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Do countries strategically improve their institutions to access increased debt relief?

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Abstract

This paper examines how indebted countries have reacted to the recent shift in the global debt relief architecture towards rewarding indebted countries that have 'superior' institutions with increased debt relief by probing whether there is any empirical evidence to suggest that countries may be taking advantage of this shift. The findings suggest that debtor countries have quickly adapted to the shift by strategically improving in key areas of institutional governance prior to applying for debt relief.

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1. Introduction

The prevailing idea behind debt relief for much of the 1980s and 90s was that a debt burden beyond a certain threshold was counterproductive as it impeded financial flows and discouraged foreign investment, leading to poor or stunted economic growth. Debt relief for countries with large external debt stocks would therefore reduce debt burdens and foster economic growth. However, Bird and Milne (2003) found evidence that among highly indebted low-income countries, higher levels of external debts were often correlated with higher levels of net resource transfers from official sources. Marchesi and Missale (2004) support this assertion, finding that among highly indebted poor countries, the amount of loans they receive increased with their level of multilateral debts. They concluded that creditor countries may be engaging in 'defensive lending', where they granted new loans to help cover the debt service falling due on existing loans. Debt relief and aid thus appeared to be given on considerations other than debt stock levels and debt service obligations, contrary to the public rhetoric. Renewed interest in the role of political and governance institutions in economic development in the late 1990s and early 2000s precipitated a shift in the focus of debt relief efforts. Knack and Keefer (2005) argued that despite the good intensions behind them, good policy prescriptions will almost certainly fail where there are poor institutions such as insecure property rights, inefficient and bureaucratic government machinery and weak rule of law. Burnside and Dollar (2000) also found evidence that foreign aid and debt relief induced growth only in countries that have good institutions. The emerging consensus was that countries with better institutions often performed better with aid and debt relief.

Consequently, there were calls for aid and debt relief efforts to be explicitly linked to institutional quality in recipient countries (e.g. Asiedu 2003; Michaelowa 2003). These calls appear to have been heeded to some extent as Chauvin and Kraay (2007) find that over the period 1993-2003, more debt relief went to countries with better institutions. This shift towards rewarding countries with superior institutions provides an incentive for indebted countries to strategically improve their institutions in order to increase their chances of securing debt relief but whether this opportunity has been exploited or not has not been examined in the literature. This paper is a first attempt at examining how indebted countries have reacted to this shift by probing whether there is any empirical evidence to suggest that countries may be taking advantage of this shift. Section 2 presents the analytical framework and methodology of the study whilst section 3 presents the results followed by conclusions and policy implications in section 4.

2. Analytical Framework And Methodology

We analyse the effect of the shift by examining the experience of countries that applied for debt relief under the Highly Indebted Poor Countries (HIPC) Initiative launched in September 1996 by the IMF and World Bank. The HIPC initiative was aimed at reducing debt burdens of highly indebted countries to sustainable levels through substantial reductions in debt service obligations and commitment to a series of reforms aimed at shifting resources away from debt servicing toward productive investments in health and education. The primary hypothesis is that a country that is about to apply for debt relief will be more likely to improve its institutions as opposed to a country that is not applying for debt relief. To test this, I select 25 countries – all 16 countries that applied for debt relief under the Highly Indebted Poor Countries (HIPC) initiative in the year 2000 and 9 non-HIPC countries (see Appendix). All the countries are observed over the period 1996-2000 to see if there were any improvements in institutional quality. Three key measures of institutional quality are observed over the period – government effectiveness (GE), government regulatory quality (RQ) and social freedoms (VA). These measures adequately capture government performance and the impact of its policies and are selected as a collective measure of institutional quality largely because the government has a more direct impact on these measures and hence are likely to be the focus of government efforts to impress creditors prior to applying for debt relief. Table 1 details these variables.

Table 1. Variable description and Sources

Indicator	Description and source	Expected effect on dependent variable
Dependent Variable		
IMPROVE	Dichotomous. Equals 1 if country improved in at least two of the three measures of institutional quality between 1996 and 2000.	
Variable of interest		
HIPC	Dummy. Equals 1 if country joined the HIPC initiative in the year 2000	Possibly +
Other control variables		
GDPpc	GDP per capita. Source: World Development Indicators (WDI, 2012)	Could be + or -
GDPpcGrowth	The GDP per capita growth rate (%). Source: World Development Indicators (WDI, 2012)	Could be + or -
ExDebtStock	External debt stock (% of GNI). Source: World Development Indicators (WDI, 2012)	Possibly -
TotalDebtServ	Total debt service obligation (% of GNI) – an indicator of the debt service commitments. Source: World Development Indicators (WDI, 2012)	Possibly -
Africa	Dummy. Equals 1 if country is in Africa	Could be + or -
*PolStab**	Political Stability – measures the likelihood that government may be destabilised through unconstitutional or violent means such as a coup d'etat, rebellion or terrorism. Source: World Governance Indicators (Kaufman et al, 2010)	Possibly -
Indicators of Institutional Quality		
GE*	Government Effectiveness – an indicator of the quality of public services and the quality of the civil service as well as the degree of its independence from political pressures. Also measures the quality of policy formulation and implementation and the credibility of government commitment to that process.	
VA*	Voice and Accountability – an indicator reflecting the level of freedom of expression, freedom of association and a free media as well as the extent to which a citizens are able to participate in selecting their government.	
RQ*	Regulatory Quality – Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development Source: World Governance Indicators (Kaufman et al, 2010)	

* normalised, with a zero mean and a standard deviation of one and range from -2.5 to 2.5. Higher values indicate "better" governance/institutional quality.

I use a probit regression model to estimate the probability that a country will improve its institutions prior to seeking debt relief. The estimated model takes the form:

$$P(IMPROVE^*_{it} = 1 | x_t \beta_t) = F(X_t, \beta_t) \quad (1)$$

Functionally, (1) can be represented as:

$$IMPROVE^*_{it} = \beta X_i + \varphi HIPC_i + \mu_i \quad (2)$$

$$E[\mu] = 0$$

$$Var[\mu] = 1$$

Where $IMPROVE^*_{it}$ is an unobserved latent variable. Empirically, we observe the binary variable *IMPROVE* that takes a value of one if there was a positive difference in at least 2 of the 3 indicators of institutional quality between 1996 and 2000 ($IMPROVE^*_{it} > 0$) and zero otherwise ($IMPROVE^*_{it} \leq 0$). X is a vector of control variables and *HIPC* is the explanatory variable of interest - a dummy variable that captures the effect of a country joining a debt relief programme, in this case the HIPC initiative, at the end of the observation period. It takes a value of one if the country joined the HIPC initiative and zero otherwise. μ is an i.i.d error term with a normal distribution.

3. Results

Two models are estimated to investigate the probability of institutional improvement (Table 2). Model 1 includes the HIPC variable and all other control variables. The results indicate that a country about to join the HIPC initiative shows a higher probability of improving its institutions as opposed to a country that is not joining. GDP per capita and its growth rate are not significant but have the expected negative impact on the probability of improvement. This negative effect is reasonable because countries with higher GDP per capita and faster growth rates are more likely to be better run with lower debt burdens. There is also no significant difference in institutional improvement between African and non-African countries, as captured by the *Africa* dummy. Model 2 includes the HIPC variable and only the control variables most likely to influence government's motivation and political will to pre-emptively improve its institutions. Again, countries that joined the HIPC initiative were significantly more likely to improve their institutions. Additionally, improvements in political stability reduced the probability of pre-emptive institutional improvement and are reasonable since countries that are more politically stable are likely to be better run and hence are likely to have lower debt burdens.

Table 2. Probit Estimates

	Model 1			Model 2		
Variable	Coefficient	Std. Err	P-Value	Coefficient	Std. Err	P-Value
C	2.289	3.322	0.490	-0.151	1.132	0.894
ExDebtStock	-0.011	0.016	0.509	-0.016	0.136	0.241
TotDebtServ	-0.332	0.463	0.474	-0.133	0.185	0.473
PolStab	-1.493	1.309	0.254	-1.745	1.057	0.099**
HIPC	4.905	2.609	0.060**	4.588	2.320	0.048***
GDPpc	-0.001	0.006	0.835			
GDPpcGrowth	-0.575	0.596	0.334			
Africa	-1.744	1.541	0.257			
Log likelihood	-5.587			-6.726		
LR χ^2 *(7;4)*	21.495		0.003	19.22		0.000

**significant at 5%; ***significant at 1%

The level of external debt stocks and debt service are not significant but have the expected negative effects on the probability of pre-emptive institutional improvement. Consistent with the theoretical and empirical literature (e.g. Alesina and Weder, 2002; Chauvin and Kraay, 2007), countries with large debt stocks and debt service obligations are likely to be poorly run and lack many of the preconditions necessary for institutional improvement. Consequently, the higher a country's debt stock and debt service, the less likely it is to be able to improve its institutions, although it may have the political will to do so.

4. Conclusion And Policy Implications

Recent shifts in the global aid and debt relief architecture has meant that countries with superior institutions tend to be rewarded with increasing aid and debt relief presenting an incentive for indebted countries to strategically and pre-emptively improve their institutions prior to seeking debt relief. This paper examines how indebted countries have reacted to this shift by probing whether there is any empirical evidence to suggest that countries may be taking advantage of this shift. The findings suggest that debtor countries have quickly adapted to the shift by strategically improving in key areas of institutional governance prior to applying for debt relief. For instance, countries applying for debt relief under the HIPC initiative were much more likely to strategically improve their institutions compared to countries not applying for debt relief. By tying debt relief to institutional improvement, it appears that creditors have succeeded in reinforcing the political will and motivations of politicians and bureaucrats in debtor countries to improve their institutional and governance environments. This is good news for policy makers involved in the design of aid and debt relief programmes but tighter controls may be necessary to ensure that these purported improvements are real and not merely cosmetic, aimed at 'gaming' the system.

APPENDIX: Sample Countries

country
Angola
Argentina
Benin
Brazil
Cameroon
Chile
Gambia
Guinea
Guinea-Bissau
Honduras
Kenya
Madagascar
Malawi
Mauritania
Nicaragua
Niger
Nigeria
Peru
Rwanda
Sao Tome and Principe
Senegal
South Africa
Tanzania
Zambia
Zimbabwe

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