds have been greater than the agreed-upon encashment interest rate for IDA and ADF. We estimate that during the replenishment period from 2009 through 2011, early encashment will cost the United States an additional \$39 million, \$41 million more for IDA and \$2 million less for ADF. (See app. VI for more information on this cost differential.) In September 2008, the Congressional Budget Office (CBO) forecasted Treasury note borrowing interest rates. For the 4-year period from fiscal year 2009 through fiscal year 2012, CBO projected the average borrowing cost to the U.S. government to be 5 percent. This interest rate is greater than the 4 percent interest rate used by IDA and the 4.69 percent used by ADF to calculate early encashment credits.²⁴

²⁴For CBO forecast data see <http://www.cbo.gov/budget/data/econproj.xls>.

The Extent to Which Countries Spend Debt Relief Resources to Reduce Poverty Is Unknown

We estimate that 41 countries²⁵ are to receive nearly \$44 billion in additional MDRI and HIPC resources from the four IFIs, but the degree to which the countries target these resources at poverty-reducing activities is unknown. The \$44 billion consists of freed-up resources resulting from HIPC Initiative²⁶ and MDRI debt relief, as well as a MDRI-related reduction and subsequent reallocation of IDA and ADF assistance.²⁷ The estimated amount by which IFI assistance will increase or decrease as a result of MDRI resource reallocation varies by country. The World Bank and IMF encourage countries to spend debt relief resources on activities to reduce poverty and make progress toward the UN Millennium Development Goals (MDG). Although the World Bank and IMF have suggested an association between reduced debt service payments and increased poverty-reducing expenditures, the extent to which countries spend debt relief resources on poverty-reducing activities is unknown. It is difficult to establish that debt relief has led directly to increased poverty-reducing expenditures for two reasons: (1) debt relief resources are difficult to track and (2) country spending data are not comparable and also may not be reliable.

Countries Projected to Receive Nearly \$44 Billion in Additional HIPC Initiative and MDRI Resources

Overall, we project that the 41 countries receiving debt relief are to receive \$43.8 billion in additional resources from the four IFIs between 2000 and 2054. As shown in figure 3, this estimate is based on three projected amounts:

- \$21.4 billion in HIPC debt relief,

²⁵Debt relief resources for this analysis are based on varying numbers of countries depending on which IFI and debt relief program, HIPC or MDRI, we are analyzing. For IDA, our analysis of the annual MDRI program is based on 41 countries.

²⁶While other creditors, including other IFIs and individual countries, also provide debt relief under the HIPC Initiative, our report focuses solely on debt relief provided by IDA, IMF, ADF, and IaDB.

²⁷In addition to providing debt relief, each year IDA and ADF are to reduce the amount of planned assistance to each eligible country by an amount equivalent to the debt relief to be provided that year. IDA and ADF are then to reallocate the aggregate amount of this funding to all eligible low-income countries (i.e., countries eligible to receive concessional loans from IDA or ADF, only some of whom receive debt relief) based on the institution's assessment of each country's performance.

-
- \$28.3 billion in MDRI debt relief²⁸ (IFIs will provide about 95 percent of MDRI debt relief by 2034), and
 - \$5.9 billion in reduced new IDA and ADF assistance resulting from MDRI's two-step process. Under this process, IDA and ADF reduce their new assistance to MDRI debt relief recipients by the amount of debt relief provided,²⁹ \$18.9 billion, and reallocate \$13.0 billion of this reduction to MDRI recipients.³⁰ IDA and ADF then reallocate the remaining approximately \$5.9 billion to all low-income countries eligible to receive only concessional resources from IDA or ADF³¹ that did not receive debt relief. IDA and ADF determine the amount of

²⁸For the purposes of this discussion, the combined total of HIPC Initiative and MDRI debt relief, \$21.4 billion and \$28.3 billion, respectively, is \$49.7 billion. This amount differs from the \$58 billion in total debt relief cited earlier—\$28.4 billion for HIPC and \$29.6 billion for MDRI—primarily due to differences in HIPC Initiative data. The \$21.4 billion HIPC amount does not include annual HIPC debt service relief data for all countries, as ADF, IaDB, and IMF did not provide annual data for all completion point, decision point, and pre-decision point countries. After 2006, IMF delivered the remaining HIPC assistance on a stock basis for countries that reached HIPC Completion Point, and therefore did not provide annual HIPC debt service relief data for the completion point countries after 2006. IDA told us that discrepancies between its aggregate reported HIPC data (\$15.0 billion) and our calculation based on the annual HIPC debt service relief (\$12.7 billion) was due, in part, to the arrears clearance mechanism. The MDRI amounts differ by \$1.3 billion primarily because the data for IMF covers only the 23 completion point countries.

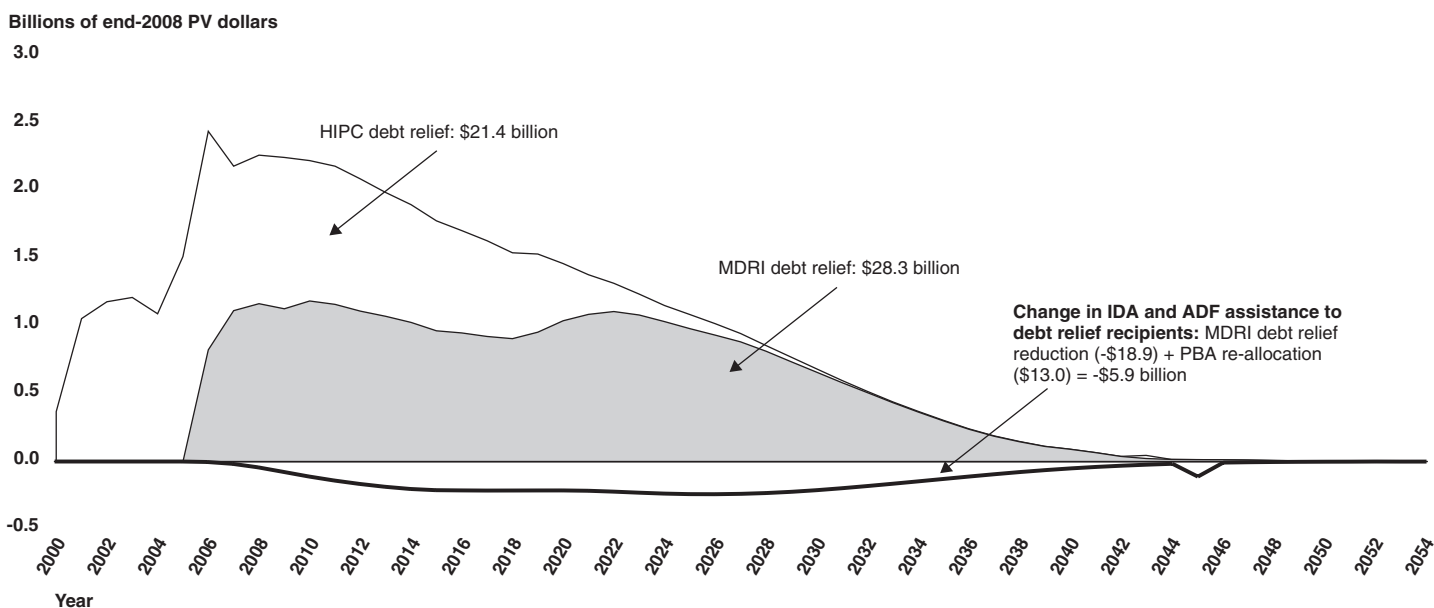
²⁹According to IDA's MDRI process, IDA reduces its annual commitments to a country by the amount of that year's MDRI debt relief. However, the associated annual reduction in disbursed assistance is only a portion of the reduction of the annual commitments. This is because the associated reduction in disbursements occurs over a 9-year period for IDA and a 10-year period for ADF. When analyzed taking into account the time value of money and these disbursement patterns, the aggregate net present value of MDRI debt relief, \$28.3 billion, is greater than the aggregate net present value of the reduction in disbursed assistance, \$18.9 billion, for countries receiving MDRI debt relief.

³⁰The annual MDRI debt relief reduction, aggregated over all MDRI recipients, is the amount to be reallocated to IDA-only recipients—a larger subset of IDA recipients than those that receive MDRI debt relief—on the basis of performance. We refer to this as the performance-based reallocation, or PBA reallocation.

³¹There are 23 IDA-only countries that will not receive MDRI debt service relief, but will receive the MDRI debt relief reallocation: Angola, Bangladesh, Bhutan, Cambodia, Cape Verde, Djibouti, Kenya, Kiribati, Kyrgyz Republic, Lao People's Democratic Republic, Lesotho, Maldives, Moldova, Mongolia, Nigeria, Samoa, Solomon Islands, Tajikistan, Timor-Leste, Tonga, Vanuatu, Vietnam, and Yemen. Three inactive IDA-only countries are excluded, namely Burma, Somalia, and Sudan.

funding each country is to receive primarily on the basis of country performance.³²

Figure 3: Projected HIPC Initiative and MDRI Annual Debt Relief and IFI Assistance due to MDRI, 2000-2054 (Billions of end-2008 present value dollars)



Source: GAO analysis of HIPC and MDRI data provided by IDA, ADF, laDB, and IMF.

Note:

The MDRI debt relief data covers the period 2006-2054 and includes all countries for IDA and ADF and only completion point countries for IMF and laDB, as these latter IFIs did not provide us with data for the interim and pre-decision point countries. The associated MDRI disbursements cover the period 2006 to 2062.

³²IDA bases the distribution of its resources on Country Performance Ratings, which reflect primarily an assessment of a country's policy and institutional framework, or CPIA, as established by the World Bank. The CPIA consists of 16 criteria representing the different policy and institutional dimensions of an effective poverty reduction and growth strategy. These 16 criteria are grouped into four clusters as follows: (1) *economic management*: macroeconomic management, fiscal policy, debt policy; (2) *structural policies*: trade, financial sector, business regulatory environment; (3) *policies for social inclusion/equity*: gender equality, equity of public resource use, building human resources, social protection and labor, policies and institutions for environmental sustainability; and (4) *public sector management and institutions*: property rights and rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilization, quality of public administration, and transparency, accountability, and corruption in the public sector. Population and per capita income are also determinants of IDA allocations.

The HIPC data in this figure cover the period 2000 to 2044 and include all 41 countries for IDA, the 25 completion point and decision point countries for ADF, and laDB's 4 completion point countries. We obtained limited annual HIPC Initiative data from IMF for completion point and decision point countries covering the period from 2006 onward as IMF delivered the remaining HIPC debt relief as stock reduction rather than on a flow basis and did not provide us annual HIPC data for these countries.

Net Change in IDA and ADF Assistance for Each Country due to MDRI Varies

Based on our projections, individual countries will have different results from MDRI as they realize increases, decreases, or both in their annual IDA and ADF assistance due to the resource reallocation process. For example, while the overall net change in resources³³ available due to MDRI is positive for each of the five countries we analyzed (Ethiopia, Ghana, Tanzania, Nicaragua, and Rwanda), the countries are projected to receive different amounts of new IDA and ADF assistance. Table 4 illustrates the overall projected impact of MDRI, including the net change in IDA and ADF assistance, for our five case study countries.

Table 4: Projected Change in New IDA and ADF Assistance due to MDRI for Five Countries (In millions of end-2008 present value dollars)

	Projected MDRI debt service relief	Projected change in new IDA and ADF assistance due to MDRI	Total net change in resources available due to MDRI
Ghana	\$2,069.7	\$(560.7)	\$1,509.1
Ethiopia	1,447.9	776.0	2,224.0
Nicaragua	1,014.7	(149.7)	865.0
Rwanda	214.0	92.2	306.2
Tanzania	2,037.3	206.2	2,243.5

Source: GAO analysis of IDA, laDB, ADF, and IMF MDRI data.

Notes:

These calculations are linked to IDA14 performance. See app. I for more information.

Totals may not sum due to rounding.

We project that, even as MDRI debt relief frees up fiscal resources, Ghana and Nicaragua may experience a decrease in IFI assistance over the life of MDRI due to the MDRI netting out and reallocation process. In contrast, for Tanzania and Ethiopia, we project that this MDRI process may result in an increase in assistance from IDA and ADF. For Rwanda, MDRI may

³³Net change in resources is the sum of MDRI debt relief, the IDA and ADF reduction in assistance due to MDRI debt relief, and the performance-based reallocation.

provide a mixture of increases and reductions in IDA and ADF's annual assistance over the MDRI period. (See app. VII for additional information on the impact of MDRI for our five case study countries, and app. VIII for additional information regarding the mechanics of the MDRI process.)

Countries Are Encouraged to Spend Debt Relief Resources on Poverty Reduction, but the Extent of Such Spending Is Unknown

While IFI and U.S. government documents state that countries should spend savings from debt relief on activities to reduce poverty and make progress toward the MDGs, the extent to which countries do so is unknown. In 2008, the World Bank and IMF suggested an association between reduced debt service payments and increased poverty-reducing expenditures, while acknowledging that it is difficult to show causation.³⁴ Specifically, these IFIs reported that since the late 1990s, the debt service payments of countries that received debt relief have declined by about 2 percent of GDP, while poverty-reducing expenditures have increased by about the same amount.³⁵ However, it is difficult to establish that debt relief has led directly to increased poverty-reducing expenditures for two reasons: (1) debt relief resources are difficult to track, and (2) country spending data are not comparable and also may not be reliable.

Debt Relief Resources Are Difficult to Track

The IFIs have suggested an association between debt relief and increased poverty-reducing expenditures. However, IMF and World Bank officials told us that they are unable to link debt relief resources directly to poverty-reducing expenditures because it is difficult to separate debt relief resources from other types of financial flows, such as international assistance and fiscal revenue. Based on the five case study countries, we found that these other resources often represent a much larger percentage of country budgets than savings from debt relief. For example, in the 2007 budgets of Ethiopia and Ghana, tax revenue and grant assistance represented at least 67 percent of government revenue combined, while

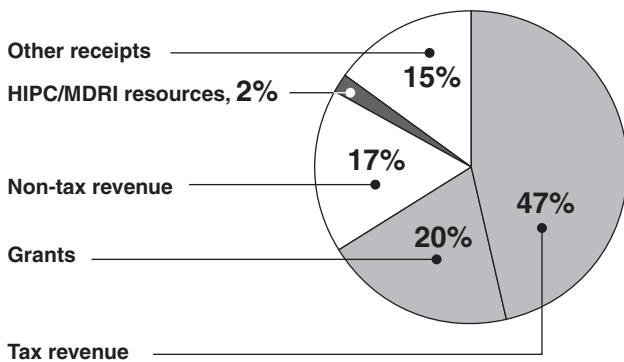
³⁴*Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation*, IMF and World Bank (Washington, D.C.: Aug. 27, 2008).

³⁵IMF and World Bank officials told us that it is difficult to estimate the amount of annual debt relief provided to countries due to lack of bilateral and private creditor data. As a result, the association discussed in IMF and World Bank documents is between debt service payments and poverty-reducing expenditures. The World Bank and IMF do not show any causation between debt service payments and poverty-reducing expenditures, but present a graphical representation of an association between rising levels of poverty-reducing expenditures and declining debt service payments. The underlying implication is that declining debt service payments are resulting from increased amounts of debt relief from the HIPC Initiative and MDRI.

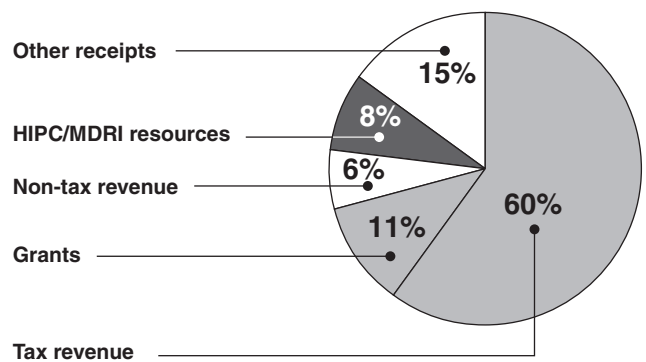
HIPC Initiative and MDRI debt relief resources represented less than 8 percent (see fig. 4).

Figure 4: Government Fiscal Revenue for Ethiopia and Ghana in 2007

Ethiopia fiscal revenue, in 2007



Ghana fiscal revenue, in 2007



Source: GAO analysis of IMF and World Bank data, and country budget documents..

Note: HIPC/MDRI resources include bilateral and multilateral HIPC relief and multilateral MDRI relief. Other receipts include external and domestic financing. For Ethiopia, the total percentage exceeds 100 due to rounding.

Spending Data Are not
Comparable and also May not
Be Reliable

Although IMF and the World Bank publish aggregated poverty-reducing expenditures for all countries that received debt relief, individual countries can define and report such expenditures differently, resulting in data that are not comparable. We found that definitions of poverty-reducing expenditures vary. For most countries that receive debt relief, reported poverty-reducing expenditures include spending on primary education, basic health care, and rural development; however, countries can also choose to include additional categories.³⁶ For example, as shown in figure 5, some countries consider expenditures in areas such as energy development, transport, or judicial systems as poverty reducing, while other countries do not.

³⁶We reviewed the most recent online country budget documents available on the five countries' Ministry of Finance Web sites to determine how countries were reporting their poverty-reducing expenditures.

Figure 5: Reporting of Five Countries' Poverty-Reducing Categories in 2007

	Ethiopia	Ghana	Nicaragua	Rwanda	Tanzania
Education	●	—	●	—	●
Primary education	—	○	—	○	—
Health	●	—	●	—	●
Public health	—	○	—	○	—
HIV/AIDs programs	—	—	—	—	○
Rural development	●	—	●	—	●
Poverty focused agriculture	—	○	—	—	—
Water/sanitation	—	—	●	—	●
Rural water	—	○	—	—	—
Roads/transport	●	—	●	—	●
Rural roads	—	○	—	—	—
Energy development	—	—	●	●	—
Rural electricity	—	○	—	—	—
Judicial systems	—	—	—	—	●

- Country reports on aggregate spending in this category, which it considers as poverty reducing
- Country reports on specific spending in this category, which it considers as poverty reducing
- Country does not consider this category as poverty reducing

Source: GAO analysis of IMF and World Bank data, and country budget documents.

Note: Nicaragua's country budget defined additional categories as poverty reducing, such as the Ministry of Development Industry and Trade, the Nicaraguan Institute for Fishery and Aquaculture, and the Social Investment Fund of Emergency.

Country definitions of poverty-reducing expenditures can also change over time to include or exclude categories. For example, in 2005, Rwanda expanded its definition of poverty-reducing expenditures to include energy development, while Nicaragua no longer included institutional strengthening. Such differences in definitions between countries, as well as changing definitions for particular countries, complicate comparability across countries and over time.

In addition, we found that three of our five case study countries report aggregate spending in broad areas such as education, health and rural

development rather than providing a detailed breakdown of poverty-reducing expenditures in these areas. For example, as shown above, while two countries (Ghana and Rwanda) reported specific spending in primary education and public health in their country budget documents, three countries (Ethiopia, Nicaragua, and Tanzania) reported only on aggregate spending in these two areas.³⁷ Aggregate spending data can include activities that do not directly affect the poor and may overestimate actual poverty-reducing expenditures. For example, a 2003 IMF and World Bank Poverty and Social Impact Analysis³⁸ for Nicaragua found that almost no public spending on university education affects the extremely poor, who generally do not participate at that level of the educational system.

Furthermore, country capacity to collect and report on poverty-reducing expenditures is questionable. According to several IFI assessments, countries receiving debt relief have numerous weaknesses in collecting and reporting information on poverty-reducing expenditures that raise doubts about the data's reliability. For example, a 2005 IMF assessment of country capacity to track poverty-reducing expenditures found that 19 out of 26 countries needed substantial upgrades to their data management systems and had weaknesses in tracking budgetary expenditures in areas such as budget formulation, execution and reporting.³⁹ IMF and the World Bank do not independently track poverty-reducing expenditures, and instead rely on country governments to provide such data even though the accuracy of these data and country capacity to provide such information

³⁷According to IMF officials, countries report to the IMF country teams on their poverty-reducing expenditures as outlined in their PRSPs. Each country determines the level of aggregation in its reporting, which can range from an aggregated total to a detailed breakdown of spending.

³⁸In 2001, the World Bank and IMF committed to a systematic assessment of poverty and the social impacts of policy reforms in low-income countries. The Policy and Social Impact Analysis applies tools and techniques of social and economic analysis to analyze impacts of economy wide policy reforms before those reforms are carried out (ex ante analysis), and more systematic use of that analysis to inform policy advice and policy design.

³⁹International Monetary Fund and World Bank, *Update on the Assessments and Implementation of Action Plans to Strengthen Capacity of HIPC's to Track Poverty-Reducing Public Spending* (Washington, D.C.: Apr. 12, 2005). Most recent assessments of HIPC performance in tracking budgetary processes are conducted under the Public Expenditure and Financial Accountability (PEFA) framework. PEFA is a partnership between the World Bank, IMF, the European Commission and several bilateral aid agencies. We found for the five case study countries that only three had PEFA assessments online, of which the most recent information provided was collected in 2006. For more information on PEFA, see <http://www.pefa.org/>.

are uncertain.⁴⁰ Additionally, the 2005 IMF assessment found that while 20 countries define poverty-reducing spending in their PRSPs, not all countries could identify these areas of expenditures in their budgets or report on such spending.⁴¹ Limitations in country capacity to report on poverty-reducing spending raise further concerns about the reliability of the combined data published by IMF and the World Bank.

Moreover, while it is difficult to establish that debt relief has led directly to increased poverty-reducing expenditures, it is even more difficult to determine if debt relief has improved progress toward the MDGs. We found that for all five of our case study countries, progress data on the MDG targets were often either lacking or incomplete.⁴² In 2008, IMF and the World Bank reported that it is difficult to quantify the impact of debt relief on the MDGs and that they have instead focused their analysis on linking debt relief and poverty-reducing expenditures.⁴³

⁴⁰According to IMF officials, when IMF country teams visit countries, they collect and attempt to standardize the countries' poverty-reducing expenditure data and send them to other IMF officials, who aggregate the data into one line item to be reported as poverty-reducing expenditures. The World Bank and IMF jointly publish annual poverty-reducing expenditure data in an annual debt relief status of implementation report. The reports show actual data from 2001 through 2007 and estimates from 2008 through 2012.

⁴¹Additionally, according to a 2006 ADF country assessment report, countries such as Ethiopia and Ghana experienced a number of weaknesses and challenges in their public expenditure management systems that caused delays in pro-poor spending and prevented timely internal reporting of budget execution. For additional information on this assessment, see the African Development Fund's *Implementation Modalities of the Multilateral Debt Relief Initiative* (Apr. 10, 2006).

⁴²We found for our five case study countries that some targets, such as access to drinking water, net enrolment ratio in primary education, and infant mortality rates, had more complete information.

⁴³World Bank officials also told us that insufficient time has passed since the inception of MDRI to assess the impact of poverty-reducing expenditures on attaining the MDGs, given that it takes time to realize the effects of investing in areas such as education and health care. However, some recent studies have attempted to examine the impact of the various aspects of the debt relief process, including the formulation of the PRSP on MDG outcomes. For additional information on these studies, see <http://www1.worldbank.org/economicpolicy/debtconf08/DebtConferenceMaterials.asp>

The World Bank and IMF Have Improved Their Country Debt Sustainability Analyses and Identified Numerous Actions Countries Should Take to Avoid Future Unsustainable Debt Levels

The World Bank and IMF have improved their country debt sustainability analyses (DSA) since 2005, including by addressing weaknesses that GAO and others have previously identified. If countries do not realize the objectives outlined in the new DSAs, they once again may experience unsustainable debt levels. These objectives are ambitious and could prove difficult for these poor countries to achieve over the course of the 20-year projection period.

World Bank and IMF Established New Approach That Improves Projections of Country Debt Sustainability

The World Bank and IMF introduced the Debt Sustainability Framework (DSF) in 2005 to provide a new and improved approach to assessing debt sustainability in low-income countries. The DSF is intended to

- help guide financing for low-income countries' development needs, while also reducing the chances of another excessive build-up of debt in the future;
- help detect potential problems early so that preventative action can be taken;
- improve World Bank and IMF assessments and policy advice; and
- provide guidance for country borrowing and creditor lending decisions.

Under the DSF, IMF and World Bank staff prepare DSAs, which project debt sustainability indicators over a 20-year period and are conducted

DSAs Determine Risk Based on the Strength of Country Performance and Analysis of Numerous Possible Scenarios

roughly every 12 to 18 months for low-income countries.⁴⁴ These DSAs include elements that were lacking in the past and address weaknesses that had previously been identified by GAO, such as overly-optimistic economic assumptions. Furthermore, DSAs now result in a linkage between debt sustainability and the composition of future IFI assistance (grants and concessional loans), thus addressing a previous GAO assessment that IFIs should provide grants as a way of addressing future debt concerns.

In a departure from prior DSAs,⁴⁵ the new DSAs consider the strength of a country's policies and institutions in assessing risk and determining sustainable debt loads; countries with strong policies and institutions are considered capable of successfully carrying greater levels of debt. The DSF uses the World Bank's CPIA index to sort countries into three policy performance categories (strong, medium, or poor). Countries with strong policies and institutions have a higher CPIA rating.⁴⁶ An acceptable risk of debt distress for current strong performers, such as Tanzania, allows for higher levels of debt compared to countries with currently low CPIA ratings, such as Sierra Leone. Furthermore, performance categories are

⁴⁴For IMF, DSAs are required in the context of Article IV consultation or a Poverty Reduction Growth Facility (PRGF) arrangement request or review. Article IV consultations are usually conducted annually with member countries, and IMF economists travel to the countries to gather and report on information collected from government, central bank, and other officials. PRGF arrangements link IMF low-interest lending closely to poverty-reducing efforts of countries, specifically to country PRSPs. IMF officials also noted that DSAs could be done on a stand-alone basis if, for example, the World Bank needed a joint DSA for its operations but there was no scheduled Article IV consultation or program review at that time. For the World Bank, the DSA is required for Country Assistance Strategies and IDA allocation purposes. For the purposes of this report, we are addressing DSA components relating to external debt sustainability and not the public debt issues also included in the analyses.

⁴⁵Prior to establishment of the DSF, IMF and the World Bank conducted analyses at a country's decision point and completion point to determine the level of debt relief that was required to bring a country's debt level to within HIPC Initiative targets. These debt relief analyses are still conducted and are not the focus of this report.

⁴⁶Strong performing countries have a CPIA rating of 3.75 or higher, while medium performers have a rating between 3.25 and 3.75 and poor performers have a rating of 3.25 or lower. In order to reduce uncertainty regarding appropriate creditor assistance that could be associated with potential annual fluctuations in a country's CPIA rating, a 3-year moving CPIA average is used to determine a country's performance. IMF officials explained that the empirical evidence establishing that countries with better policies and institutions can carry substantially higher debt burdens without increasing the risk of debt distress was reported by Aart Kraay and Vikram Nehru in "When Is External Debt Sustainable," *World Bank Economic Review*, Vol. 20, No. 3, August 28, 2006.

updated annually according to the latest CPIA ratings and, therefore, certain countries' annual performance categories have varied since the new process was introduced in 2005. For example, Burkina Faso's 2007 DSA noted that the country was a strong performer, but the country's CPIA rating was subsequently lowered and the 2008 DSA identified Burkina Faso as a medium performer. As a result, DSAs for Burkina Faso now require lower levels of debt in order to be categorized as debt sustainable. The new process provides flexibility to assess every country's risk differently based on individual performance, as well as an ability to adjust risk assessments within a specific country's DSA over time as CPIA ratings shift. Currently, of the 23 countries receiving HIPC Initiative and MDRI debt relief, a majority (14) have been identified as medium performers, 5 as poor performers, and 4 as strong performers.

DSAs conducted under the DSF now consider debt burden "threshold" indicators when assessing a country's debt sustainability position. Five thresholds have been established that provide key insights into a country's debt situation and that vary according to a country's CPIA-based performance category (see table 5). Other DSAs, on the other hand, assess primarily only one variable.⁴⁷ Strong performers have higher thresholds, indicating an ability to carry higher debt levels while maintaining debt sustainability.

Table 5: Debt Burden Indicator Thresholds Based on Country Performance Ratings

	Debt as a percentage of			Debt service as a percentage of	
	Exports	GDP	Revenue	Exports	Revenue
Strong	200	50	300	25	35
Medium	150	40	250	20	30
Weak	100	30	200	15	25

Source: Joint World Bank-International Monetary Fund, "Debt Sustainability Framework for Low-Income Countries."

In order to project a country's risk of future debt distress, these threshold indicators are compared against a country's performance under a "baseline" scenario based on assumptions of macroeconomic performance expected for the future in areas such as national income, inflation,

⁴⁷Prior to the establishment of the DSF, almost all countries' debt sustainability was assessed in the same manner and was defined as maintaining a debt stock-to-exports ratio of 150 percent or lower.

exports, imports, and government revenues and expenditures. Various sensitivity scenarios are also used to test the robustness of the indicators to changes in key assumptions. These scenarios include the following: (1) numerous temporary standardized “stress” or “shock” scenarios that consider possibilities such as lower growth in national income or exports than experienced in the past; and (2) two additional scenarios: (a) a scenario that assumes a level of public loans on terms that are less concessional, and (b) a historical scenario that uses macroeconomic assumptions based on past performance (which has often, but not always, been less optimistic than the baseline scenario in the past). IMF and World Bank staff explained that baseline assumptions will diverge from the historical scenario if the institutions agree that the economic outlook of a country has changed. Such changes must be explained in the DSA. For example, in the case of Tanzania’s 2007 DSA, a baseline GDP growth rate of 7.6 percent was used, rather than the historical 5.3 percent growth rate. According to the DSA, this change reflected “strong overall ratings of Tanzania’s macroeconomic policies, as well as ongoing structural reforms in key areas.”

A country’s risk of future debt distress is then categorized as follows:

- *Low risk* – All scenario debt burden indicators are well below the thresholds throughout the 20-year projection period, and sensitivity testing does not result in significant breaches of thresholds;
- *Moderate risk* – Debt burden indicators are below the thresholds under the baseline scenario, but sensitivity testing causes them to exceed thresholds;
- *High risk* – Debt burden indicators exceed thresholds under the baseline scenario, and sensitivity testing further exacerbates the situation; or
- *In debt distress* – Debt burden indicators are currently in significant or sustained breach of thresholds, and the country is already experiencing repayment difficulties.⁴⁸

As shown in table 6, for the 23 countries receiving HIPC Initiative and MDRI debt relief, 9 are classified at “moderate” risk of future debt distress,

⁴⁸IMF and World Bank officials told us that while the debt burden indicator analysis is the basis for determining a country’s future risk of debt distress, officials also use their judgment in making a final decision. For example, if a threshold is breached in a marginal or temporary way, a risk determination would take this circumstance into account.

4 at “high” risk, and 10 at “low” risk. IFI officials have considered refinements to the “moderate” risk classification that would provide greater distinctions within risk assessments, but have determined that there is currently no need to revise the category.

Table 6: Debt Risk Classification and CPIA Rating for Countries Receiving HIPC Initiative and MDRI Debt Relief

Performance rating	Risk of debt distress		
	Low	Moderate	High
Poor	Cameroon	Mauritania Sierra Leone	The Gambia Sao Tome & Principe
Medium	Bolivia Madagascar Mali Mozambique Senegal Zambia	Benin Ethiopia Guyana Malawi Nicaragua Niger	Burkina Faso Rwanda
Strong	Honduras Tanzania Uganda	Ghana	

Source: IMF-World Bank DSAs, 2007-2008.

Note: While Cameroon is classified as a poor performer under the CPIA rating system, it has a low risk of debt distress due to its low levels of external debt, according to IMF officials.

New DSA assessments of country debt sustainability under multiple scenarios address past concerns that DSAs only used one scenario, which may have contained overly-optimistic economic assumptions. For example, we reported in 1998, 2000, and 2004 that expected debt sustainability for debt relief countries was calculated based on one scenario that assumed high economic growth, including strong and sustained export growth.⁴⁹ We noted that such growth could be unrealistic given that many countries had very narrow export diversity (i.e., a limited number of exported goods), and these exports tended to be concentrated in the area of commodities that are highly vulnerable to events outside a country’s control, such as drought or price fluctuations. IMF officials told

⁴⁹See GAO, *Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative*, [GAO/NSIAD-98-229](#) (Washington, D.C.: Sept. 30, 1998); *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*, [GAO/NSIAD-00-161](#) (Washington, D.C.: June 29, 2000); and *Developing Countries: Achieving Poor Countries’ Economic Growth and Debt Relief Targets Faces Significant Financing Challenges*, [GAO-04-405](#) (Washington, D.C.: Apr. 14, 2004).

us that current DSAs use assumptions that have been lowered to more realistic levels. They also stated that DSAs, which include descriptions of macroeconomic assumptions, are now transparent because they are publicly available and subject to scrutiny by outside parties.⁵⁰ In addition, IMF officials noted that because DSAs are conducted on an annual basis, DSAs can now begin to incorporate events such as increases in food or fuel prices in a timelier manner.

However, IMF officials also noted that the current approach for determining future macroeconomic performance assumptions is “not a perfect science,” particularly when it makes projections over a 20-year period, and cannot be executed without potential forecast errors. In addition, a debt management capacity building group concluded that the sensitivity analyses contained in DSAs do not alter all relevant variables and exclude additional or secondary effects. It also reported that DSAs do not necessarily reflect all the risks that a country may think are likely in its own economic or borrowing prospects.⁵¹

IFIs Now Base Future Country Assistance on Risk of Future Debt Distress

IDA and ADF have adopted a revised system for providing future assistance based on DSA results. According to IDA officials, countries with a high risk of debt distress, or countries that are already in debt distress, receive 100 percent grant assistance, countries with a moderate risk of debt distress receive 50 percent grants and 50 percent concessional loans, and countries with a low risk of debt distress receive only concessional loans. ADF officials told us that ADF has adopted a similar system. According to World Bank officials, when a country’s risk of future debt distress changes, the change is reflected in IDA allocations annually.⁵² This approach directly aligns IDA and ADF assistance with a country’s assessed ability to repay debt, and is relevant to our past reporting that the

⁵⁰DSAs are available on the World Bank Web site at www.worldbank.org/debt and the IMF Web site at www.imf.org/dsa.

⁵¹*Strategies for Financing Development*, newsletter of the HIPC CBP and the FPC CBP, Issue 35, 2nd quarter 2008.

⁵²For example, when Mauritania’s risk rating changed from “low” to “moderate” in fiscal year 2008, IDA’s assistance to the country changed from 100 percent loans in fiscal year 2007 to 50 percent grants and 50 percent loans in fiscal year 2008. According to World Bank staff, this risk reclassification is due, in part, to the emergence of substantial arrears to external creditors that were previously considered “passive debt,” or debt for which creditors had not requested payment for many years. After Mauritania passed the completion point, the holders of these claims indicated that their claims had not been waived.

increased use of grant assistance would have a positive impact on future debt sustainability.⁵³ However, IDA and ADF reduce the volume of grant assistance provided under this system. Specifically, IDA and ADF reduce grant assistance by 20 percent for countries classified at a high or moderate risk of debt distress, thereby reducing resources available for poverty reduction. The 20 percent volume reduction is divided into an “incentives”-related portion and a “charges”-related portion.⁵⁴ The incentives-related portion is reallocated to IDA-only countries based on performance, and the charges-related portion is provided to creditworthy blend countries. According to IDA, this grant reduction was instated to maintain IDA’s performance incentive.⁵⁵

Other IFIs, such as IaDB and the Asian Development Bank, are also utilizing the new DSAs as part of their lending decision-making process, according to IMF and World Bank officials. In addition, OECD export credit agencies adopted a set of lending principles that adhere to IDA and IMF concessionality in January 2008.⁵⁶ Conversely, regarding borrowing decisions, IDA, ADF, and IMF officials stated that they work with country governments to improve their understanding and use of DSAs in future borrowing decisions. For example, IMF officials noted that DSAs are discussed as part of regular economic consultations with countries. Furthermore, according to an IMF and World Bank report, since 2005 eight training workshops have been organized in Africa, Asia, and Latin America and attended by officials from all 23 countries receiving HIPC Initiative and MDRI debt relief. However, IMF officials pointed out that countries

⁵³In 2002 we reported that a shift of multilateral loans to grants would lessen poor countries’ debt burdens, increasing their ability to repay future debt. See *Developing Countries: Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens*, GAO-02-593 (Washington, D.C.: Apr. 19, 2002).

⁵⁴During IDA14, the divide between the incentives-related portion and the charges-related portion was 11 percent and 9 percent, respectively. According to the World Bank, in fiscal year 2009, the divide was changed to 13 percent and 7 percent, respectively, reflecting no IDA commitment charge in fiscal year 2009.

⁵⁵IDA documentation notes that “Given the negative correlation between risk of debt distress and performance, grants based on debt sustainability can result in higher resource transfers to low-performing countries, thereby weakening the performance incentive. This weakening is moderated by applying the 20 percent discount to grant volumes.” See *The Role of IDA in Ensuring Debt Sustainability: A Progress Report*, International Development Association Resource Mobilization Department, September 2007.

⁵⁶IFI outreach to commercial creditors has been less active, with IMF and World Bank reports noting that progress is needed to improve DSA visibility with this group of creditors.

currently range widely in terms of their ability to use the DSA process to conduct their own analyses, and some country officials have said that they find the DSA process to be overly complicated.

DSAs Have Identified Numerous Ambitious Actions Countries Should Take in Order to Avoid Unsustainable Debt Levels

The new DSAs have cited many actions that countries receiving HIPC Initiative and MDRI debt relief should take in order to avoid unsustainable debt burdens in the future. Of the 23 countries receiving HIPC Initiative and MDRI debt relief, 13 (over 50 percent) have been found to have a moderate or high risk of future debt distress. These countries maintain this level of risk despite substantial HIPC Initiative and MDRI debt relief.⁵⁷ DSAs have stressed numerous policies or growth scenarios that countries should achieve in order to avoid further eroding their debt sustainability. For example, DSAs note that projected debt sustainability could be eroded if countries do not realize broad objectives that affect their overall economy, such as the following: continued concessional borrowing, implementation of sound macroeconomic policies, strengthened debt management capacity, sustained national income or export growth, and increased export diversity.

Such broad and ambitious objectives could prove difficult for countries to achieve over the course of the 20-year DSA period for various reasons. A country's debt position may be at risk even after it receives significant debt relief if, for example, its economy remains overly dependent on one export. For instance, Burkina Faso still held a moderate debt risk in 2007 despite World Bank and IMF reports that the HIPC Initiative and MDRI had substantially reduced its debt burden, because its economy is highly dependent on cotton exports (60 percent of total export value in 2006) which are vulnerable to large price fluctuations and weather shocks such as drought. In 2008, Burkina Faso's debt risk was elevated to high due to deteriorating country performance. Other unexpected factors beyond a country's control, such as oil and food import prices, may also affect economic position and debt sustainability. IMF and the World Bank have

⁵⁷For example, IMF and the World Bank reported that at the end of 2007, countries receiving both HIPC Initiative and MDRI debt relief had an average debt-to-exports ratio of 63 percent, while countries not yet benefiting from both programs had an average debt-to-exports ratio of 200 percent.

projected that countries may eventually return to pre-MDRI debt positions as they accumulate new debt over time.⁵⁸

Continued concessional borrowing is cited frequently as an action countries must take to maintain debt sustainability.⁵⁹ IFIs have taken actions to address the issue of excessive nonconcessional borrowing. While IFIs aim to lower the risk of debt distress in low-income countries by providing new financial assistance on appropriately concessional terms, other creditors and borrowing governments may gain from nonconcessional lending that is made possible following large-scale debt relief or in conjunction with IFI grant assistance. According to the World Bank, rating agencies may upgrade commercial risk ratings for countries that have received MDRI debt relief, improving the countries' ability to secure nonconcessional loans. The risk of realizing an unsustainable nonconcessional debt burden is particularly high in resource-rich countries that can more easily obtain nonconcessional borrowing by using expected future export earnings as collateral to back such loans. In addition, IDA has noted that countries are experiencing significant risks associated with their weak debt management capacity. Debt management offices in low-income countries lack adequate capacity to monitor and accurately record debt data and new resource flows, let alone effectively manage them.⁶⁰

IDA established a nonconcessional borrowing policy in 2006 to prevent the rapid reaccumulation of unsustainable debt.⁶¹ This policy states that IDA

⁵⁸This projection includes stable assumptions regarding borrowing and growth of national income and exports. See *Review of Low-Income Country Debt Sustainability Framework and Implications of the MDRI*, International Development Association and International Monetary Fund (Mar. 27, 2006).

⁵⁹A concessional loan is a loan extended by a creditor at below market terms. IDA's nonconcessional borrowing policy defines a loan with at least a 35 percent grant element as concessional. The grant element is the difference between the nominal value of a loan and the present value of a loan.

⁶⁰The World Bank and IMF are providing assistance to help low-income countries improve their debt management capabilities. For example, countries can use the Debt Management Performance Assessment as a diagnostic tool for identifying strengths and weaknesses in debt management operations. The World Bank and IMF also provide technical assistance in designing Medium-Term Debt Management Strategies (MTDS). An MTDS helps to operationalize a country's debt management objectives by outlining cost-risk tradeoffs in meeting a government's financing needs and payment obligations.

⁶¹See *IDA Countries and Non-Concessional Debt: Dealing with the 'Free Rider' Problem in IDA14 Grant-Recipient and Post-MDRI Countries*, Resource Mobilization Department (FRM) (June 19, 2006).

has two instruments at its disposal to confront excessive nonconcessional borrowing— reducing its assistance volumes (primarily used in countries where debt sustainability is a major concern) and “hardening” its lending terms in countries with stronger debt sustainability and greater financial market access. According to IDA staff, hardened lending terms could include an increased interest rate, a shorter grace period, or a reduced repayment period. IDA has also reported that these options come with trade-offs as volume cuts reduce resources available to pursue poverty reduction, and hardened terms may exacerbate debt sustainability problems. As of June 2008, IDA reported that there had been two cases of hardened lending terms (Angola and Ghana) and, as allowed, one exception (Mali) granted under its nonconcessional borrowing policy.⁶² IMF can impose limits on nonconcessional loans for countries that have a current arrangement with the institution.⁶³ For countries that do not have a loan arrangement with IMF, there is nothing IMF officials can do when countries borrow on a nonconcessional basis beyond consulting with borrowing country officials.

Conclusions

While HIPC Initiative and MDRI debt relief are projected to provide countries with additional resources, it is unknown how much of these additional resources countries will spend on poverty-reducing expenditures or pursuit of the MDGs. Furthermore, some countries may have difficulty maintaining debt sustainability, which requires demonstrating strong and sustained performance in numerous critical areas such as national income and export growth over the next several decades. The current U.S. approach for financing MDRI has several limitations. First, if the U.S. government does not fully pay its regular

⁶²In 2007, IDA granted Mali an exception to its nonconcessional financing policy to finance a power plant that would help ease a short-term crisis in the energy sector by increasing the country’s electricity generation capacity. Mali entered into a nonconcessional financing agreement for over \$70 million for this project. The country’s strong policies and institutions indicated an ability to manage modest levels of nonconcessional borrowing for a critical economic need. In addition, the power plant is expected to generate sufficiently high economic and financial rates of return to justify the loan. IDA has since granted to Rwanda and Mauritania two additional preliminary exceptions to its nonconcessional borrowing policy.

⁶³For example, IMF can impose ceilings on nonconcessional borrowing when countries have a PRGF arrangement loan or a Policy Support Instrument to help design IMF-approved economic programs that signal strong country policies to other parties. According to IMF officials, IMF can provide for exceptions to its nonconcessional borrowing limits.

contributions to IDA on time, which is currently the case primarily due to withholdings, early encashment funding will be used to cover shortfalls in U.S. funding to IDA, rather than to solely fund debt relief. Second, according to our estimates, the U.S. financing approach will likely result in future shortfalls for funding MDRI for both IDA and ADF as early as 2014, even if the U.S. government provides full funding in a timely manner. Given these limitations, reassessing the options for funding U.S. MDRI commitments for IDA and ADF is critical.

Recommendation for Executive Action

To address limitations in the U.S. approach for financing MDRI, we recommend that the Secretary of the Treasury consider the use of different funding options that clarify the priority between paying U.S. arrears owed to IDA and paying MDRI obligations, such as requesting separate appropriations from Congress.

Agency Comments and Our Evaluation

The Department of the Treasury, the World Bank, and IMF provided written comments on a draft of this report, which are reprinted in appendixes IX, X, and XI. Treasury stated that it is open to our recommendation that alternative U.S. funding approaches for MDRI be considered in the future. Treasury emphasized its objective to fully meet its current IDA and MDRI funding commitments while also noting that a lack of full funding would jeopardize this objective. In addition, Treasury expressed a view that World Bank and IMF analyses produced under the Debt Sustainability Framework represent an improved ability to assess the debt sustainability outlook in low-income countries. Treasury explained that while debt relief can be a valuable tool, merely canceling debt is not sufficient to ensure long-term debt sustainability if underlying economic vulnerabilities remain.

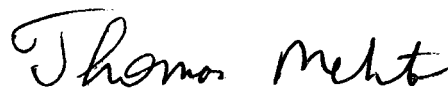
The World Bank stressed the importance of full funding for IDA and a sustainable U.S. funding approach to cover debt relief costs. The World Bank also noted that our report could more explicitly state that it will not be possible for the United States to fund future MDRI costs through early encashment of the regular IDA contributions. The World Bank reported that the annual MDRI costs of IDA will more than triple over the next two decades, reaching an estimated \$1.8 billion per year by 2025. Continuing the current practice would presuppose a commensurate increase in regular IDA contributions from the United States. The World Bank further noted that funds from debt cancellation are small, relative to domestic revenues and external aid flows in countries benefiting from the debt

relief, but represent a source of predictable financing for poverty-reducing expenditures.

IMF stated that poverty-reducing spending has increased in countries that have benefitted from debt relief - a point also made by Treasury. IMF further noted its disagreement with our position that the impact of debt relief on poverty-reducing spending is unknown. We maintain that our position is accurate since, while data compiled by IMF report that poverty-reducing spending has increased in countries receiving debt relief, it is not possible to link such increases to debt relief. Multiple factors, including challenges in tracking how debt relief resources are used and data reliability concerns, make it difficult to establish a linkage.

Treasury, the World Bank, IMF, and the African Development Bank provided technical comments on a draft of this report, which we have incorporated as appropriate. The World Bank's technical comments are included as part of its formal comment letter and suggested, as did IMF technical comments, that we better distinguish between recent debt sustainability analyses conducted under the Debt Sustainability Framework and other analyses conducted to establish the amount of debt relief needed to lower external public debt to agreed HIPC Initiative thresholds. We have altered our report to address this point. The African Development Bank provided comments on the U.S. costs for funding MDRI. We requested comments from IaDB, but none were provided.

We are sending copies of this report to other congressional offices and the Department of the Treasury, as well as the World Bank, IMF, AfDB, and IaDB. The report also is available at no charge on the GAO Web site at <http://www.gao.gov>. If you or your staff have any questions about this report, please contact me at (202) 512-9601 or at melitot@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Other contacts and major contributors are listed in appendix XII.



Thomas Melito
Director, International Affairs and Trade

List of Requesters

The Honorable John F. Kerry
Chairman
Committee on Foreign Relations
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Luis Gutierrez
The Honorable Barbara Lee
The Honorable Donald Payne
The Honorable Maxine Waters
House of Representatives

Appendix I: Objectives, Scope, and Methodology

Our objectives were to (1) analyze the U.S. financing approach for debt relief efforts, (2) review the extent to which the Multilateral Debt Relief Initiative (MDRI) might affect resources available to countries for poverty-reducing activities, and (3) assess revisions to the analyses conducted by the World Bank and IMF to review and promote future debt sustainability.

U.S. Financing for Debt Relief

To analyze U.S. financing for debt relief, we compiled data from Treasury and IFI staff and reviewed the U.S. contribution with these staff. To evaluate whether the U.S. approach to funding its IDA and ADF MDRI costs was adequate to fully pay U.S. commitments, we estimated total U.S. commitments in each IDA and ADF replenishment period and then used this amount in a simulation model of the U.S. payment schedule in order to estimate the amount of early payment credits that would be earned annually if Treasury continued to use the early encashment approach. To evaluate the early encashment approach the United States is using to finance its IDA and ADF MDRI costs during 2006-2011, we analyzed the statistical models that IDA and ADF are using to calculate U.S. encashment income. We performed simulations of shortfalls in U.S. replenishment payments and discussed our results with officials from Treasury and these IFIs. We developed a model to compare the costs to the United States of paying the MDRI obligation using the current early encashment approach rather than paying annual MDRI costs directly when due. Appendixes V and VI provide additional information regarding the costs associated with use of early encashment. We calculated and have presented all figures in this report in end-2008 present value dollars unless otherwise noted.¹ We assessed the reliability of the data analyzed and found the data to be sufficiently reliable for the purpose of this report.

MDRI and Resources Available for Poverty-Reducing Activities

To estimate the impact of MDRI debt relief on countries' resources, we calculated the aggregate net change in resources for MDRI recipient countries using an approach that considers the value of money over time. Our methodology reflects the three elements of MDRI's structure: MDRI debt relief, IDA and ADF reductions of annual assistance to the countries by the amount of debt relief provided in that year, and the reallocation of a portion of the cancelled debt service to countries based on their

¹We used a discount rate of 4.9 percent to compute present values. The IMF/IDA September 2008 "Status of Implementation" report used this rate in their present value cost updating exercise.

performance. IDA, ADF, and IaDB provided aggregate, annual debt relief and country-specific annual MDRI debt relief data for all current and expected future MDRI recipient countries, including our five case-study countries.² To calculate the aggregate reduction of annual assistance from IDA and ADF, we applied each IFI's encashment schedule to the disbursement of the annual MDRI debt relief that both IDA and ADF provided. While 1 year's debt relief is matched by a reduction in 1 year's IDA or ADF assistance, the reduction in assistance takes place over a 9-year disbursement cycle for IDA and a 10-year disbursement cycle for ADF.³ This annual MDRI debt relief reduction, aggregated over all MDRI recipients, is the amount to be reallocated to IDA-only recipients—a larger subset of IDA recipients than those that receive MDRI debt relief—on the basis of performance. We refer to this as the performance-based reallocation, or PBA reallocation. We discussed our methodology with IMF and World Bank officials. The staff of both IFIs concurred that our approach was a valid way to analyze MDRI.

To determine the portion of the MDRI debt relief to be reallocated to recipients as additional HIPC countries reach their completion point, we created a weighted allocation index based on data provided by the World Bank. The World Bank told us that the group of 23 completion point countries is currently receiving 50 percent of the reallocated cancelled debt relief funds, and that this would rise to 60 percent as the interim (decision point) countries⁴ reach their completion points, which is assumed to occur during 2009 and 2010. To determine the portion of the additional 10 percentage points that would go to each of the 10 interim countries, we created a weighted allocation index by dividing each country's projected percentage of IDA14 assistance flows by the portion of IDA14 assistance going to this group of 10 countries. To compute each

²Both IMF and IaDB are providing MDRI debt relief as debt stock reduction rather than on a flow basis. IMF provided data for 17 of the 23 MDRI recipients. We calculated IMF's annual debt service reduction based on outstanding MDRI-eligible debt for the remaining six countries (Cameroon, The Gambia, Malawi, Mauritania, São Tomé and Príncipe, and Sierra Leone) using data from IMF's external Web site.

³A World Bank official noted that the 9-year encashment schedule may vary on a country-by-country basis.

⁴The 10 interim countries used in this analysis are Afghanistan, Burundi, Central African Republic, Chad, Democratic Republic of the Congo, Republic of the Congo, Guinea, Guinea-Bissau, Haiti, and Liberia. Togo is not included in the list of interim countries because it reached the decision point on November 25, 2008, which is outside the scope of this analysis.

country's share of the IDA PBA reallocation, we multiplied their weighted allocation index by the 10 additional percentage points to calculate the portion of the 10 percent that each would receive. Finally, to calculate the changing PBA allocation over the period as the individual countries reach their completion point, we added each country's respective share of the 10 percentage points on to the 50 percent base, arriving at 60 percent in 2010. We used the same methodology to determine the additional portion of the MDRI pool of debt relief that would go to 8 pre-decision point countries,⁵ based on their projected completion point dates that the Bank provided. We assume that the pre-decision point countries will account for a proportional percentage of the 10 percentage points, reflecting their projected portion of IDA14 assistance flows. Based on this methodology, we estimate that, adding on the 8 pre-decision point countries, 41 HIPCs would receive about 67 percent of the reallocated MDRI debt relief and the remainder would go to all other low-income countries eligible to receive only concessional loans from IDA or ADF. ADF provided us with the amount of MDRI debt relief reallocated to all of its member countries, as well as the projected completion point dates for the HIPCs. To determine the portion of ADF's MDRI debt relief to be reallocated to recipients as additional HIPC countries reach their completion point, we added each country's percentage of total MDRI debt relief to the current reallocation percentage as countries successively reach their completion point. For ADF countries, by 2016, 33 HIPC countries would account for nearly 90 percent of ADF's reallocated MDRI debt relief. For all efforts to review the impact of MDRI on country resources, we assessed the reliability of the data analyzed and found the data to be sufficiently reliable for the purposes of this report.

We also included Enhanced HIPC Initiative debt relief in our analysis to present a more complete picture of the IFIs' contribution to debt relief. IDA, ADF, IaDB, and IMF provided annual data for Enhanced HIPC, by country. We included these data in our reported estimate of overall debt relief resources.

To calculate the impact of MDRI debt relief on individual countries, we selected five countries (Ethiopia, Ghana, Nicaragua, Rwanda, and Tanzania) as case studies based on several criteria, including dispersion of country ranking in terms of the percentage of total HIPC and MDRI debt

⁵The eight pre-decision point countries used in this analysis are Comoros, Cote d'Ivoire, Eritrea, Kyrgyz Republic, Nepal, Somalia, Sudan, and Togo.

relief they received from the four institutions, geographic diversity, and debt sustainability risk classification. In terms of percentage of debt relief received, we selected countries at or near the top, middle, and bottom of the ranking to use as examples of how the program works. Our choice of countries is meant to be illustrative, not representative. We used the same methodology to estimate the three components of MDRI debt relief for individual countries as we used in the aggregate.

To determine whether countries receiving debt relief are using the savings toward poverty reduction and achieving the MDGs, we reviewed documents provided by Treasury, the World Bank, IMF, ADF and IaDB, and spoke with officials at Treasury and these four institutions. We also examined publicly-available online data sources for poverty-reducing expenditures in areas such as education and health. To illustrate the impact of debt relief on individual nations, we examined the spending data for the five countries cited above. We reviewed the most recent Poverty Reduction Strategy Papers (PRSP) of the five countries in order to examine their poverty-reducing goals and objectives. In addition, we reviewed the most recent (2007) online country budgets and IMF Article IV consultation documents for our five case study countries to examine how countries were reporting their poverty-reducing expenditures.

Debt Sustainability Analyses

In order to assess revisions to IMF and World Bank debt sustainability analyses (DSA) since 2005, we first reviewed prior GAO reports issued between 1998 and 2004 that identified weaknesses in past DSAs. We then examined IMF and World Bank documentation explaining the Debt Sustainability Framework (DSF) and the related DSAs and other relevant issues, the following in particular:

- *Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries*, October 6, 2008;
- *Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation*, September 12, 2008;
- *IDA’s Nonconcessional Borrowing Policy: Review and Update*, June 2008;
- *Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief*, November 6, 2006;

- *How to Do a Debt Sustainability Analysis for Low-Income Countries*, October 2006;
- *IDA Countries and Nonconcessional Debt: Dealing with the “Free Rider” Problem in IDA14 Grant-Recipient and Post-MDRI Countries*, June 19, 2006;
- *Review of Low-Income Country Debt Sustainability Framework and Implications of the MDRI*, March 27, 2006; and
- *Operational Framework for Debt Sustainability Assessments in Low-Income Countries – Further Considerations*, March 28, 2005.

We then collected and reviewed all DSAs performed for 23 completion point countries since the DSF was implemented in 2005 as part of IMF Article IV consultations, IMF Poverty Reduction Growth Facility (PRGF) arrangement requests or reviews, or other events. We identified the assumptions and scenarios used, and compiled the most recent risk determinations for each country. We did not independently assess the accuracy or comprehensiveness of the assumptions and data included in the DSAs. We discussed the DSA process with IMF and World Bank officials and found the DSA information sufficiently reliable for descriptive purposes.

We compared the current process against the weaknesses we had previously identified to determine whether the new process addressed these limitations. Furthermore, we identified additional alterations to the process and interviewed IMF, World Bank, IaDB, and AfDB officials to obtain their views on the new DSA process and results. Finally, we compiled the results of DSAs to determine the debt distress risk of countries currently receiving HIPC Initiative and MDRI debt relief, as well as DSA recommendations for actions such countries should take in order to avoid future downgrading of their debt risk classification and deterioration of their debt sustainability. Our work focused on analyses related to external debt and not domestic public debt.

We conducted this performance audit from December 2007 through January 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Commercial Lawsuits to Collect Unpaid Debt from Debt Relief Countries

Lawsuits by commercial creditors to collect on outstanding HIPC country debt can erode gains made through debt relief. International courts and U.S. federal courts have allowed commercial creditors to pursue legal action in order to recover funds owed to them, but these creditors are sometimes viewed as creating difficult circumstances for countries that have received debt relief from other creditors.¹ As of the end of 2007, based on survey data provided by country governments, 47 litigating creditors had filed suits against 11 countries receiving HIPC Initiative and MDRI debt relief (see table 7). Over \$1 billion has been awarded by courts and is due to commercial creditors. About one-third of this total, or over \$440 million, has been awarded against the Republic of Congo, followed by over \$350 million against Liberia, and \$100 million against the Democratic Republic of the Congo.

Table 7: Commercial Creditor Lawsuits against Countries Receiving HIPC Initiative and MDRI Assistance (As of the end of 2007)

(Dollars in millions)

Country	Number of litigating creditors	Creditor claims	Court awards
<i>Completion Point Countries</i>			
Cameroon	4	\$158	\$51
Ethiopia	2	187	— ^a
Guyana	3	46	—
Honduras	1	1	—
Nicaragua	5	9	0 ^b
Sierra Leone	5	29	25
Uganda	6	36	30
Zambia	2	55	16
<i>Decision Point Countries</i>			
Democratic Republic of the Congo	1	100	100

¹Under the Foreign Sovereign Immunities Act, foreign states are not immune from the jurisdiction of U.S. courts in any case in which immunity has been waived, or in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States (28 U.S.C. §1605(a)(1), §1605(a)(2)).

**Appendix II: Commercial Lawsuits to Collect
Unpaid Debt from Debt Relief Countries**

Country	Number of litigating creditors	Creditor claims	Court awards
Republic of Congo	8	575	443
Liberia	10	130 ^c	357
Total	47	\$1,326	\$1,022

Source: "Heavily Indebted Poor Countries (HIPC), Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation," prepared by IDA and IMF staff, Aug. 2008; and IMF officials.

^aDashes indicate no information.

^bCourt awards against Nicaragua do not include amounts resolved through the Debt Reduction Facility.

^cCreditor claims against Liberia appear to be less than court awards because data regarding creditor claims are incomplete.

Treasury officials told us that while a court can award claims in favor of commercial creditors, actually enforcing the judgments and receiving payment is a separate, potentially more difficult exercise.

The international community has taken numerous actions to address such cases:

- The World Bank’s Debt Reduction Facility (DRF) allows governments to buy back—at a deep discount—country debts owed to external, commercial creditors. Through grants, the DRF supports heavily indebted IDA-only countries that undertake reforms to retain professional services necessary in preparing these commercial debt reduction operations and assists the countries in funding the cost of these operations. For example, court judgments against Nicaragua were settled through the DRF-supported buyback. All four litigating creditors participated in the buyback operation and accepted a significant cut in the value of their legal claims. The Nicaragua buyback extinguished about \$1.3 billion in commercial debt. Another buyback operation has been concluded for Mozambique. Furthermore, according to Treasury officials, a DRF operation is currently being prepared for Liberia, and the United States intends to contribute \$5 million to help fund the cost of this buyback.
- Paris Club creditors have committed as a group not to sell claims on HIPC countries to creditors who do not intend to provide debt relief.²

²Press Release of the Paris Club on the Threats Posed by Some Litigating Creditors to Heavily Indebted Poor Countries, Paris Club (May 22, 2007).

- In April 2008, AfDB approved a proposal to establish the African Legal Support Facility (ALSF), which would provide (1) technical legal advice to members of the facility in creditor litigation, and (2) technical legal assistance to members of the facility to strengthen their legal expertise and negotiating capacity in matters related to debt management and other issues.³ The U.S. government was the only participating state to vote against establishment of the ALSF, and Treasury officials have noted that countries that have been the target of recent litigation have had very able legal representation to date, calling into question the need for ALSF assistance. In addition, Treasury staff expressed a position that some of the proposed activities for the ALSF are not an appropriate use of AfDB funds and noted concerns over the substantial administrative costs associated with ALSF. Furthermore, Treasury staff have emphasized that the DRF—an option already in operation that is achieving results in reducing country debt burdens to commercial creditors—is a preferred alternative.

³The African Legal Support Facility, which is not yet operational, will come into existence when the agreement creating the facility is signed by at least 10 participating states or international organizations, and instruments of ratification, acceptance, or approval are deposited by at least 7 of those participating states or international organizations.

Appendix III: Funding Provided for the HIPC Initiative and MDRI

IDA and ADF have not secured all financing that will be required to meet their HIPC Initiative and MDRI debt relief commitments for countries currently receiving such relief, though IADB and IMF have secured all necessary funding. Overall, about 65 percent of the \$47 billion in funding required to cover debt relief over the next several decades has been secured. Countries have currently received about \$14 billion in debt relief. Overall, we project that the U.S. government is committed to provide about \$8.4 billion in funding for the HIPC Initiative and MDRI.

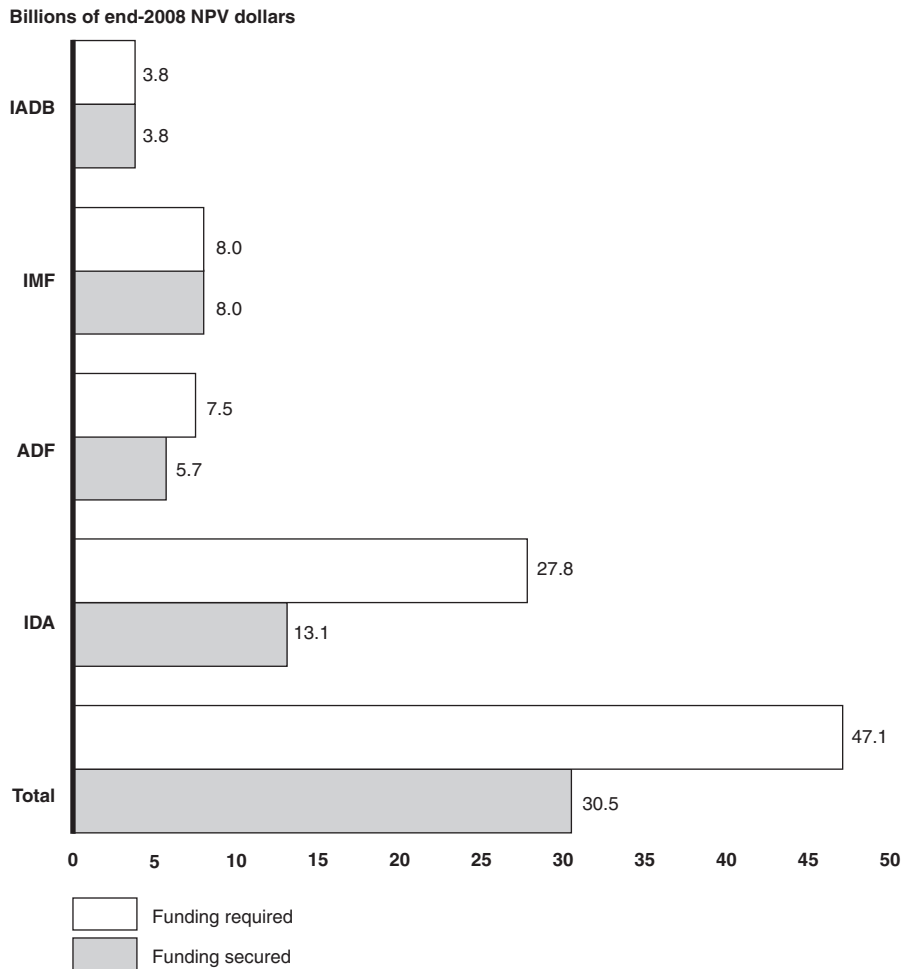
IDA and ADF Have Not Secured All Necessary Financing

Of the \$27.8 billion required to finance IDA's HIPC Initiative and MDRI debt relief for the 33 countries currently receiving such relief, IDA has secured about \$8.6 billion for the HIPC Initiative and \$4.4 billion for MDRI (see fig. 6).¹ This total of \$13.1 billion represents 47 percent of the total required financing for both debt relief initiatives.²

¹Secured funding includes donor commitments that are part of the IDA15 replenishment to cover IDA's costs for the HIPC Initiative (\$1.7 billion) and arrears clearance for HIPC countries (\$1.1 billion).

²In addition, IDA, ADF, IADB, and IMF will need an estimated \$11 billion in additional financing to cover countries that are not yet eligible to receive debt relief: 8 countries under the HIPC Initiative and 18 countries under MDRI.

Figure 6: IFI HIPC Initiative and MDRI Debt Relief Funding Required and Secured for Countries Currently Receiving Debt Relief Assistance



Source: GAO analysis of IMF and World Bank documents and data.

Note: Funding includes amounts for the 23 countries receiving HIPC Initiative and MDRI debt relief and 10 additional countries receiving only HIPC Initiative debt relief. Funding amounts do not include the eight countries that have not yet met the requirements to receive debt relief under either program.

IDA previously financed the HIPC Initiative primarily through transfers from the World Bank's International Bank for Reconstruction and Development.³ Beginning in July 2006, this financing process changed and

³These IBRD transfers were from income earned primarily from interest payments by middle-income borrower countries.

became part of the regular 3-year replenishment process. Donors have agreed to finance MDRI costs on a “dollar for dollar” basis (i.e., total MDRI costs will be covered) in conjunction with, and in addition to, replenishment contributions through 2044.⁴

According to our projections, ADF is to provide about \$7.5 billion in HIPC Initiative and MDRI debt relief and has secured about \$5.7 billion, or more than 75 percent, of this amount. ADF has secured \$4.6 billion for the HIPC Initiative and \$1.1 billion for MDRI. ADF is financing the HIPC Initiative from internal African Development Bank resources and donor contributions, all of which are channeled through the HIPC Trust Fund administered by the World Bank. As with IDA, donors have agreed to finance ADF’s MDRI costs on a “dollar for dollar” basis in conjunction with, and in addition to, replenishment contributions through 2054.

IMF and IaDB Have Secured HIPC Initiative and MDRI Funding

IMF and IaDB have fully financed their \$8 billion and \$3.8 billion of HIPC Initiative and MDRI debt relief for the countries currently receiving such relief, respectively, using internal resources and donor-provided funds.⁵ Because these two institutions have fully funded their HIPC Initiative and MDRI debt relief for the countries currently receiving debt relief, almost 65 percent of total debt relief costs for all four IFIs have been secured. To fund HIPC Initiative and MDRI debt relief, IMF uses internal resources, including proceeds from its 1999 and 2000 off-market gold sales, and donor contributions. IMF has also secured some of the funds to cover its future debt relief costs for the countries not yet receiving debt relief.⁶ IaDB has fully financed its HIPC Initiative debt relief from internal resources and donor funding through the HIPC Trust Fund. With the advent of its

⁴While donors provide funding for the HIPC Initiative as part of their regular replenishment funding, donors provide additional funding for MDRI in conjunction with their replenishment funding.

⁵While IFIs can provide debt relief either by canceling debt service payments as they come due (referred to as “flow” debt relief) or by canceling a portion of a country’s outstanding debt (known as “stock” debt relief), the approach makes no difference to the countries receiving debt relief as they only realize the benefits of additional available resources as debt payments that would have come due are no longer required to be paid. The present value costs of either approach are the same for the IFI.

⁶IMF has an estimated \$0.54 billion to cover un-anticipated HIPC Initiative costs (referred to as topping-up assistance) as well as future debt relief costs for Somalia and Sudan, countries with protracted arrears of about \$1.8 billion as of the end of November 2008. Additional financing may be required when these countries are ready to clear their arrears and embark on the HIPC Initiative.

MDRI-like program in 2007, IaDB created a blended loan product made up of concessional and nonconcessional funds, according to Treasury officials. The process of creating this blended product freed up resources to be used for debt relief while allowing IaDB to continue to provide concessional lending. Furthermore, Treasury officials noted that IaDB took other measures to obtain additional resources, such as canceling undisbursed portions of nonperforming concessional loans, to gain access to additional funding. IaDB freed up sufficient internal resources to provide debt relief for its four member countries receiving HIPC Initiative and MDRI debt relief as well as reserves of about \$0.4 billion for Haiti when it completes both programs.

Countries Have Realized \$14 Billion in Debt Relief Assistance

Countries currently receiving debt relief have thus far realized less than a third of expected assistance. Countries realize the benefits of debt relief as annual debt service payments to IFIs that would have come due are no longer required to be paid. Debt relief provides the countries with additional available resources that they can spend on other activities, such as poverty-reduction programs. Table 8 shows the amount of debt relief assistance that each IFI has delivered compared to the required amount of assistance that has been approved.⁷

Table 8: Total HIPC Initiative and MDRI Debt Relief Required and Delivered to 33 Countries Currently Receiving Debt Relief Assistance (In billions of end-2008 present value dollars)

	Total	IDA	ADF	IMF	IaDB
Funding required	47.1	27.8	7.5	8.0	3.8
Delivered debt relief	14.3	6.2	2.1	4.8	1.2
—HIPC debt relief	11.4	5.2	1.9	3.2	1.0
—MDRI debt relief	2.9	1.0	0.1	1.6	0.2
Delivered as % of required	30%	22%	28%	60%	32%

Source: GAO analysis of IMF, IDA, ADF, and IaDB documents and data.

Notes:

Totals may not sum due to rounding.

⁷In order to provide comparable debt relief delivered figures for the four IFIs, we estimated the amount of debt service relief through 2008 implied by the debt stock cancellation by IMF and IaDB.

Appendix III: Funding Provided for the HIPC Initiative and MDRI

Required funding includes 23 countries receiving HIPC Initiative and MDRI debt relief and 10 additional countries receiving only HIPC Initiative debt relief (MDRI funding is not included for these 10 countries). Funding does not include the eight countries that have not yet met the requirements to receive debt relief under either program.

The IFIs have delivered a total of \$14.3 billion in debt relief, which is 30 percent of the approved \$47.1 billion for the 33 countries. IDA has delivered the largest amount, \$6.2 billion, representing 22 percent of its approved \$27.8 billion in debt relief assistance. IMF has delivered \$4.8 billion, or 60 percent, of its approved \$8 billion in debt relief. The HIPC Initiative has delivered nearly 80 percent, or \$11.4 billion, of the debt relief delivered to date. Countries began receiving HIPC Initiative debt relief benefits in 1998, whereas MDRI debt relief began in 2006.

Appendix IV: U.S. Bilateral HIPC Initiative Debt Relief

Table 9 shows the budget cost and the amount of bilateral debt relief the U.S. government has provided or is projected to provide to 30 countries under the HIPC Initiative.

Table 9: U.S. Bilateral Debt Relief Provided under the Enhanced HIPC Initiative

Country	HIPC Decision Point	Nominal bilateral debt (millions of dollars)	Budget cost ^a	Budget cost as percent of cancelled debt
Completion Point HIPCs				
Bolivia	Feb-00	\$59.5	\$28,926,235	49
Cameroon	Oct-00	47.7	15,585,552	33
Ethiopia	Nov-01	64.6	8,917,788	14
Ghana	Feb-02	11.3	3,660,831	32
Guyana	Nov-00	34.1	6,455,791	19
Honduras	Jun-00	54.1	20,430,401	38
Madagascar	Dec-00	8.5	6,500,000	76
Mali ^b	Sep-00	0	3,584	28
Mauritania	Feb-00	7.1	2,266,122	32
Mozambique	Apr-00	5.0	1,630,059	33
Nicaragua	Dec-00	42.2	11,359,365	27
Niger	Dec-00	4.1	1,330,360	32
Rwanda	Dec-00	1.6	117,121	7
Senegal	Jun-00	8.6	4,040,014	47
Sierra Leone	Mar-02	71.4	3,711,261	5
Tanzania	Apr-00	16.2	2,411,274	15
Uganda	Feb-00	0.2	101,141	51
Zambia	Dec-00	280.3	17,159,357	6
Sub-total		\$716.5	\$134,606,256	19
Interim HIPCs				
Afghanistan	Jul-07	\$114.3	\$7,148,394	6
Central African Republic	Sep-07	6.9	373,334	5
Congo, Democratic Republic of ^c	Jul-03	1,668.6	176,699,730	11
Congo, Republic of	Mar-06	56.9	5,067,204	9
Guinea	Dec-00	122.4	15,906,602	13
Haiti	Nov-06	14.4	2,798,751	19
Liberia	Mar-08	422.7	36,905,617	9
Sub-total		\$2,406.2	\$244,899,632	10

**Appendix IV: U.S. Bilateral HIPC Initiative
Debt Relief**

Country	HIPC Decision Point	Nominal bilateral debt (millions of dollars)	Budget cost^a	Budget cost as percent of cancelled debt
Pre-Decision Point		(Estimated)	(Estimated)	(Estimated)
Cote D'Ivoire, Eritrea, Somalia, Sudan, and Togo ^d	—	\$1,600.0	\$126 million	8
Total		\$4,722.7	\$505,505,888	11

Source: GAO analysis of U.S. Department of the Treasury data as of November 1, 2008.

Note: Eleven countries for which the U.S. government is or was not a creditor are omitted.

^aExpected nominal bilateral debt relief as of HIPC Decision Point. For countries that have not reached HIPC Completion Point, full debt relief is dependent on successful completion of the HIPC Initiative requirements, and associated budget costs should be considered estimates.

^bAmount of "0" indicates nominal debt was less than \$50,000. Actual debt forgiven for Mali was \$12,800.

^cThe expected nominal debt relief and estimated budget cost listed for the Democratic Republic of the Congo are contingent on the availability of sufficient appropriations and have not yet been fully committed.

^dThe aggregate amounts listed for these pre-decision point countries should be considered rough estimates only and may change over time. Inclusion on this list does not guarantee future debt relief. Potential bilateral HIPC debt relief for countries in this category is contingent on successfully meeting the HIPC Initiative requirements, as well as compliance with U.S. legal requirements and the availability of sufficient appropriations.

Appendix V: Calculation of Early Encashment Credits

We calculated the outcome of the early encashment approach to funding the U.S. MDRI commitment under a scenario (1) where the U.S. government makes its payments in full and on time, and (2) where the U.S. contribution is 5 percent less than required. Our analysis demonstrates the significant impact on early encashment income and actual U.S. funding levels for MDRI when funding reductions, similar to those experienced in recent years, are realized.

The following is our explanation of the early encashment process. We use the same assumptions that are being used by Treasury and IDA, but describe the process in nominal dollars. The U.S. government plans to pay its share of IDA's debt relief costs for MDRI from the encashment income generated by paying its regular IDA replenishment commitment over a 4-year period, rather than over the standard 9-year period. Table 10 describes this process.

Table 10: Early Encashment Income When Replenishment Is Paid in Full

(Dollars in millions)

Fiscal year	Standard encashment schedule	Early encashment schedule	Excess payment balance	Encashment investment income
	(a)	(b)	(c)	(d)
2009	\$252	\$1,112	\$860	\$34
2010	478	1,235	1,617	65
2011	678	1,235	2,174	87
2012	582	124	1,715	69
2013	519		1,197	48
2014	422		774	31
2015	322		452	18
2016	259		193	8
2017	193		0	0
Total (nominal)	\$3,705	\$3,705		\$359
Total (present value)	\$3,114	\$3,414		
Percent face value		9.63		
Early encashment credits		\$357		

Source: GAO analysis of Treasury and IDA documents.

Note: Totals may not sum due to rounding.

The U.S. replenishment obligation for IDA15, which covers the period 2009 through 2011, is \$3.7 billion.¹ Column (a) describes the annual standard encashment or payment schedule over the 9-year period from 2009 through 2017. Column (b) is the annual U.S. payment over a 4-year period. Column (c) is the annual outstanding excess payment. In 2009, this amount consists of the difference between what the U.S. government pays, \$1.1 billion, and the required amount of \$252 million. In subsequent years, it consists of the annual excess in payment plus the outstanding excess payment balance. Beginning in the fifth year, no new payment is made. The excess payment balance is used to cover the required payment. In the ninth year, the excess payment balance is just sufficient to pay the last year's required payment. Column (d) is the annual encashment investment income. This amount is the estimated earned income calculated by multiplying the excess payment balance by the agreed-upon interest rate, which is 4 percent for the IDA15 replenishment. The line "Total (nominal)" shows that the total payments under the standard encashment schedule is equal to the total under the early encashment schedule. The total nominal dollar earned income is \$359 million.

Treasury and IDA use a different method to compute early encashment income. Under their method, Treasury and IDA first calculate the present value sum of the payment schedules. The present value is a statistical method that takes into consideration the amount of annual payments, the time during which these payments are made, and the interest rate when computing the sum. Although the nominal sums of the two schedules are the same, the present value of the early encashment schedule, \$3,414 million, is larger than that of the standard schedule, \$3,114 million. Treasury and IDA compute the percent face value as the difference between these present values divided by the present value of the standard schedule. The percent face value, 9.63 percent in this example, is multiplied by the nominal sum of early encashment payments, \$3,705 million, to calculate the early encashment income of \$357 million.² This is the agreed-upon methodology and \$357 million will be used toward paying the U.S. IDA MDRI commitment of \$356 million. The surplus \$1 million can be used to pay future MDRI obligations.

¹IDA15 covers the period July 1, 2008, through June 30, 2011, the IDA fiscal year 2009 through fiscal year 2011.

²The early encashment credits are not exactly the same as the interest income earned. Two different computation techniques are used. The present value approach is the agreed-upon methodology used to calculate early encashment credits.

In the previous example, the U.S. government pays its replenishment in full and all the early encashment income is used to pay its MDRI obligation. In the next example, we assume that the U.S. government does not pay its replenishment in full, either due to a rescission or a decision to withhold payment until certain reforms are made by the World Bank. Under the agreed-upon methodology, early encashment income is first used to pay off the replenishment shortfall. Any remaining encashment income is then used to pay the U.S. IDA MDRI commitment. Table 11 describes the calculation of early encashment income when there is a replenishment shortfall. We assume an across-the-board shortfall in U.S. annual payments of 5 percent, resulting in a shortfall of \$185 million.³ Thus, the total nominal early encashment payments are \$3,520 million. Since the annual U.S. payments are less, the earned income in column (d) is less: \$308 million or a 14-percent reduction. The calculated early encashment income to pay for the U.S. MDRI commitment is \$146 million, a 59 percent reduction. Most of the earned encashment income is used to pay the replenishment shortfall. If the across-the-board shortfall were 8.8 percent or more of the replenishment, all of the earned encashment income would be used to pay the shortage and nothing would be used to pay the U.S. MDRI commitment.

Table 11: Early Encashment Income When There Is a 5 Percent Shortfall in Replenishment Payments

(Dollars in millions)

Fiscal year	Standard encashment schedule	Early encashment schedule	Excess payment balance	Encashment investment income
	(a)	(b)	(c)	(d)
2009	\$252	\$1,056	\$804	\$32
2010	478	1,173	1,499	60
2011	678	1,173	1,995	80
2012	582	117	1,530	61
2013	519		1,011	40
2014	422		589	24
2015	322		267	11
2016	259		7	0.3

³The preliminary shortfall for IDA 14 is \$152 million, about 5.3 percent of the replenishment commitment. This was not an across-the-board reduction.

Appendix V: Calculation of Early Encashment Credits

Fiscal year	Standard encashment schedule	Early encashment schedule	Excess payment balance	Encashment investment income
2017	193		0	0
Total (nominal)	\$3,705	\$3,520		\$308
Total (present value)	\$3,114	\$3,243		
Percent face value		4.15		
Early encashment credits		\$146		

Source: GAO analysis.

Note: Totals may not sum due to rounding.

Treasury and ADF have agreed to use a different methodology to compute early encashment income. We applied this ADF approach to the IDA15 replenishment. If there is no funding shortfall, the results are identical between the two approaches. When there is a shortfall, the ADF approach implicitly reduces the standard encashment schedule payments by the average across-the-board percentage shortfall. Thus, the nominal total of the standard encashment schedule is the same as the total early encashment schedule payments. In the previous example with a 5 percent shortfall, the computed early encashment income would total \$339 million and all of this amount would be used to pay the MDRI obligation. None of the earned encashment income would be used to pay the shortfall to IDA.

Appendix VI: Early Encashment Costs More than Alternative Financing

Under some conditions the early encashment approach to pay the U.S. MDRI commitment may be more costly than paying the annual MDRI obligations directly when they are due. If the cost for the U.S. government to borrow the funds exceeds the agreed upon interest rate used to compute early encashment income, then the early encashment approach is more costly than paying the U.S. replenishment and MDRI obligations annually as they come due. Conversely, if the borrowing cost to the U.S. government is less than the agreed-upon interest rate used to compute early encashment income, then the early encashment approach is less expensive.

According to the Congressional Budget Office, the average medium-term cost to borrow funds during fiscal year 2009 through fiscal year 2012 is projected to be 5.0 percent.¹ This amount is greater than the 4.0 percent agreed-upon interest rate used to compute early IDA encashment income. Under these conditions, the early encashment approach to finance the U.S. IDA MDRI commitment is more costly than paying the U.S. commitment directly.

Assuming that the full replenishment and IDA MDRI commitments are paid, we estimate that the cost to the U.S. government for early encashment payments, including financing costs for IDA15, will be \$3,347.2 million in end-2008 present value dollars. This is about \$38 million more than the cost of paying IDA15 replenishment and MDRI obligations annually as they come due, a total of \$3,309.6 million. In nominal dollars, we estimate the additional cost is \$42 million. Since early encashment income earned is \$1 million more than MDRI obligations, the net additional cost is \$41 million.

A similar cost analysis for ADF-11 in end-2008 present value terms shows that the early encashment cost, including financing costs, is \$416.8 million, about \$12.2 million more than the cost of paying ADF-11 replenishment and MDRI obligations annually as they come due, a total cost of \$404.6 million. This reflects the higher government cost of borrowing, 5 percent, than the 4.69 percent used by ADF to calculate early encashment income. Again we have assumed that the United States pays its full replenishment and ADF MDRI commitment. In nominal dollars, we estimate the

¹Congressional Budget Office, Table C-2, CBO's Year-by-Year Forecast and Projections for Fiscal Years 2008 to 2018, *The Budget and Economic Outlook: An Update* (September 2008), at <http://www.cbo.gov/budget/data/econproj.xls>.

additional cost is \$14 million. Since early encashment income earned is \$16 million more than MDRI obligations, for ADF-11 early encashment results in a net benefit of \$2 million as compared to paying replenishment and MDRI obligations annually as they come due.

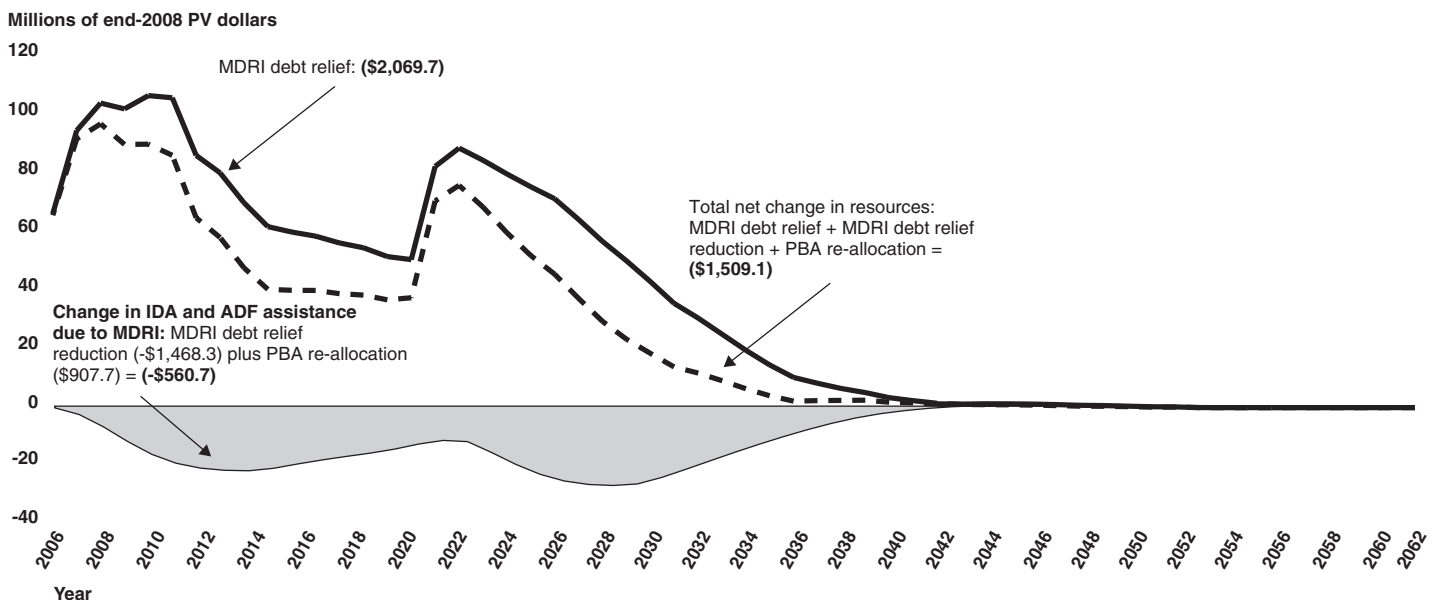
Based on CBO's projections for the cost of U.S. borrowing, we estimate that during the replenishment period from 2009 through 2011, early encashment will cost the United States an additional \$39 million, \$41 million more for IDA and \$2 million less for ADF.

Appendix VII: Projected Impact of MDRI on Five Case Study Countries

Based on our projections, while the overall net change in resources available due to MDRI is positive for each of the five countries we analyzed (Ethiopia, Ghana, Tanzania, Nicaragua, and Rwanda), individual countries may experience increases or decreases in their IFI assistance. The following graphs illustrate the projected overall impact of MDRI for these five countries. The shaded area indicates the negative (below the axis) or positive (above the axis) change in IDA and ADF assistance.

Ghana and Nicaragua are projected to experience a decrease in IFI assistance due to reduced IDA and ADF assistance over the life of MDRI, even as MDRI debt relief provides freed-up resources. (See shaded area in figs. 7 and 8.)

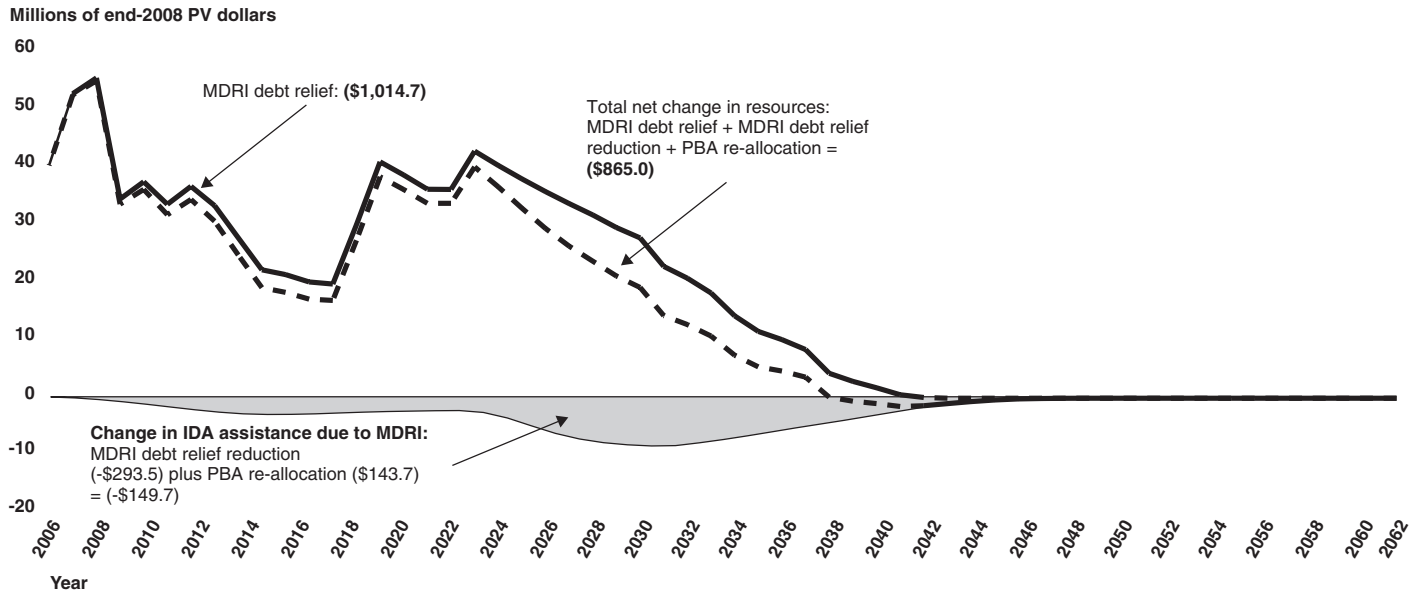
Figure 7: Projected Impact of MDRI on Ghana's Resource Availability, 2006-2062 (Millions of end-2008 present value dollars)



Source: GAO analysis of MDRI data provided by the World Bank, ADF, and IMF.

Appendix VII: Projected Impact of MDRI on Five Case Study Countries

Figure 8: Projected Impact of MDRI on Nicaragua's Resource Availability, 2006-2062 (Millions of end-2008 present value dollars)

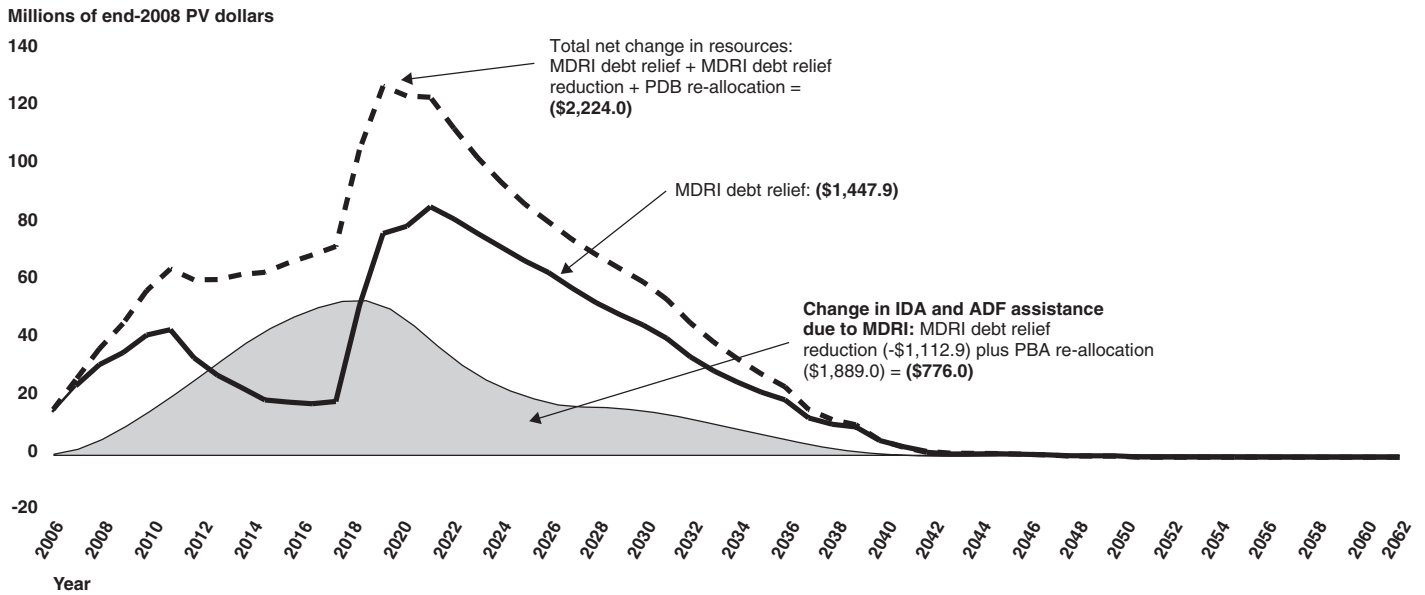


Source: GAO analysis of MDRI data provided by the World Bank, laDB, and IMF.

In contrast, for Ethiopia and Tanzania, MDRI is projected to result in an increase in assistance from IDA and ADF. (See shaded area in figs. 9 and 10.)

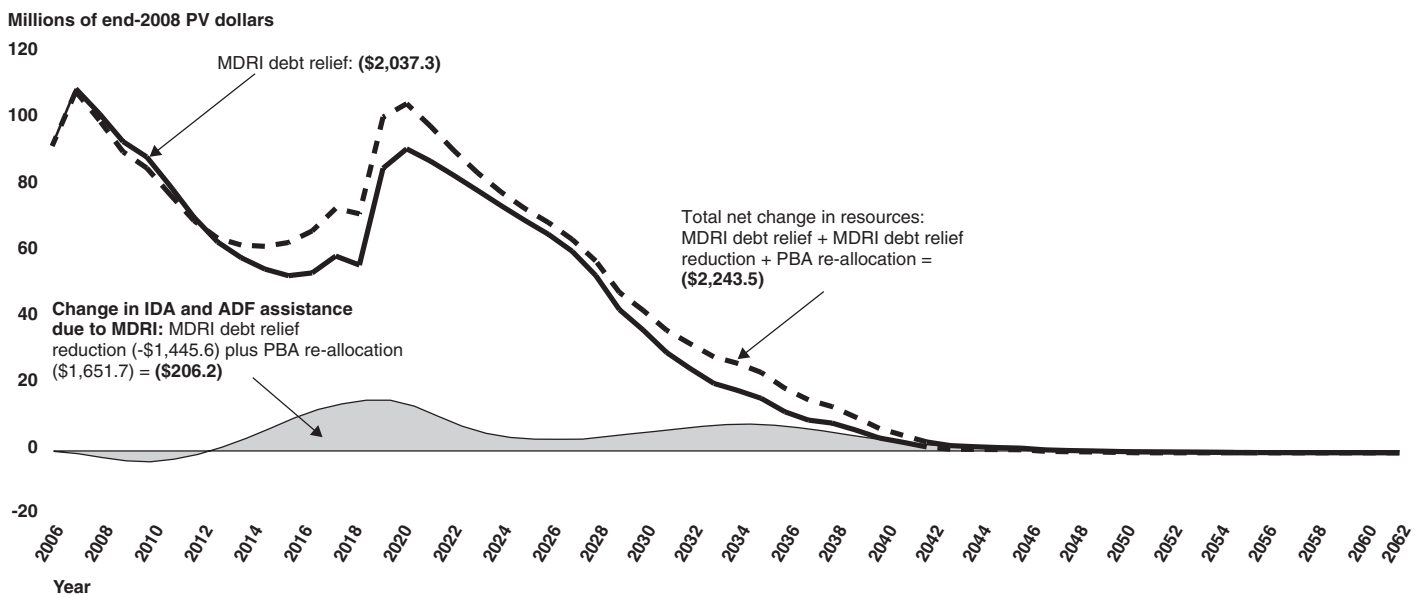
Appendix VII: Projected Impact of MDRI on Five Case Study Countries

Figure 9: Projected Impact of MDRI on Ethiopia's Resource Availability, 2006-2062 (Millions of end-2008 present value dollars)



Source: GAO analysis of MDRI data provided by the World Bank, ADF, and IMF.

Figure 10: Projected Impact of MDRI on Tanzania's Resource Availability, 2006-2062 (Millions of end-2008 present value dollars)

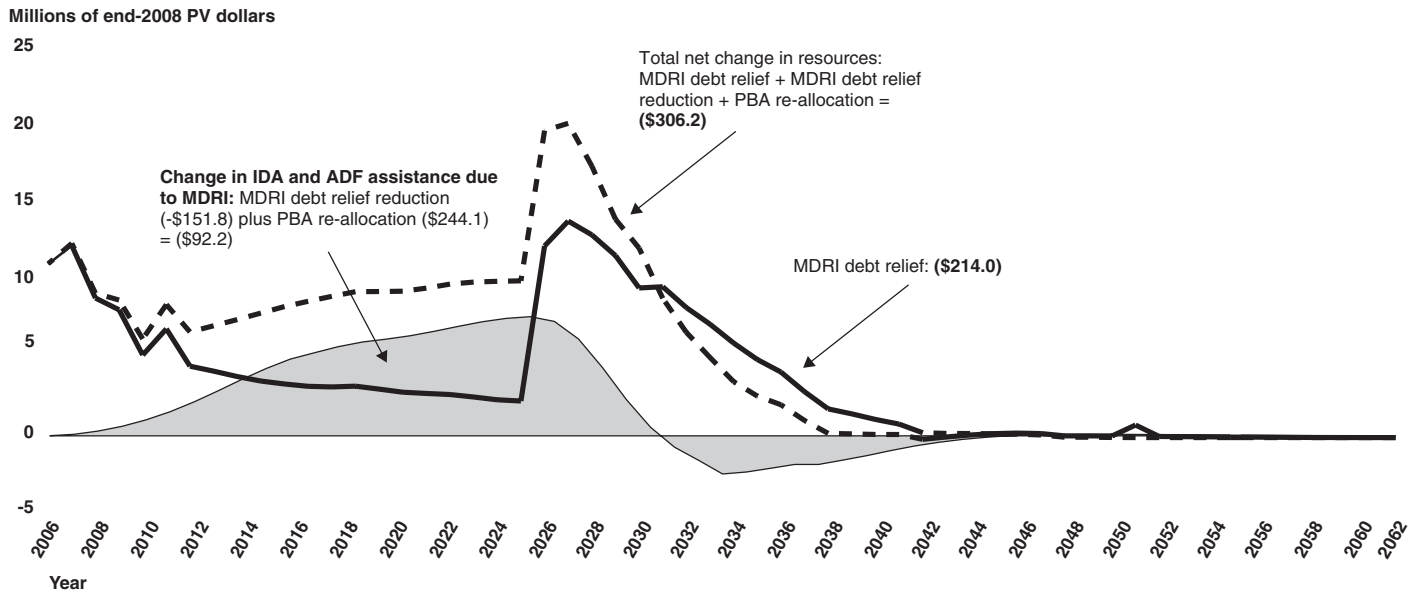


Source: GAO analysis of MDRI data provided by the World Bank, ADF, and IMF.

Appendix VII: Projected Impact of MDRI on Five Case Study Countries

As shown in figure 11, for Rwanda, MDRI is projected to provide a mixture of increases and reductions in IDA's and ADF's annual assistance over the MDRI period.

Figure 11: Projected Impact of MDRI on Rwanda's Resource Availability, 2006-2062 (Millions of end-2008 present value dollars)



Source: GAO analysis of MDRI data provided by the World Bank, ADF, and IMF.

Appendix VIII: Implementation of the Multilateral Debt Relief Initiative (MDRI) Process

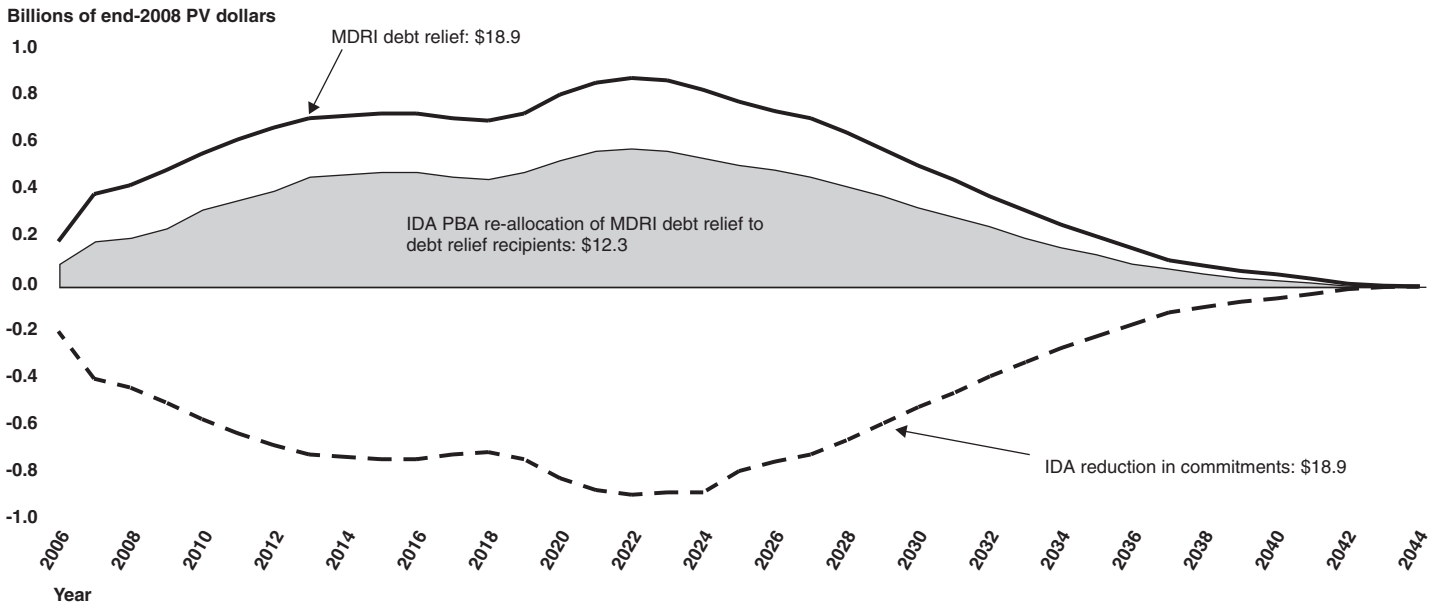
We found that countries receiving MDRI debt relief are projected to receive about \$3 billion more than suggested in World Bank/International Development Association (IDA) documents describing MDRI. IDA documents state that, in a particular year, IDA is to reduce its commitments of financial assistance to countries receiving MDRI debt relief by the amount of debt relief provided, netting each other out. Donor governments have agreed to compensate IDA for the foregone debt service payments. IDA is to reallocate these funds to all countries eligible to borrow only from IDA, which includes countries that receive MDRI debt relief as well as those that do not. Thus, when IDA reallocates the donor funds, all IDA-only countries would be at the same starting point—with no net additional funds.

We compared the projected amount of debt relief to the projected amount of reduced assistance under two scenarios, each incorporating the time value of money. In the first scenario, we assumed that IDA reduces its assistance by the amount of debt relief provided in the same year, as described in World Bank documents. In the second scenario, we considered the disbursement pattern that IDA actually uses to distribute the reduction in allocations for MDRI recipients as well as the reallocation of those funds. Under the second scenario, because the disbursement pattern takes place over a 9-year period, the dollar value of MDRI debt relief is greater than the actual reduction in IDA disbursements.

In the first scenario, IDA is projected to provide \$18.9 billion in debt relief and reduce its assistance commitments to MDRI recipients by the same amount. IDA is then projected to reallocate—on the basis of performance—a portion of this \$18.9 billion of reduced assistance commitments to recipients of debt relief, \$12.3 billion, and the remainder, \$6.6 billion, to IDA-only countries that do not receive debt relief. (See fig. 12.)

**Appendix VIII: Implementation of the
Multilateral Debt Relief Initiative (MDRI)
Process**

Figure 12: Annual Projected IDA MDRI Assistance to Debt Relief Recipients, 2006-2044 (Billions of end-2008 present value dollars)



Source: GAO analysis of World Bank data.

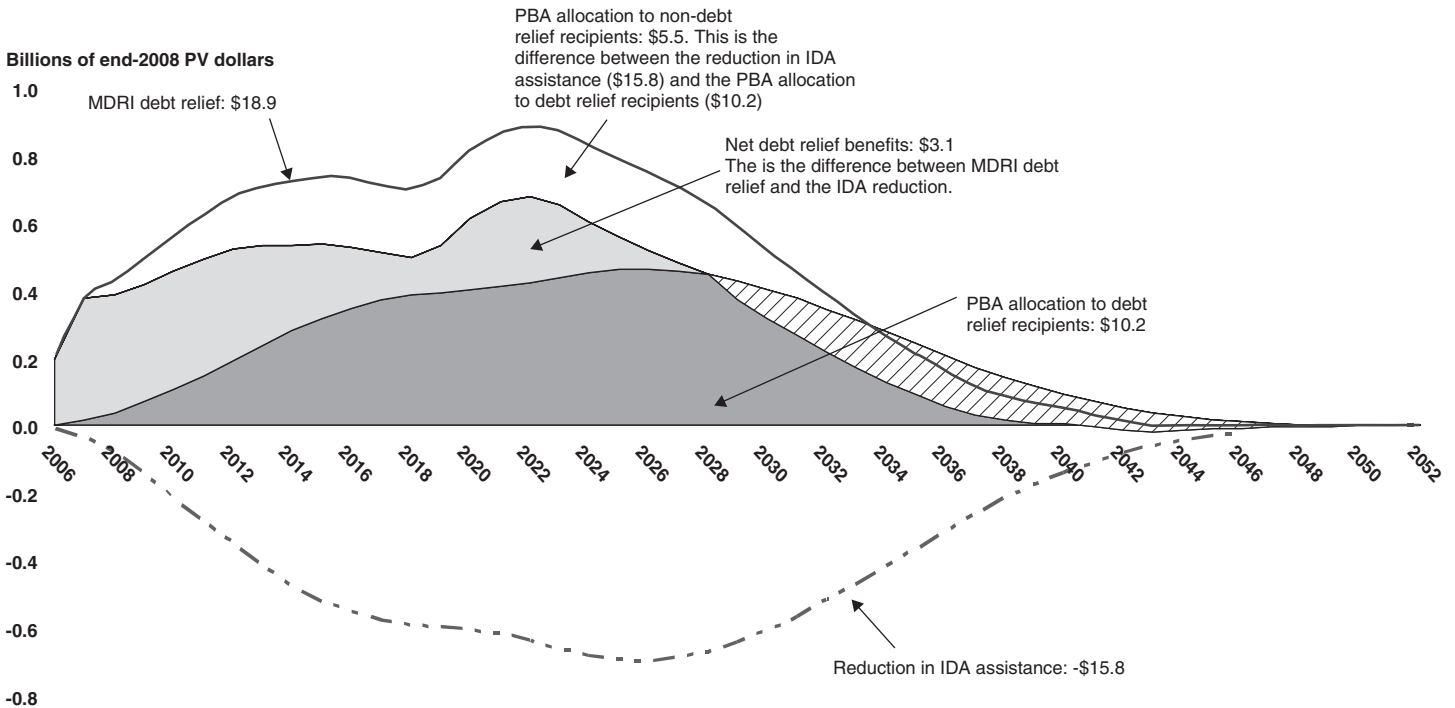
Under the second scenario, the overall annual amount of debt relief is greater than the overall annual reduction in assistance. When considering the disbursement pattern of IDA funds, the projected net present value of MDRI debt relief, \$18.9 billion, is greater than the net present value of IDA's reduction in assistance, \$15.8 billion, by \$3.1 billion.¹ Countries that receive debt relief are projected to receive this \$3.1 billion in addition to about \$10.2 billion in reallocated assistance, for total MDRI benefits of \$13.3 billion.² (See fig. 13.)

¹Numbers in this analysis may not add due to rounding.

²The \$3.1 billion consists of a \$4.9 billion gain between 2006 and 2027 and a \$1.7 billion loss between 2028 and 2052.

Appendix VIII: Implementation of the
Multilateral Debt Relief Initiative (MDRI)
Process

Figure 13: Disbursement Pattern of Projected IDA MDRI Assistance to Debt Relief Recipients, 2006-2052 (Billions of end-2008 present value dollars)



Source: GAO analysis of World Bank data.

The additional \$3.1 billion places debt relief recipients in a more advantageous position at the outset of the reallocation process than their non-debt relief counterparts.

While IDA documents indicate that donor funding provided to compensate for MDRI debt relief is to be reallocated to IDA-only countries, IDA is using donor finances to provide the \$3.1 billion in net debt relief benefits to debt relief recipients, in addition to their performance-based reallocation of donor funds. Thus, the \$18.9 billion in donor financing for MDRI is allocated as follows: \$3.1 billion to net debt relief benefits, \$10.2 billion in IDA reallocations to debt relief recipients, and \$5.5 billion in reallocations to non-debt relief recipients.

Appendix IX: Comments from the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

JAN 09 2009

Thomas Melito
Director, International Affairs and Trade
Government Accountability Office
441 G Street N.W.
Washington, DC 20548

Dear Mr. Melito:

Thank you for the opportunity to comment on the draft report regarding international debt relief initiatives and debt sustainability. The United States has consistently provided strong international leadership on debt relief for the world's most heavily-indebted poor countries and on efforts to end the lend-and-forgive cycle and promote long-term debt sustainability. As such, we have great interest in your report and are providing comments on several aspects of your findings.

Financing the Multilateral Debt Relief Initiative

In examining U.S. financing for the Multilateral Debt Relief Initiative (MDRI), your report projects several scenarios. In the context of this analysis, we would like to be clear that it remains the Treasury Department's objective to fully meet the U.S. nominal commitment to the IDA14 replenishment, and thereby meet U.S. MDRI commitments from credits earned through early encashment. However, as the Treasury Department has repeatedly emphasized, including in its response to the previous GAO report on this subject, shortfalls in funding IDA14 would jeopardize the ability of the United States to meet its commitments to finance multilateral debt relief. If the United States meets its IDA14 commitments, the alternative scenarios you describe would not be relevant and the United States would simultaneously fully finance both IDA14 and its current MDRI commitments. In fact, our fiscal year 2009 budget request for payment of IDA arrears was specifically targeted at helping to fulfill this goal.

We remain open to your recommendation that alternative funding approaches be considered for MDRI in the future. There are a variety of potential methods by which MDRI could be funded and we are open to revisiting this issue as we move forward.

Effects of Debt Relief

The draft report states that the effects of debt relief on poverty reducing expenditures are unknown, due to the difficulty of tracking debt relief resources and data limitations. Without question, many low-income countries face serious capacity constraints, including in their ability to track and report on poverty and demographic outcomes. We recognize, further, that there is no internationally recognized definition of a poverty reducing expenditure, so, as described in the report, there can be significant variability in measurement across countries. Nonetheless, available evidence strongly suggests there has been increased spending for the poor in countries

See comment 1.

which have qualified for HIPC debt relief. For example, the IMF has found that before the HIPC Initiative, eligible countries were, on average, spending slightly more on debt service than on health and education combined. Based on available data, countries that have qualified for HIPC debt relief have now increased markedly their expenditures on health, education and other social services and, on average, poverty reducing spending was estimated at about eight times the amount of debt-service payments in 2007.

Moreover, the direct impact of redirecting resources from debt service to development expenditure is not the only avenue by which debt relief can have a positive effect. International debt relief initiatives can also help countries facing unsustainable debts to re-establish a sound economic footing and reengage with the international community. This process can thereby remove a significant barrier to economic growth and support their efforts to lift people out of poverty. For example, after years of conflict, Liberia has rejoined the international community, and debt relief under HIPC and MDRI has been an important part of this transition. The debt relief has been essential not only because of the massive debts that will be cancelled, but also because it is allowing Liberia to normalize its relations with its creditors, unlocking millions of dollars of new assistance every year from the international financial institutions.

Debt Sustainability

Debt sustainability in low-income countries is an issue to which the Treasury Department pays close attention, and we have been a strong supporter of efforts such as the World Bank and IMF Debt Sustainability Framework. We agree with your assessment that the World Bank and IMF analyses produced under the Debt Sustainability Framework represent an improved ability to assess the debt sustainability outlook in low-income countries. We will continue to work with these institutions and low-income countries to make further refinements as needed.

As the draft report highlights, despite significant debt relief, there are ongoing risks to debt sustainability in low-income countries. Although debt relief can be a valuable and sometimes necessary tool, merely canceling debt is not sufficient to ensure long-term debt sustainability if the underlying economic vulnerabilities remain. For this reason, continued effort is needed to assist countries in addressing weaknesses in their macroeconomic framework and financial management systems. The report correctly highlights the need to strengthen debt management capacity in low-income countries. Recognizing this need, the Treasury Department's Office of Technical Assistance and institutions such as the World Bank and IMF have been focusing significant attention on improving debt management in low-income countries. In fact, the Treasury Department has provided, at their request, direct technical assistance for debt management in eighteen of the countries that have received HIPC or MDRI debt relief.

Sincerely,



Karen Mathiasen
Acting Deputy Assistant Secretary
International Development Finance and Debt

The following is GAO's comment on the Department of the Treasury's letter dated January 9, 2009.

GAO Comment

1. GAO could not identify sufficient empirical evidence to suggest that increases in spending for the poor are directly related to savings from debt relief. It is difficult to establish that debt relief has led directly to increased poverty-reducing expenditures for two reasons: (1) debt relief resources are difficult to track, and (2) country spending data are not comparable and also may not be reliable. Because of these limitations, it is difficult to establish if debt relief has caused these countries to increase or decrease their spending toward the poor.

Appendix X: Comments from the World Bank

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



The World Bank

Robert B. Zoellick
President

January 12, 2009

Mr. Gene L. Dodaro
Acting Comptroller General of the United States
Government Accountability Office
441 G St., NW
Washington, D.C. 20548

2009 JAN 13 AM 1:47
US GAO

Dear Mr. Dodaro,

Thank you for the opportunity to comment on the U.S. Government Accountability Office's draft report entitled "The United States has not fully funded its share of debt relief, and the impact of debt relief on countries' poverty-reducing spending is unknown."

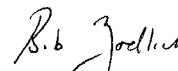
I welcome the report's recognition of the benefits of maintaining debt sustainability for low income countries to achieve their development objectives and, by extension, of the importance for donors to honor their pledges for additional funding covering the costs of IDA's debt cancellations over the long term.

The lack of additional funding would deprive not only the heavily indebted countries, but all IDA clients, of fresh loans and grants—in essence meaning that poor countries would themselves have to cover the cost of debt cancellations under debt relief initiatives, which the U.S. Government was instrumental in bringing to fruition. I believe that this report can serve as a useful reminder of the need for continued U.S. leadership in ensuring additionality of debt cancellations and new financing through replenishing IDA's resources to poor countries. I am also encouraged to see clear recognition of the need to shift to a more sustainable funding approach for the U.S. share of IDA's debt cancellation costs.

My staff has prepared comments of a more technical nature that address some of the points made in the report. They are attached to this letter, and I trust you will find them useful.

I would like to thank you and your staff for the fruitful cooperation in developing many of the findings contained in this report.

Sincerely,


Robert B. Zoellick

2009 JAN 12 PM 3:10
US GAO

Attachment
cc: Mr. Eli Whitney Debevoise, Executive Director for the United States, The World Bank

1818 H Street, NW • Washington, DC 20433 • USA

JAN 12 2009

World Bank Technical Comments on GAO's Draft Report
"The United States has not fully funded its share of debt relief, and the impact of debt relief on countries' poverty-reducing spending is unknown"
(GAO-09-162, January 2009)

1. The draft report rightly emphasizes that the additional resources which are freed up through debt cancellations granted by multilateral and bilateral creditors should be used to increase governments' poverty-reducing expenditures. It also points out that countries which receive debt relief may continue to face difficulties in maintaining debt sustainability.
2. Importantly, the report highlights that IDA's financial capacity to assist poor countries in the future would be impaired if donors fail to meet fully their commitments to IDA. Indeed, debt relief by a revolving credit fund such as IDA would be a mere accounting transaction and not provide benefits to recipients unless the lost credit reflows are replaced. That is why donors, including the United States, have committed to 'dollar-for-dollar' compensation under the Multilateral Debt Relief Initiative (MDRI) so that IDA's debt relief can lead to tangible development benefits.
3. The report rightly comments that the U.S. financing for MDRI will be increasingly insufficient if it is continued to be provided through accelerated encashment of regular IDA replenishment contributions. We believe that the report could more explicitly state that it will not be possible for the U.S. to fund future MDRI costs through early encashment of the regular IDA contributions. The annual MDRI costs of IDA will more than triple over the next two decades, reaching an estimated \$1.8 billion per year by 2025. Continuing the current practice would presuppose a commensurate increase in regular IDA contributions from the U.S. As the report correctly states, the U.S. could instead employ separate budgetary appropriations for debt relief financing, which is the avenue that is employed by most other IDA donors.
4. In our view, GAO's draft report could also be strengthened by looking at debt relief costs beyond the 3-year timeframe of the current IDA replenishment. This is because IDA credits approved today will disburse over up to a decade - the maximum length of time that development projects need for completion. IDA can enter into these long term commitments based to a large degree on the value of future repayments under earlier credits. These credit reflows are however reduced through debt cancellation under the HIPC Initiative and MDRI. Thus IDA's ability to commit against them is correspondingly reduced. To mitigate this, and to ensure that the debt cancellations remain additional as intended, donor governments recognized the need to maintain IDA's financial capacity over the full disbursement period. The MDRI Agreement thus calls for firm donor financing commitments on a rolling basis over a decade. Many IDA donors have provided such commitments already, some even for the full (40-year) duration of MDRI. As currently drafted, the report may give the impression that all donor financing for the MDRI is limited to a rolling 3-year period, which is certainly not the case.
5. While the report rightly describes the challenges to improving the tracking and effectiveness of poverty reducing expenditures, the report could better acknowledge the progress being made in this area. In most low income countries, including heavily indebted poor countries (HIPC), these expenditures are now aligned with countries' own poverty reduction strategies. It is important to remember that public expenditures in these countries are primarily financed through domestic revenues and fresh external aid flows. The funds released through multilateral debt cancellations are small relative to these other sources of financing for HIPC. However, debt relief does represent a source of predictable financing as the repayment profile on the original

credits is well known in advance. Irrevocable, up-front cancellations of such credits leave governments with clarity on at least a portion of their income, which is typically rare in low income countries.

6. Consistent with the HIPC Initiative, poverty reducing expenditures are tracked and published in the HIPC Initiative Completion Point documents. The allocation of spending at the budget-wide level is analyzed to highlight the additionality of resources freed up through debt relief to finance country-defined development priorities. By design, once a country reaches its HIPC Initiative completion point, debt relief under the HIPC Initiative and MDRI is provided irrevocably. Thus, poverty reducing expenditures are not monitored for the purposes of these two debt relief initiatives beyond the completion point. However, in the context of periodic reviews of their national poverty reduction strategies, country authorities report poverty reducing expenditures to the IMF and World Bank. These are reported in the joint IMF-World Bank annual HIPC Initiative and MDRI Status of Implementation reports. In addition, since 2005, the Public Expenditure and Financial Accountability (PEFA) framework has also been used to evaluate the quality of public expenditure in low and middle income countries. As of end-2008, PEFA assessments have been conducted in 16 HIPCs, of which 11 post-completion point countries.
7. The report rightly notes that debt sustainability analyses (DSAs) are now more rigorous in defining the risk of debt distress for all LICs, thanks to assessments based on standardized and country specific shocks. However, the report should clearly distinguish between DSAs conducted under the HIPC Initiative and DSAs under the Low Income Country Debt Sustainability Framework (LIC DSF). HIPC DSAs are designed to establish the amount of debt relief needed to lower external public debt to the agreed HIPC Initiative thresholds. In contrast, DSAs under the LIC DSF are forward-looking to support LICs in their efforts to achieve their development goals without creating future debt problems. Efforts to improve their public debt management capacities are also being made through appropriate technical assistance.

See comment 1.

The following is GAO's comment on the World Bank's letter dated January 12, 2009.

GAO Comment

1. We have revised our report language to clarify this distinction between DSAs.

Appendix XI: Comments from the International Monetary Fund

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

Facsimile Number
1-202-623-4661

January 8, 2008

Mr. Thomas Melito
Director, International Affairs and Trade
Government Accountability Office
Washington, D.C.

Dear Mr. Melito:

Thank you for seeking our comments on the draft GAO report titled “The United States Has Not Fully Funded Its Share of Debt Relief, and the Impact of Debt Relief on Countries’ Poverty-Reducing Spending Is Unknown.” This report covers topics of great importance to the international community. We welcome the close collaboration between GAO and IMF staff during its preparation over the past few months.

We broadly agree with the report’s main findings relevant for the IMF. We were particularly gratified with the finding that the IMF and the World Bank have improved their debt sustainability analyses since 2005. The report describes well the methodology of the debt sustainability framework (DSF) as well as its benefits. As mentioned in the report, the DSF is being used by an increasing number of lenders and borrowers.

We also concur that debt relief initiatives—both the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI)—have freed up substantial resources for recipient countries, a point abundantly made in the report although not reflected in the title. This is an important conclusion that is well worth stressing, as we have done in our 2008 Report with the World Bank on the Status of Implementation of the HIPC Initiative and MDRI and other publications.

However, we do not share the report’s headline message on the impact of debt relief initiatives on poverty-reduction spending. As rightly argued in the report, it is generally not possible to track how debt service savings are used, as money is fungible and debt service savings are just one of the many ways to finance higher poverty-reducing spending. Thus, a feasible approach is to measure how much fiscal space has been created by debt relief and whether this has been associated with higher poverty-reducing spending. The former is done in the report; the latter is a difficult task, particularly when attempting comparisons across countries, because of differences in data and definitions. Analysis for specific countries is not affected by these latter problems, however, and does show that poverty-reducing spending has increased significantly in most of the countries that have benefited from debt relief. It is

See comment 1.

2

true that these data may be subject to other, idiosyncratic, weaknesses in some countries, so precision is not always possible. But we do not think that these weaknesses are so pervasive as to invalidate the conclusion that poverty-reducing spending has generally increased. Moreover, we would note that many of the report's observations regarding data shortcomings are based on five countries, a sample that GAO staff acknowledges is "illustrative, not representative."

In short, we believe this is a good report, and that it would merit a title that accords more closely with the evidence on which it is based. We hope that, even at this late stage, this is a suggestion you might consider.

Sincerely yours,



Reza Moghadam
Director
Strategy, Policy, and Review Department

The following is GAO's comment on the International Monetary Fund's letter dated January 8, 2009.

GAO Comment

1. Based on our evidence, we found that the impact of debt relief on poverty-reducing expenditures is unknown. Our report shows that additional resources have been created by debt relief, but it is difficult to establish that debt relief has led directly to increased poverty-reducing expenditures for two reasons: (1) it is not possible to track how debt relief resources are used, and (2) country spending data are not comparable and also may not be reliable. In addition, based on our review of five MDRI case study countries, we found that debt relief resources are often much less than other types of resources such as tax revenue and grants. Therefore, while we agree that associations between debt relief and poverty-reducing expenditures may exist, the impact is unknown.

Appendix XII: GAO Contact and Staff Acknowledgments

GAO Contact

Thomas Melito (202) 512-9601 or melitot@gao.gov

Staff Acknowledgments

In addition to the person named above, Cheryl Goodman, Assistant Director; Leslie Holen; Bruce Kutnick; RG Steinman; Farahnaaz Khakoo; Ashley Alley; and Debbie Chung made key contributions to this report.

Related GAO Products

Developing Countries: U.S. Financing for Multilateral Debt Relief Initiative Currently Experiencing a Shortfall. [GAO-08-888R](#). Washington, D.C.: July 24, 2008.

Developing Countries: Challenges in Financing Poor Countries' Economic Growth and Debt Relief Targets. [GAO-04-688T](#). Washington, D.C.: April 20, 2004.

Developing Countries: Achieving Poor Countries' Economic Growth and Debt Relief Targets Faces Significant Financing Challenges. [GAO-04-405](#). Washington, D.C.: April 14, 2004.

Developing Countries: Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens. [GAO-02-593](#). Washington, D.C.: April 19, 2002.

Developing Countries: Challenges Confronting Debt Relief and IMF Lending to Poor Countries. [GAO-01-745T](#). Washington, D.C.: May 15, 2001.

Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges. [GAO/NSIAD-00-161](#). Washington, D.C.: June 29, 2000.

Developing Countries: Status of the Heavily Indebted Poor Countries Debt Relief Initiative. [GAO/NSIAD-98-229](#). Washington, D.C.: September 30, 1998.

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