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HIPC Debt Relief and Poverty Reduction Strategies: Uganda's Experience

Florence N. Kuteesa and Rosetti Nabbumba

In this chapter, we highlight the main issues relating to Uganda's experience in debt stock management and debt relief, explore the benefits of the HIPC Initiative, and conclude by looking at the relationship between the HIPC resources, debt sustainability and poverty reduction. The additional resources from the HIPC Initiative have been instrumental in reducing poverty but have not resulted in debt sustainability as expected.

1 Debt Relief Before and After HIPC

Uganda's debt burden in nominal terms rose from \$172 million in 1970 to \$3.6 billion in 1998, the year in which it first received debt relief under the HIPC Initiative. The country's external debt had increased over the decades because of arrears accumulation as a result of successive governments defaulting on debt obligations, deteriorating terms of trade, expansionary fiscal policies and heavy borrowing for economic recovery and stabilisation programmes.

Historically, the country had been contracting medium to long-term loans, short-term credits having ceased in the 1970s. The proportion of concessional debt to total debt rose steadily in the 1980s and 1990s, exceeding 70 percent by the mid-1990s in line with the country's borrowing guidelines.

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Table 1 Uganda's Debt Relief Experiences

	Year
Paris Club	
• Toronto terms	1989
• London terms	1992
• Naples terms	1995
• Lyon terms (HIPC I)	1998
• Cologne terms (HIPC II)	1999
Commercial Debt Buyback	1992
Multilateral Debt Fund (Uganda)	1992-95
HIPC	1998
Enhanced HIPC	2000

Debt relief is not a new phenomenon in the case of Uganda. The country has benefited from debt relief reschedulings from the international community since the mid-1980s. However, apart from an IDA-funded commercial debt buyback in 1992, until the late 1990s only bilateral Paris Club creditors were willing to offer debt relief. Unfortunately, their relief only had a limited impact on Uganda's overall debt position, mainly because by 1994, 70 percent of Uganda's debt was owed to multilateral creditors. A number of bilateral donors therefore set up a Multilateral Debt Fund, into which they paid funds in order to help Uganda repay its debt obligations to multilateral creditors. This initiative was a precursor to the HIPC Initiative which engaged the multilateral lending institutions in direct negotiations on debt relief for the first time.

Uganda's experience with the HIPC Initiative has been broadly positive. Uganda was the first country to qualify for debt relief under both the first HIPC and the Enhanced HIPC Initiative in April 1998 and April 2000, respectively. The speed with which Uganda qualified, without having to go through a standard six-year qualifying period, was a reflection of the country's exemplary record of macroeconomic reform and a proven commitment to poverty reduction. In total, as a result of both initiatives, Uganda was granted debt relief amounting to $1 billion[1] in NPV terms to be delivered over a period of twenty years. As a consequence, Uganda has

[1] This figure assumed full delivery of HIPC debt relief by all creditors, including those bilateral creditors who had refused the commercial debt buy-back in 1992 and non-OECD bilateral creditors who were not members of the Bretton Woods institutions.

received substantial cash savings, averaging $60 million per annum over the past 4 years, accounting for almost a quarter of the total budget support over the period. This figure has risen now to approximately $90 million per annum in debt relief and is set to rise further in the medium term.

2 Poverty Reduction

Prior to the HIPC Initiative, Uganda had adopted a national strategy for poverty eradication, the Poverty Eradication Action Plan (PEAP), which guides policy formulation and public spending over the medium term. As a way of protecting funds going specifically to poverty eradication programmes from budgetary cuts, the government formed the Poverty Action Fund (PAF) as an integral part of the government's budget. The PAF is a virtual fund within the budget that is funded by HIPC savings, "earmarked" donor funds, and government revenues. The trends in HIPC savings and PAF expenditures are shown in Figure 1, while the increase in budgets for PAF expenditure areas are shown in Figure 2.

Figure 1 HIPC Savings and Poverty Expenditures
(in millions of dollars and percentage of total budget)

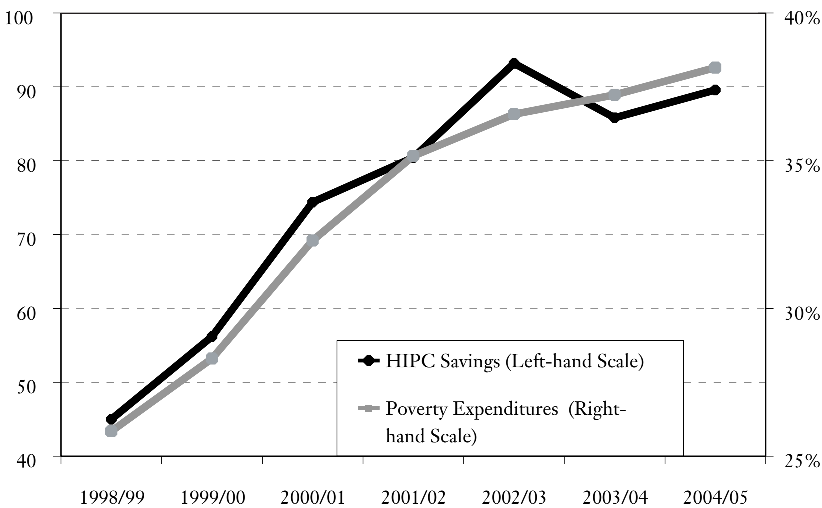
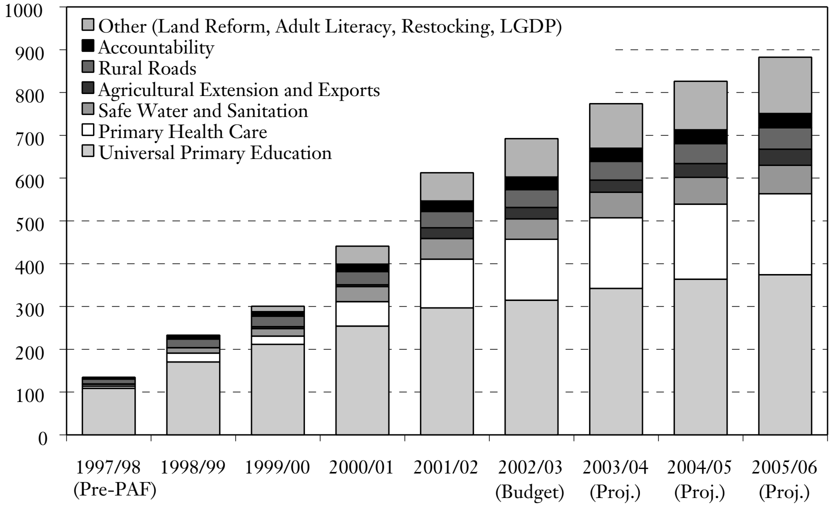


Figure 2 Expenditures on Poverty Reduction Areas
(in billions of Ugandian shillings)



The resources saved from HIPC debt relief that were purposively channeled to the PAF allowed Uganda to increase the budget for the most critical areas such as primary education, primary health care, rural roads, safe water and sanitation, and agriculture.

Over the past four years, annual expenditures on education increased by 9 percent. Yearly growth for health expenditures was 20 percent. There have also been substantial increases in spending on water, rural roads, gender, HIV/AIDS, justice, law and order, and on environmental spending. Throughout the 1990s, social service delivery improved significantly and poverty declined noticeably, as a result of increased budgets for poverty reduction, as shown in Table 2. These achievements are in line with the fulfilment of the Millennium Development Goals (MDGs) since there is a substantial overlap between the Poverty Eradication Action Plan and MDG targets:

- *Education*: Uganda's Universal Primary Education policy, initiated in 1997, has led to an upsurge in gross primary enrolment from 2.6 million to 7.3 million pupils in 2002. The gender gap at the primary level has been closed. However, pupil retention, the quality of education and increased access to post-primary schooling still needs to be improved.

Table 2 Development Indicators, Uganda, 1991–2000

Indicator	1991	1995	2000	Target	Year
Poverty and Inequality					
Poverty Level (%)	56	44	35	10	2017
Gini Coefficient (inequality)	0.364	0.366	0.384		
Demographic indicators					
Total Population (millions)	16.7	19.3	22.2		
Population Growth Rate (%)	2.5		2.9		
Macroeconomic Indicators					
GDP ($ billion)		5.5	6.2		
GDP per capita ($)		285	280		
Government Expenditure (% GDP)		17.2	21		
Government Revenue (% of GDP)		11.1	11.3		
Budget Deficit (% GDP, excl. grants)		6.4	11.5		
Education and Literacy					
Gross Primary Enrolment (millions)	2.3	2.6	6.8		
Net Primary Enrolment (%)		84	77	100	2003
Ratio of girls enrolment to boys (%)		95	99		
Pupil-Teacher Ratio			65:1	49:1	2005
Adult Literacy Rate (%)	54	62	68	85	2005
Health and Nutrition					
Infant Mortality (per 1,000 live births)	122	81	88.4	68	2005
Children Underweight (weight-for-age)		25.5	22.5		
Immunisation (DPT3) (%)		61	48	60	2005
Malaria (proportional morbidity) (%)		25	37		
HIV/AIDS Prevalence (%)		14	6.1	5	2005
Fertility Rate (children per woman)		6.9	6.9		
Water and Sanitation					
Rural access to safe drinking water (%)		39	53	65	2005
Urban access to safe drinking water(%)			62	80	2005
Households with latrine or toilet (%)		79.9	82.3		

Sources: Uganda, Ministry of Health, *Uganda Demographic and Health Survey*, 1995, 2000-2001; Ministry of Finance, *Uganda PRSP*, March 2002; Ministry of Water, Lands and Environment, *Uganda Poverty Status Reports*, 2001, 2003; Appleton,S., L. Song, "Income and Human Development at the Household Level", 1999; IMF and World Bank, "PRSP – Progress in Implementation", IMF, 2002.

- *HIV/AIDS*: prevalence rates have fallen considerably from 14 percent in the mid-1990s to 6.5 percent during 2001-2002.
- *Roads*: the share of the rural road network being maintained regularly has increased from 20 percent in 1997-98 to 60 percent in 2000.
- *Water and Sanitation*: access to water has improved nationally from 40 percent in 1997 to 52 percent in 2001. Sanitation, however, remains a problematic area.
- *Health*: improving the health status of the Ugandan populations remains a major challenge. There is still too little progress in reducing infant, child and maternal mortality rates and increasing immunisation rates.
- *Poverty*: incidence fell dramatically from 56 percent in 1992 to 35 percent in 2000, but has since risen again to 38 percent in 2002. As seen above, the Poverty Action Fund significantly improved social service delivery and its impact. However, less investment has gone to the productive sectors, particularly agriculture, where the majority of the poor derive their livelihood and hence the observed rise in poverty. Inequalities between socio-economic groups and regions also persist.

The Medium-Term Expenditure Framework and the newly created Long-Term Expenditure Framework are being re-oriented to address these new challenges so as to enhance the poverty focus of public spending. The government is committed to increase the share of the budget spent on PAF, which has risen from 18 percent in 1997-98 to 35 percent in 2001-02, and protect PAF expenditures from within-year budget cuts arising from the cash-management system.

3 HIPC and Debt Sustainability

The combined debt relief given to Uganda under HIPC I and II was supposed to enable Uganda to remain on a sustainable debt path for the foreseeable future, as measured by a continuing NPV debt-to-exports ratio of below 150 percent, thus delivering total exit from debt rescheduling. However, results of two debt sustainability analyses (DSA) conducted in 2002 showed a rise in Uganda's debt-to-exports ratio over the 18 months since the Enhanced HIPC completion point to almost 200 percent. Calculations made by the

Ministry of Finance, Planning and Economic Development at the end of 2003 suggest that this ratio has since risen further, to 307 percent as at end of June 2003. This ratio is fifty percentage points higher than Uganda's NPV debt-to-exports level prior to accessing HIPC I.

It should be noted from the outset that the rapid rise in the unsustainability levels of the debt is not a result of poor macroeconomic management: inflation remains at an average level of 5 percent, the government is currently pursuing a fiscal strategy of deficit reduction to enhance private sector development and emphasis is being placed on efficiency rather than volume of public spending. Rather, there are four main reasons explaining the rise in Uganda's debt-to-exports ratio.

First, the terms of trade deteriorated for Uganda's major exports, due to the fall in global commodity prices. For example, at the Enhanced HIPC decision point, the three-year average value of Uganda's export earnings for the year ending 2002-03 was projected at $1,007 million but the actual value turned out to be $726 million, reflecting a fall of 28 percent.

Second, at the Enhanced HIPC decision point, estimates for new financing in the macroeconomic framework and balance of payments were not fully incorporated in the Debt Sustainability Analysis. Uganda has borrowed $1 billion since reaching HIPC completion point, and although these new borrowings, which were primarily from the multilateral development institutions, have been on highly concessional terms,[2] they have led the nominal debt stock to increase from $3.2 billion at the time of Enhanced HIPC to $4.2 billion as at end of June 2003.

Third, not all creditors have been willing to deliver debt relief under the HIPC Initiative, as had been assumed. In particular, commercial creditors who refused the 1992 debt buyback and non-OECD bilateral creditors have been unwilling to extend relief, leading to arrears accumulation, which has contributed to the rise in the debt stock. As at end June 2003, arrears amounted to 7 percent of the total debt stock.

2 Uganda's National Debt Strategy stipulates that all new borrowings must have a minimum grant element of 78 percent, and/or have equivalent concessionality to IDA lending.

Fourth, low global interest rates have increased the present value of Uganda's debt and reduced the concessionality of IDA lending terms. Given prevailing market interest rates, IDA lending is only 55 percent concessional, a decline of almost twenty percentage points since HIPC completion.

Other unforeseen challenges relate to the fact that not all creditors have been willing to participate in equal burden-sharing and some have outright rejected participation in the HIPC initiative. A number of creditors have taken Uganda to court, suing it for the payment of their debts in full, plus compensation. To date, four cases have been successful, although one is currently on appeal, and Uganda has been forced to pay over $20 million in recompense so far. This amounts to almost a quarter of this year's HIPC relief savings.

Uganda has adopted a three-pronged strategy for maintaining debt sustainability in the future: ensuring all new borrowings continue to be highly concessional; reducing the country's fiscal deficit in the medium term; and implementing of growth-enhancing policy reforms that expand and diversify export production, thus minimising shocks to the economy.

However, the international community needs to do more in helping Uganda achieve and maintain debt sustainability in the future. First, Uganda has been unduly penalised by virtue of the fact that it was the first country to access the HIPC debt relief initiative. Errors made in the calculation of HIPC debt relief to Uganda have been corrected for subsequent countries. Moreover, subsequent countries accessing the Initiative have had their exports valued at the prevailing lower global commodity prices, which means they have been given relatively more relief to enable them to arrive at the same PV debt-to-exports ratio. There is therefore a strong case for additional relief to be extended to Uganda to rectify these inequalities and to help improve its debt sustainability indicators. Second, Uganda has not received all the relief it expected, as a result of the non-participation of a number of creditors. Further international debt relief would also help to ease the financial impact on Uganda of this unforeseen non-participation. Third, the international community can help reduce Uganda's future debt burden by giving more aid in the form of grants, rather than loans, thus reducing Uganda's future borrowings from multilateral development institutions.

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4 Challenges for the Future

Key challenges to be addressed now and in the medium term are: the unsustainability of Uganda's current debt despite the HIPC Initiative; the slow implementation of pay reform; the tensions between fiscal decentralisation and capacity at local government level; the fiduciary issues associated with budget support; and the need to reduce Uganda's fiscal deficit.

Macroeconomic policies can contribute directly to poverty reduction by delivering stability and growth. However, in the short run there is a trade-off between strong growth in budget expenditure funded by donor aid, on the one hand, and macroeconomic stability, on the other. This is because large donor-funded expenditures have a macroeconomic impact, which needs to be 'neutralised' by a stronger exchange rate or higher interest rates to enable inflation to remain under control. A stronger exchange rate hurts export production, while high interest rates discourage private sector investment. This trade-off can be partially avoided by integrating donor projects into the budget so as to allow sectors to shift from project to budget support, thus reducing inefficient project spending funded by donor loans and grants, and increasing the efficiency of budget allocations and expenditures. A lower fiscal deficit should also enable Uganda to slowly bring its debt back to sustainable levels. Conversely, the macroeconomic impacts of aid-financed budget expenditures can also be mitigated if more aid is given as debt relief, rather than in the form of new concessional loans.