What Potential for Debt-for-Education Swaps in financing Education for All?

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Introduction

Remarkable progress has been made towards meeting the six Education for All (EFA) goals since international commitments were made at the 2000 World Education Forum in Dakar. The most recent EFA Global Monitoring Report\(^2\) shows that with respect to net enrolment ratios significant advances can be observed, even in sub-Saharan Africa and South and West Asia, regions that have traditionally been lagging behind. Nevertheless, regional, intra-regional and intra-country inequalities persist.

The current global financial crisis casts its long shadow over any hard-won gains in the education sector of developing and emerging countries and could worsen inequalities, threatening to undermine the achievement of EFA goals. Lower economic growth will increase fiscal pressure on education budgets, while at the same time diminishing households’ disposable income for education, especially of those that are most vulnerable. The majority of low-income countries lack the capacity to provide a pro-poor fiscal stimulus.\(^3\) To attain EFA in these countries an estimated annual sum of USD 11 billion is required.\(^4\) According to OECD-DAC, worldwide official development assistance (ODA) commitments earmarked to basic education reached USD 2.3 billion in 2007\(^5\), leaving a huge financing gap. Donor countries are moreover expected to cut back on aid because of the crisis, as occurred during financial stresses in the 1990s.

It is hence acknowledged that public education spending in the developing world is falling behind targets and will continue to do so if there is no major effort at scaling-up and/or reallocating resources on part of national governments and the international community. Furthermore, UNESCO has argued, with widespread endorsement at various conferences and summits, that continued and counter-cyclical investment in human resources is crucial in combating the crisis and can spur economic recovery.\(^6\)

In view of countering the adverse effects of the economic downturn, UNESCO is now in search of innovative approaches to augment education spending and close the EFA financing gap. The organisation is considering debt-for-education swaps as one of the possible mechanisms to bring solace, in accordance with the resolution submitted at the 34th session of the UNESCO’s General Conference. Other lines of reasoning include engagement with

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4 UNESCO (2008), op. cit.


emerging donors to boost ODA and the promotion of private-public partnerships in the education sector.7

The advantageous nature of debt-for-education swaps is, however, not be taken for granted. Previous experiences have shown that what might seem a convenient and promising instrument for both debtors and creditors at first sight has often turned out to be seriously flawed. This paper seeks to systematise and build further on some important concerns that have been raised in recent research on debt-for-education swaps and the wider debt-for-development literature in order to identify the necessary conditions to transform such swaps into a more effective and efficient tool for EFA financing. After outlining the origins of debt-for-education swaps (section I), focus will be on their macro-economic practicalities (section II) and role within the current aid architecture (section III). Section IV consequently explores the potential of multi-creditor ‘EduFund’ or ‘Debt4Education’ swap operations in imitation of preceding initiatives in the conservation and health sector. Conclusions are drawn in section V. In the annex I, a more schematic overview of the typical structure of a debt-for-education swap, as well as the related critical issues covered in the text of this paper, is given. In the annex II, a glossary of key terms and concepts is provided.

I. A short history of debt-for-education swaps

Debt-for-education swaps can be defined as the cancellation of external debt in exchange for the debtor government’s commitment to mobilise domestic resources (in local currency) for education spending, as also shown visually in annex.8 The concept of debt-for-education swaps belongs to a broader category of so-called debt-for-development swaps, arrangements which are designed to divert public resources from debt service to agreed upon development oriented spending.

The origins of debt swaps lay, however, in the commercial sphere. The secondary market for discounted debt of developing countries started to grow at an increasing pace when the Latin American debt crisis took off in 1982, triggered by Mexico’s decision to default on its debt service. Chile was the first country to implement an institutionalised debt-for-equity swap scheme in 1985. Such debt-for-equity swaps involve the sale of external (typically commercial) debt, purchased at a reduced price in the secondary market by an investor, to the debtor government in return for capital investment or shares in local debtor country companies. The underlying rationale is that by engaging in these swaps the debtor nation enjoys some debt relief, while the foreign investor buys itself into companies at a preferential exchange rate which magnifies its purchasing power.9 Debt-for-equity conversions were very much linked to privatisation programmes, swapping debt for public assets, in countries such as Argentina, Mexico and the Philippines during the 1980-90s.10 In its peak period, from 1985 to 1996, debt-for-equity operations totalled USD 38 billion.11 Primarily due to the falling popularity of privatisation since the mid-1990s and growing critiques on the inflationary

7 UNESCO (2009c) Conference on Emerging Donors and Innovative Approaches to Education Financing, Draft Concept Note.
character of these often large-scale interventions, debt-for-equity swaps lost their appeal in the ensuing years.12

The mechanisms developed for executing debt-for-equity swaps inspired NGOs to finance environmental projects by investing in and reselling debt paper to the debtor country concerned. The first debt-for-nature swap took place in 1987, when US-based Conservation International exchanged debt with the Bolivian government for its commitments to protect a biosphere reserve and establish a supporting fund in local currency.13 Soon, similar debt-for-development initiatives followed in other sectors, most notably child development, education and health. Initially limited to commercial debt, this first wave of debt-for-development conversions surged with the introduction of the Paris Club debt swap clause14 in 1991, making bilateral debt eligible for swap transactions between Paris Club creditors and their debtors.15 The United States, Canada and Switzerland pioneered the possibility of bilateral arrangements.16

However, these debt-for-development swaps also attracted strong criticism for the partly fictitious nature of their financial transfers, their insufficient scale to bring about systemic economic change, and inappropriate conditionalities. Donor emphasis subsequently shifted towards larger-scale and more comprehensive debt relief initiatives, most notably the Heavily Indebted Poor Countries (HIPC) Initiative and its successor, the Multilateral Debt Relief Initiative (MDRI).17 In 1996, the IMF and World Bank together launched the HIPC Initiative to bring back to manageable levels the debt levels of a number of selected severely indebted low-income countries. The original HIPC terms were reviewed in 1999 under the Enhanced HIPC Initiative, resulting in a relaxation of eligibility and progress criteria and the introduction of Poverty Reduction Strategy Paper (PRSP) conditionality (see later). In 2005, the IMF, World Bank and African Development Fund supplemented HIPC debt relief with the MDRI in which debt owed to the three multilateral organisations was forgiven for post-HIPC-completion countries. To date, HIPC debt reduction packages have been approved for 35 countries, providing an estimated USD 51 billion of nominal debt service relief over time.18

In spite of earlier criticism, debt-for-development swaps have re-emerged in recent years and further initiatives are being proposed. This second wave of swaps typically targets low- and middle-income non-HIPC-eligible countries and non-HIPC/MDRI-eligible debt titles. Whereas during the 1980s and 1990s debt-for-development swaps were largely multi-sector and nature/environment-based, education appears to gain importance as a beneficiary sector. Since 1998, 18 debt-for-education swap initiatives have been initiated in 14 different debtor

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12 Buckley (2009), op. cit.
13 Buckley (2009), op. cit.
14 The Paris Club is an informal forum to discuss debt service problems and negotiate debt restructurings between indebted developing countries and their official bilateral creditors. A Paris Club creditor country is permitted to swap up to 100% of its concessional bilateral debt (ODA claims) for development purposes. The conversion of non-concessional debt is subject to restrictions, which have become more generous over time. See Paris Club (2009) Debt swap provision, Available: http://www.clubdeparis.org/sections/types-traitemtent/reechelonnement/clause-conversions.
15 Moye (2001), op. cit.
countries, representing a conversion of about USD 608.8 million of debt into USD 283.2 million worth of local education support. These education swaps account for approximately 10% of total debt conversion and development support generated by the 128 debt swaps targeted to social sector spending that have been identified for the period 1988-March 2008.19

Germany has conducted three debt-for-education swaps with Indonesia and one with Pakistan and a German swap with Jordan was also partially directed towards the education sector. France has been another Paris Club member interested in these exchanges, earmarking part of its Contracts for Debt Relief and Development (C2D) to education sector support in Cameroon, Mauritania, Tanzania and Nicaragua. Current pacesetter among creditor countries implementing debt-for-education swaps, however, is Spain.20 The Spanish leadership role was established in September 2004 at the Summit against Hunger and Poverty in New York, when Spanish Minister-President José Luis Rodríguez Zapatero declared Spain’s intentions, beyond its HIPC commitments, to actively engage in debt-for-development swaps, especially those geared towards primary education. A year later, debt-for-education swaps were termed a cornerstone of the Master Plan for Spanish Cooperation 2005-2008, Spain’s main development policy document, and negotiations with several Latin American countries began.21 So far, Spain has signed agreements with Ecuador, Nicaragua, Honduras, El Salvador, Bolivia, Peru, the Dominican Republic and Paraguay.22

The recently renewed interest for debt-for-development interventions has to a large extent come from Latin American governments, regional intergovernmental organisations and civil society.23 At the XII and XIII Iberoamerican Conferences on Education in 2002 and 2003, the Ministers of Education called upon regional Heads of States to consider debt-for-education swaps as a vehicle to convert a part of regional debt into education funding, thereby supported by civil society organisations and the Organisation of Iberoamerican States for Education, Science and Culture (OEI). In 2003, during the 32nd session of UNESCO’s General Conference, Argentina, Brazil, Venezuela and Peru also proposed UNESCO to lead a global debt-for-education initiative. Their requests were answered when resolution 33 C/16, urging the establishment of a Working Group on Debt Swaps for Education, was passed at UNESCO’s 33rd General Conference session in 2005. This Working Group, chaired by Argentine Minister for Education, Science and Technology Mr Daniel Filmus and composed of representatives of both creditor and debtor countries with debt swap experience, UN agencies, international organisations, regional development banks and civil society, met for the first time in Paris on 27-28 November 2006.24 The meeting resulted in the establishment of a basic conceptual framework, an exchange of experiences and a work plan for the period leading up to the 34th session of UNESCO’s General Conference. A second Working Group meeting was held in Buenos Aires on 12-13 July 2007. Key concepts and models, lessons

22 Filmus and Serrani (2009), op. cit.
23 The following overview is primarily based on Working Group on Debt Swaps for Education (2007), op. cit. and Filmus and Serrani (2009), op. cit.
learned from debt swap experiences, guidelines on best practices and recommendations resulted in a report submitted to the UNESCO’s Director-General Mr Koichiro Matsuura for the 34th session of the General Conference. This General Conference asked the Director-General to continue to convene the Working Group and to lead the debate on debt-for-education swap initiatives by promoting inter-agency meetings on alternative financing of education. The Group ceased to convene when no extra-budgetary sources were received to finance follow-up activities and traditional and potential donors did not express much interest in the initiative. Nevertheless, the debate on debt swaps as one of alternative financing initiatives will continue during the Conference on Emerging Donors and Innovative Approaches to Education Financing in 2010. In the meantime, the Latin American stakeholders have continued to research and promote the debt-for-education concept.

Now that debt-for-education swaps have been placed in historical perspective, Section II and III will argue that debt-for-education swaps are much more complex interventions than one might think in first instance. Luckily, the naive view that debt swaps constitute a panacea, simultaneously reducing debt burdens and multiplying social sector spending, seems to have been abandoned in most recent proposals. Nevertheless, it may be well-worth to summarise and elaborate on previous concerns in order to distil necessary conditions for debt-for-education swaps to become effective and efficient mechanisms to finance EFA.

II. The (troublesome) macro-economic nature of debt swaps

Fiscal space

In the past, it has often been considered self-evident that debt swaps would increase net financial transfers to recipient countries. Debt relief to the public sector, whether implemented through debt swap transactions or other modalities, would allow the debtor government to divert public resources, otherwise leaving the country via debt service payments, to domestic spending in areas beneficiary for development, such as the health sector, the environment or the education sector or to bring down any existing budgetary deficits. In other words, the condonation or conversion of debt creates additional room or ‘fiscal space’ in the recipient country’s budget, which it can spend without compromising the sustainability of its fiscal and macro-economic position. However, the above is only a very simplistic representation of debt relief mechanisms, debt swaps in particular, and several important qualifications have to be taken into account.

Time inconsistency

First of all, there is a problem of time inconsistency between the budgetary gains from debt relief and the domestic counterpart resources that have to be mobilised in a swap arrangement. The former only gradually materialise over time, typically over many years or even decades, at the pace of the contractual debt service payments cancelled with the exact

26 See e.g. Filmus and Serrani (2009), op. cit. for an extensive study on debt-for-education swaps by the OEI and Fundación SES.
28 Cassimon et al. (2008), op. cit.
timing depending on the specific original repayment terms and schedule of the debt. The latter, on the other hand, is typically due much earlier, frontloaded to an early point in time, at best within a span of a few years. The nominal value of the cancelled debt does therefore not necessarily give a reliable projection of the budgetary gains of debt relief. The net present value (NPV) of the stream of all future contractual debt service payments, using the interest rate on international borrowing or interest rate at which the debtor country can raise this money in the domestic market, is arguably a more correct measure. Especially when the debt concerned in a swap intervention is highly concessional, bearing very low interest rates and long maturity and repayment periods as is the case with claims accounted for as ODA, the NPV will be significantly lower than the nominal measure. Similarly, counterpart payments can also be most usefully expressed in NPV terms.

A look at past practice shows that the above reasoning is of great relevance to recent debt-for-education swaps. The Spanish government applied a discount rate of 40% on the local counterpart funds in swaps with HIPC countries Honduras and Nicaragua, but demanded full conversion in swaps with non-HIPC countries Ecuador, El Salvador and Peru. In German swaps with Indonesia and Jordan, also non-HIPC countries, discount rates of 50% were agreed upon, although these were not determined on a NPV basis. Time inconsistency was often not resolved. Whereas the original debt service planning was maintained for counterpart payments in the case of the Spanish-Honduran swap, this procedure was not followed in the Spanish-El Salvadorian swap where payments had to be made upfront. The combination of no discount on the converted sum and the frontloading of counterpart funds makes that in the case of El Salvador fiscal space was destroyed rather than created by the debt-for-education agreement. For these reasons, several civil society (and other) organisations have argued for more fiscal flexibility in the design of debt-for-education swaps, by increasing discount rates and by matching counterpart payments more closely to the original terms of debt service. These principles have also been adopted by the UNESCO Working Group on Debt swaps for Education. In order to avoid excessive counterpart obligations, one could moreover target non-concessional rather than concessional debt with debt-for-education swaps. It must, however, be noted that this elevates the debt relief effort and thus the cost to the bilateral donor. In the same line, creditors prefer heavily discounted and spread-out counterpart funds so as to avoid fiscal pressures, while donors would like to boost publicity and their popularity by bringing as much funds possible forward in time. Political considerations and bargaining power certainly play their role. Holding debt swap negotiations between creditor and debtor countries on the basis of NPV figures would at least go a way in creating more transparency.

\[29\] For an example, see Cassimon et al. (2008), op. cit., p. 1190.
\[30\] Navarro (2006), op. cit.
\[35\] See Working Group on Debt Swaps for Education (2007), op. cit.
\[36\] Ruiz (2007), op. cit.
\[37\] Cassimon et al. (2008), op. cit.
Repayment of debt

An implicit assumption in the foregoing is that the original debt would have been fully serviced in the absence of the debt relief operation. Such reasoning is obviously overly optimistic, especially with respect to countries that experience debt service problems. If not all debt would be serviced, the resource effect of debt reduction is partly virtual and could be referred to as merely an accounting clean-up of historical and future arrears accumulation. The possibility of debt service defaulting has to be taken into account because only the share of debt service that would have been actually paid up to the creditor in the absence of debt relief generates true fiscal space. Debt relief operations, such as debt-for-education swaps, that seem generous at first sight may therefore only lead to minor budgetary gains. They may in fact result in less fiscal space for the debtor country than before if counterpart payments are large in comparison to the expected debt service these operations forgive. Replacing debt relief service in hard currency by local currency counterpart transfers may, however, represent a relief on itself. Even if fiscal space effects are zero or negative, the balance of payment (BOP) situation of the debtor country can be positively impacted by such a switch, to the extent that the country suffers from severe foreign exchange shortages. Most important, the literature suggests that debt relief resulting from the earlier mentioned first wave of debt-for-development swap initiatives was indeed largely fictitious in budgetary terms. The same conclusion also extends in part to debt relief granted under the HIPC Initiative.

To determine whether the second, more recent wave of debt-for-development, to which debt-for-education swaps belong, score better in this respect, these interventions will have to be assessed on a case-by-case basis. It is not because the countries these swaps are typically targeting are not classified as HIPCs that they do not experience debt service problems and would have fulfilled all of their obligations. While Indonesia, for example, has been servicing its foreign debts, the fact that the country has enjoyed Paris Club debt rescheduling on so-called Houston terms for lower middle-income countries in 2000 and 2002, hints at some previously existing debt serving problems. Other non-HIPC debtors involved in debt-for-education swaps with Germany and Spain have also benefited from Houston treatments: Pakistan (1999 and 2001), Jordan (1994, 1997, 1999 and 2002), Ecuador (1992, 1994, 2000 and 2002), El Salvador (1990), Peru (1991, 1993 and 1996) and the Dominican Republic (1991). Possible default on debt service by these countries may have been merely averted by the Paris Club arrangements mentioned. If debt-for-education swaps are to be more than simply virtual transactions they should convert debt that would have been repaid in their absence. Estimating the counterfactual, i.e. the probability of default on debt titles while making abstraction of a debt relief operation that has taken place, is however clearly a difficult task.

40 Cassimon and Vaessen (2007), op. cit.
41 Cassimon et al. (2008), op. cit.
42 Cassimon et al. (2009), op. cit.
43 Paris Club (2009b) List of the countries that have benefited from Houston, Available: http://www.clubdeparis.org/termscountry_view?t=HO.
**Additionality**

All too often it has been assumed that debt swaps, whether in the education sector or not, are brokered on top of all other forms of donor support and thus increase net transfers to recipient countries. This assumption is especially recurrent when the countries being targeted are non-HIPCs and swaps are said to draw in ‘additional’ debt titles outside current large-scale debt relief initiatives. However, increasingly it is acknowledged that debt swap arrangements may crowd out other, potentially more effective, aid interventions such as budget support, as well as domestic budgetary resources (for the education sector).

A certain degree of fungibility, whereby developing country governments reduce their own resources in the sector or for the project that receives aid and use them elsewhere, is not constrained to debt swaps but inherent to most types of aid instruments, albeit more pronounced in the case of specifically targeted support. From a creditor perspective, similar fungibility behaviour appears equally rational. Current aid accounting rules seem to incite donors to treat debt for education swaps and other debt relief operations as substitutes for new aid. The Development Assistance Committee (DAC) of the OECD uses ODA as the major benchmark against which the generosity of donors is weighted. ODA statistics are used to assess whether individual bilateral donors attain the 0.7 % of gross national income (GNI) target set by the UN or live up to any other aid commitments made and hence feature widely in the public debate within donor country constituencies. Since DAC allows the whole nominal value of debt relief to be counted as ODA, debt-for-education swaps are an attractive option for donors to boost ODA figures. If the donor in question is aiming for a certain ODA level (e.g. the prescribed 0.7% of GNI), as donors often do, then it will tend to compensate the costs incurred from debt swaps by reducing other categories of ODA spending. The question that suggests itself then is whether engaging in debt-for-education swaps at the expense of, for example, budget support or the financing of education projects is all that attractive. Because the nominal value of debt-for-education swaps typically overstates both the benefit to the debtor country and the cost to the creditor, as outlined before, it may very well not be.

Debt-for-education swaps can only be properly judged on their own merits if there is full additionality from a creditor and a debtor perspective, with freed-up funds coming on top of other aid interventions as well as budgetary resources that had already been reserved by the recipient government. Empirical evidence does not support the argument that debt swaps have increased financial disbursements to recipient countries in the past. There is furthermore no systemised data on whether swap operations are additional from a debtor perspective. The need for additionality ‘in a double sense’ has been strongly emphasised in publications on debt-for-development and debt-for-education in particular and has consequently been taken aboard by the UNESCO Working Group on Debt Swaps for Education. There have been some attempts to put these principles into practice. German debt swap modalities, for example, prescribe that local currency funds can only be directed to new projects or ongoing

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45 Cassimon et al. (2008), op. cit.
47 See e.g. Moye (2001), op. cit. and Ruiz (2007), op. cit.
49 See Working Group on Debt Swaps for Education (2007), op. cit.
projects whose funding is jeopardised. Measuring debtor government education spending against a historical spending baseline could also possibly give an indication of the degree of additionality from a debtor perspective of debt swaps. Persuading donors to undertake debt-for-education swaps above and beyond other aid commitments seems politically difficult under prevailing ODA rules, but it may not be impossible.

Indirect effects

The above analysis is not complete. Even if debt-for-education swaps do not automatically generate additional fiscal space for their recipients, it is important to look deeper in their potential to induce other, more indirect, positive effects at the macro-economic level. Focus will be here on the theories of debt overhang and defensive lending and how debt swaps connect to these.

Excessive debt burdens often incite debtor governments to react in undesirable ways. Large debt service payments may lead to lower spending on the country’s developing priorities or other sub-optimal fiscal behaviour such as high levels on domestic borrowing, which displaces the private sector, irresponsible inflationary financing and disproportionate taxation of the productive sectors in the economy. Economic reform is moreover discouraged if any form of economic progress primarily benefits foreign creditors. This could in turn hold back private investment in the indebted economy, further depressing the economic growth rate. The vicious circle described is usually referred to as the ‘debt overhang’ hypothesis. Debt relief interventions, independent of their earlier described macro-economic effects could possibly break through this debt overhang, relaunching the recipient country on a path to economic growth and development. Education as other social sector spending may well benefit from a more comfortable public finance situation triggered by economic recovery.

In addition, net international public transfers could also be positively affected by reducing debt burdens. It has been found that the build-up of debt has undermined the selectivity of donors. Bilateral donors have been inclined to provide the most-indebted countries with fresh credits to allow them to fulfil their debt service obligations, rather than putting these funds to better development use in less-indebted countries with often better policy choices. This practice has been coined ‘defensive lending’. The above reasoning implies that debt relief eliminating the debt overhang would restore donor selectivity as the need for defensive lending diminishes. Furthermore, higher ‘marginal productivity’ of aid through improved donor behaviour may well make it politically possible to convince constituencies in donor countries to maintain or even enlarge development aid budgets.

Again important qualifications apply. To start with, the existence of a negative relation between debt and economic growth caused by debt overhang has been questioned, in particular with respect to low-income countries and extremely low or high levels of debt.

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50 Berensmann (2007), op. cit.
51 OEI (2006), op. cit.
52 Cassimon et al. (2008), op. cit.
53 See e.g. Krugman (1988), op. cit.
54 Birdsall et al. (2003), op. cit.
burden. Critics argue that excessive external debt, rather than leading to depressed growth, is in itself a result of more systemic problems that cause growth rates to decline. Accordingly, debt relief can therefore only be part of a lasting solution if coupled with thorough institutional, economic and political reform. However, for middle-income countries, the typical recipients of debt-for-education swaps, some empirical evidence supporting the debt overhang thesis has been reported.

More problematical is the logic that only when debt relief reaches a certain critical mass and is effectuated in a harmonised and concerted way, a country will have a chance to escape the high debt-low growth trap. Debt swaps are deemed too small, in comparison with the overall debt burden of countries suffering from debt overhang, to make a real dent. Looking at some of recent cases, it becomes clear that debt-for-education swaps are no exception. One should, for example, not have too high expectations of a Spanish swap of USD 50 million with Ecuador, representing only 18% of the latter’s bilateral debt owed to Spain and a mere 0.3% of the total Ecuadorian external debt stock at the time (approximately USD 17 billion). The same holds for the Spanish-El Salvadorian and the German-Indonesian debt-for-education agreements. The insight that a debt overhang can only be addressed through a ‘discrete shock’ delivered by large and comprehensive debt relief operations led to the gradual demise of the first wave of debt swaps and the rise of schemes such as the HIPC Initiative (see before) and the Brady deals for middle-income countries with large external private debts, that normally involved many hundreds of millions of USD per country. In the Brady debt reduction deals between 1989 and 1995, 16 middle-income countries and their private creditors engaged in swapping syndicated bank debt for bond debt at lower nominal value and/or reduced interest rates. The principal goal of tackling debt overhang in those countries was arguably achieved.

With respect to debt-for-education and other ‘second-wave’ debt swaps, critical voices have demanded to increase the size of operations. The upper limits for bilateral debt conversion set by the Paris Club are indeed far from being reached, even by forerunners Germany and Spain. It is also imperative to understand the structure of developing country debt. Aggregated World Bank data show that a large proportion (25%) of the external debt of low-income countries is in private hands. For middle-income countries the share of private creditors is almost three times higher (74%). There seems, however, to be considerable variation between developing countries in the composition of their external debt. Nevertheless, even if hypothetically all bilateral debt would be cancelled or converted through swap arrangements, it would have a minor impact on the overall debt burdens of most of

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58 Navarro (2006), op. cit.
60 See Cassimon et al. (2009), op. cit.
61 Bulow and Rogoff (1991), op. cit.
63 See footnote 14.
64 See Berensmann (2007), op. cit. and Navarro (2006), op. cit. respectively.
65 Figures come from an aggregation of Global Development Finance data by Ruiz (2007), op. cit.
It is therefore widely acknowledged that bilateral debt(-for-education) swaps can not be used to solve the problem of excessive debt in developing countries\textsuperscript{68} and are no substitute for a more structural global response.\textsuperscript{69}

So far, the analysis has focused on the peculiar macro-economics of the debt swap instrument, which need to be understood if debt-for-education swaps are to be rendered more effective in creating fiscal space. This is of course only part of the story. In what follows, the modalities of education support resulting from such swaps and how this fits into current thinking on development aid will be examined.

### III. The role of debt swaps within the current aid architecture

#### Evolution of donor thinking

To the extent that debt relief frees up additional budgetary resources for the recipient government it is very similar to general budget support. It is, however, not automatically the case that debtor governments will use these extra resources for a desirable, development-oriented purpose, say education. Donors have used this argument to restrict the freedom of manoeuvre to developing country governments. Consequently, they have tempted to control to a certain degree in which ways the proceeds of debt relief operations are being spent, either by giving binding advice on the utilisation of funds or, more subtly, by trying to influence recipient behaviour through policy dialogue and broader conditionalities. The first strategy is referred to as ‘earmarking’ in donor jargon. Different types of earmarking exist\textsuperscript{70} and control mechanisms, for debt relief as for other aid modalities, have changed over time according to shifting trends in donor thinking.

Debt swaps of the ‘first wave’ are generally seen as an instance of so-called ‘micro-earmarking’, with donors trying to keep close track of the use of freed-up resources and to exert control down to the smallest detail. To achieve this, resources are placed in counterpart funds, often created outside the regular budget of the recipient country, that are jointly-managed by donor and debtor. Mechanisms for implementation, monitoring and implementation are typically donor-imposed and bypass the recipient government’s own public system. The practice of micro-earmarking was common during the hey days of the old project aid paradigm. Its advantages are strong donor commitment, ease of monitoring and evaluation and a high degree of donor accountability towards home constituencies. A first well-known weakness of micro-earmarking is high fungibility. Because of fungibility, such micro-earmarking does not lead automatically to more resources being available for public development spending (see before). Other drawbacks are elevated transaction costs, lack of long-term capacity building and strengthening of the public system, and resulting weak ownership and sustainability.\textsuperscript{71}

\textsuperscript{67} OEI (2006), op. cit.
\textsuperscript{68} See e.g. Ruiz (2007), op. cit. and Navarro (2006), op. cit.
\textsuperscript{69} See e.g. Ayuda en Acción et al. (2005), op cit. and Filmus and Serrani (2009), op. cit.
Since the new millennium, the second strategy of donor control describe above is favoured. Donors, at least in their official discourse, propose to leave the allocation of funds, the subsequent planning, budgeting and implementation of projects and the corresponding monitoring and evaluation processes in the hands of the recipient government, but at the same time attempt to exert pressure to gradually improve public sector functioning. Within debt relief practice, the evolution in donor thinking, from stringent and largely donor-driven earmarking towards linking freed-up resources to broad recipient country-owned priority setting, has been translated into the Poverty Reduction Strategy Paper (PRSP) process in the HIPC Initiative. A PRSP sets out a country’s macro-economic, structural and social policies and programmes that will be pursued over a period of time for economic growth and poverty reduction, as well as the associated financing needs and sources. This document is prepared by developing country governments, domestic stakeholders and external development partners in a participatory way and is since 1999 a precondition to qualify for debt relief under the enhanced HIPC Initiative and concessional IMF/World Bank financing. As such, most debt relief has evolved to what can be denoted as ‘debt-to-PRSP swaps’.72

More recently, at various gatherings and summits, donors have committed themselves further to the new aid paradigm. The 2005 Paris Declaration on Aid Effectiveness and the 2008 Accra Agenda for Action are well-known. In Paris, individual donors as well as multilateral and bilateral development organisations subscribed to, among other principles, the concepts of ‘policy alignment’, promising to base their support on partner countries’ national development strategies, and ‘system alignment’, using countries’ own institutions and systems for public management, implementation, monitoring and evaluation where these can be considered reliable, effective and accountable. The Accra Agenda for Action used the Paris Declaration as baseline and called to accelerate and deepen its implementation. Besides to country ownership and the predictability of aid, much attention went out to avoid ‘donor proliferation’, reducing the number of donor channels through which ODA is provided to a given recipient country, and ‘aid fragmentation’, bringing down the number of donor-funded activities and increasing their average value.

In view of the foregoing, one could wonder to what extent debt-for-education swaps, belonging to the second wave of debt swaps, go against the current of the new aid paradigm and return to the old habit of micro-earmarking for which their predecessors were criticised. The remainder of this section will discuss how well commitments of policy and system alignment and of avoiding donor proliferation and aid fragmentation have been respected in executing these swaps and will suggest some ways forward to fit the debt-for-education concept better into the current aid architecture.

Policy and system alignment

Research on debt-for-education swaps has stressed the importance of the alignment of education support resulting from these swaps with national development plans and/or sectoral

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73 Cassimon and Vaessen (2007), op. cit.
strategies, a principle endorsed by the UNESCO Working group on Debt Swaps for Education in its guidelines on best practices. Evidence on recent swaps shows that significant progress has been made in policy alignment when compared with first-wave debt swaps, but room for improvement remains. It has been argued that the two first German-Indonesian debt-for-education swaps were well attuned to Indonesia’s Interim-PRSP and EFA strategy for 2003-2015. As many middle-income countries have not produced a PRSP, resources will need to be integrated into other, similar national development or education strategies and EFA action plans if they exist. In Jordan, for example, debt swaps are said to have been embedded in the National Agenda and the Socio-Economic Transformation Plan. Similarly, in El Salvador, proceeds from a debt swap with Spain were used to support, as requested by the El Salvadorian government, two of eleven strategic programmes of the long-term National Plan for Education 2021. For resources coming from Spanish debt swaps with Nicaragua and Honduras, although loosely linked to the respective PRSPs, prioritisation along the recipient countries’ interests was far less clear. Further increasing policy alignment of debt-for-education swaps could stimulate country ownership and hence improve sustainability of the education support given.

System alignment along the whole debt-for-education swap process, working with the recipient country’s systems and procedures to the maximum extent possible, is indispensable for long-term capacity building and strengthening of the public sector. Nevertheless, various studies cast doubts on how system-aligned recent swap initiatives in the education sector have been. In present-day Spanish debt-for-education swaps with Latin American countries counterpart funds are administered and approved by a binational Political Committee composed of two representatives of the Spanish Ministry of Economy and Finance and two debtor country representatives, generally affiliated with the Ministries of Economy, Finance or Planning and/or the Central Bank. Participation of the Ministries of Education and civil society is however lacking on this decision-making level. The Political Committee is assisted by a binational Technical Committee, responsible for the analysis and presentation of programmes or projects. The exact composition of the Technical Committee varies between different swap arrangements. In all cases the Spanish Technical Cooperation OTC and a selected Spanish NGO with experience in educational matters of the debtor country in question have been assigned a role in this consultative body. On the Latin American side, apart from in arrangements with El Salvador and Peru, Education Ministries have not been given voice. Debtor country civil society organisations have been granted representation in the Technical Committees of Spanish debt swaps with Ecuador, Honduras, Peru and Bolivia but no room for participation of similar organisations has been created in swaps with Nicaragua and El Salvador. In some deals the Technical Committee gets additional technical and financial management support by a third party, such as the Andean Development Corporation (Ecuador) or the Central American Bank for Economic Integration (Honduras). Although these international financial organisations are said to improve the efficiency and transparency of operations, their involvement can possibly add extra bureaucracy.

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76 See e.g. Vera (2007), op. cit.
77 See Working Group on Debt Swaps for Education (2007), op. cit.
78 Cassimon et al. (2009), op. cit.
79 Berensmann (2007), op. cit.
80 Navarro (2006), op. cit.
81 The following analysis focuses on the system alignment of Spanish debt-for-education swaps as they are best-documented. For more info on German initiatives with Indonesia and Jordan, see Berensmann (2007), op. cit.
82 Navarro (2006), op. cit.
83 See Vera (2007), op. cit.
conditionality and expenses to the debt swap which could have been avoided.\textsuperscript{84} To make things worse, Spanish swap arrangements contain contractual clauses stipulating that, whenever possible, counterpart funds should be used to finance projects that are implemented by Spanish or debtor country companies and NGOs with sufficient Spanish participation. Spain has demonstrated some flexibility in applying these stipulations, allowing an open tender for the implementation of certain projects.\textsuperscript{85} Nevertheless, it would be preferable to scrap the clauses all together in future debt swap contracts, as the long-time discredited practice of ‘aid tying’ undermines the development of local capacities in the debtor country and stands in explicit contrast to the principles agreed upon in Paris and Accra. Spanish and Latin American civil society also rightly demand much more social participation at every stage of future debt swap processes.\textsuperscript{86}

Donor proliferation and aid fragmentation

The global aid landscape has become progressively more crowded and complex. With ever more bilateral donors and an increasing number of multilateral channels, donor proliferation at the country level has continued to grow over time. The average number of donors per recipient country was 33 for the 2001-2005 period, compared to about 12 in the 1960s.\textsuperscript{87} The proliferation of aid channels is most problematic in the health sector\textsuperscript{88} but also apparent, albeit to a lesser extent, in the education sector. Although financing to education is dominated by a small core of donors (France, the Netherlands, Germany, the United Kingdom and the World Bank’s International Development Association), many other OECD-DAC, non-DAC and private donors are active in this field. The EFA Fast Track Initiative, which was launched in 2002 as a global partnership designed to achieve greater harmonisation and complementarity between multilateral and bilateral donors, represents only a minor part of the aid to education. Donors primarily operate their own bilateral programmes and projects, often in neglect of EFA goals.\textsuperscript{89} Resources for these programmes and projects have moreover been generated through different channels, of which the debt-for-education swap mechanism is just one of the latest additions. Multiple non-harmonised aid channels impose an additional burden on already weak administrative and implementation capacities in developing countries. As various donors all formulate their own requirements for negotiating on, implementing, monitoring and evaluating programmes and projects, managing ODA flows coming through many different channels becomes a huge challenge for aid recipients.\textsuperscript{90}

The World Bank reports that donor proliferation has been combined with the fragmentation of aid, especially in social sectors such as health and education, where the number of donor-funded activities is vast and average financial size is small. Aid fragmentation seems to be more outspoken in recipient countries with lower institutional capacities.\textsuperscript{91} In spite of commitments to deliver 66% of aid flows in the context of programme-based approaches by

\textsuperscript{84} Navarro (2006), op. cit.
\textsuperscript{85} Vera (2007), op. cit.
\textsuperscript{86} See e.g. Mealla (2007), op. cit.
\textsuperscript{87} World Bank (2007), op. cit.
\textsuperscript{89} See UNESCO (2008), op cit.
\textsuperscript{91} World Bank (2007), op. cit.
2010, donors continue to earmark most of their contributions to a wide variety of non-aligned small projects. This practice has been said to lead to elevated transaction costs for the recipient country, both direct and indirect, through the absorption of the scarce energies and attentions of relatively senior government staff and the stimulation of dysfunctional bureaucratic and political behaviour.

Debt-for-education swaps, if limited in size, strongly earmarked and insufficiently coordinated with other education sector support, thus may add to donor proliferation and aid fragmentation, standing in the way of a holistic approach to education and the development of a sustainable sector in the recipient country. Evidence from recent swap initiatives suggests that in most cases there was at least a certain degree of integration into existing bilateral and/or multilateral education support arrangements. Proceeds from the first two German-Indonesian debt-for-education swaps were used within the framework of the Science Education Quality Improvement Project, an ongoing partnership between the German and Indonesian government, and to complement activities sponsored by the World Bank. The German swap with Jordan was embedded in the Education Reform for the Knowledge Economy programme, an USAID initiative in which German development agencies had participated before. In the case of Spanish initiatives, full integration of debt swaps into Spain’s development policy, although acknowledged in the country’s 2006 Law on External Debt, has been hampered by the typically belated involvement of the Spanish Agency for International Cooperation in the negotiation phase of these swaps. Harmonisation and complementarity with education support of other donors operating in the same country has moreover varied from considerable in El Salvador and Honduras to almost non-existent in Nicaragua.

IV. Towards an EduFund or Debt4Education initiative?

As pointed out before, recent ‘second wave’ debt-for-education swaps have been negotiated on a strictly one-to-one bilateral basis. It may therefore not come as a surprise that there is now a general tendency to look at multilateral agreements, in which resources generated by debt relief from various creditors are pooled into a single fund for education, as the way forward. Proponents argue that such multi-creditor funds, ideally compromising creditors from the North and South, have the potential to increase the scale and sustainability of operations, bring down transaction costs and improve possibilities for the coordination of funds with both national development plans of the debtor country and creditor development policies. Often inspiration is drawn from the EcoFund, an independent fund set up by the Polish government in 1992 to finance environmental projects in exchange for a 10% cancellation of its bilateral Paris Club debts, and the Debt2Health Conversion Scheme of the Global Fund to fight AIDS, Tuberculosis and Malaria, an initiative whereby bilateral and multilateral creditors are invited to cancel debt if the debtor country agrees to transfer a certain share of the freed-up funds to the Global Fund which then supports health-related

92 See OECD-DAC (2005), op. cit.
95 Berensmann (2007), op. cit.
96 Vera (2007), op. cit.
activities in the country. The parallels are reflected in the expressions ‘EduFund’ and ‘Debt4Education’, which are suggested as names for a possible multilateral construction for education. Caution is however in order when making such comparisons, as it can be argued that the design of both the EcoFund and the Global Fund’s Debt2Health initiative is seriously flawed.

While the EcoFund was highly successful in generating a large amount of resources and improving donor coordination, it also strengthened the practice of tied aid, serving to promote the interests of foreign companies in Poland. A case study on the first Debt2Health agreement between Germany and Indonesia reveals that the Global Fund’s Conversion scheme, because of the reasons outlined in section II, does not guarantee additional fiscal space for recipient countries. Debt2Health moreover diverts public funds to global non-state actors who earmark funds oblivious of commitments of policy and system alignment. This undermines country ownership and thereby the long-term sustainability of the recipient country’s health sector. Competition with other parallel initiatives has arguably further exacerbated donor proliferation and aid fragmentation in the health sector. Modelling a multi-creditor fund for education on the Polish EcoFund or the Global Fund’s Debt2Health initiative should thus be avoided.

Even if an ‘EduFund’ or ‘Debt4Education’ initiative would avoid all the pitfalls of the EcoFund and the Debt2Health Conversion Scheme, one should not expect such a fund to constitute a cure-all with the potential to close the EFA financing gap. Only in low-income non-HIPC-eligible countries there seems to be some scope for larger-scale (multi-creditor) debt-for-education swaps. With respect to HIPC countries virtually all multilateral and bilateral debt is scheduled to be forgiven once these countries reach completion point. Middle-income countries’ debt, on the other hand, is typically owed to private creditors which would have to be compensated for the conversion of debt into education support which does not benefit them in any way. Such compensation would eventually be almost equivalent to giving education sector grants directly to debtor countries, apart from being much more complex to administer.

V. Conclusion

In the end, the effectiveness and efficiency of debt-for-education swaps as a development instrument and a potential innovative financing approach to work towards EFA goals is very much conditional on a number of practicalities and design issues. To reduce fiscal pressures on the debtor country’s government, larger discount rates on counterpart payments need to be granted and the timing of such payments has to match the original debt service schedule. Preferably, debt-for-education swaps should target non-concessional debt that is likely to be serviced. Guaranteeing that swaps are truly additional in a double sense, with freed-up funds not crowding out other aid interventions by donors or domestic budgetary resources already reserved in the debtor country, is difficult, although putting (peer) pressure on donors and using historical spending baselines to gauge debtor government education spending could possibly help. Debt-for-education swaps also risk to return to ‘old style’ micro-earmarking.

100 Cassimon et al. (2008), op. cit. See also Ruiz (2007), op. cit.
and thus to be out of step with the new aid paradigm endorsed at high-level meetings in Paris and Accra. This can be prevented by aligning the education support freed-up by these swaps with debtor country national development plans and working with the debtor country’s own systems and procedures, leading to greater country ownership and strengthening the public sector. Harmonisation of swaps with other bilateral and multilateral education support arrangements would furthermore avoid the excessive administrative burden and accompanying transaction costs for the recipient country that result from donor proliferation and aid fragmentation. In other words, it is possible to engineer a ‘new style’ of debt swaps.

Nevertheless, even if all the foregoing is taken into account, the potential of debt-for-education swaps is limited. These instruments can not solve the debt problem on their own; neither can they fully close the EFA financing gap. Almost all bilateral and multilateral debt of HIPC countries is due to be cancelled on reaching the completion point of the HIPC process. For most middle-income countries external debt is largely owed to private creditors and therefore not likely to be subject of voluntary debt conversions. Probably best qualified for debt-for-education swaps are those bilateral and multilateral debt titles that rest with a small number of non-HIPC low-income and lower middle-income countries.101 The current situation whereby the Global Fund is promoting its Debt2Health initiative and similar scenarios are being considered to combat climate change with debt relief102, however, makes it difficult for advocates of debt-for-education to lay claim on certain debt titles. Everyone seems to be fishing in the same pond and for its own purpose. Competition between thematic organisations may turn out to be fierce as the prioritisation of usage of funds that could be generated through debt conversion is anything but straightforward.

Only when both creditor(s) and debtor fully agree on earmarking resources coming from debt swaps to the education sector, the debt-for-education concept can be put to use as a complementary instrument to finance EFA. UNESCO could possibly play a role in disseminating information on past debt swap practice, bringing potentially interested creditors and debtors into contact with each other and providing a platform for dialogue where stakeholders meet on an equal basis to discuss debt-for-education swap possibilities.

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101 See Development Finance International (2009), op. cit.
102 See Development Finance International (2009), op. cit.
Annex I: Glossary of Key Terms and Concepts

**Additionality** - Extent to which a new input (action or item) adds to the existing inputs (instead of replacing any of them), resulting in a greater aggregate. To establish whether there is additionality, a with-without comparison must be made. Debt relief is fully additional (in a double sense) if freed-up funds come on top of both other donor aid interventions and the recipient country’s budgetary resources that had already been reserved, and this compared to the situation where no debt relief is provided.

**Aid fragmentation** - a situation in which the number of donor-funded activities is large and their average value low.

**Brady deals** - a series of operations in the beginning of the 1990s based on the Brady Plan (after U.S. Treasury Secretary Nicholas Brady). Here commercial (bank) creditors agreed with a number of (mostly Latin American) middle-income countries to swap private debt for bonds with a lower nominal value and/or reduced interest rates, so as to provide an element of debt relief. In principle, recipient countries had to demonstrate the willingness to implement sound economic policies, both fiscal and monetary, to qualify.

**Budget support** - aid modality whereby resources are provided directly to the government of the recipient country. These resources are then pooled with the government budget and can be spent according to the country’s own priorities. Budget support can be restricted to part of the government budget (typically a sector as health or education, but also a spending category such as salaries)

**Concessional debt** - refers to debt which involves favorable repayment terms for the debtor, involving long grace and repayment periods and/or below-market interest rates.

**Conditionality** - the use of conditions attached to a loan, debt relief, development aid or membership of international organizations, typically by the international financial institutions, regional organizations or individual donor countries.

**Counter-cyclical** - moving in the opposite direction of the overall economic cycle.

**Debt overhang** - a situation in which excessive debt burdens lead to sub-optimal debtor government behaviour, reduced (domestic and foreign) private investment and depressed economic growth rates. Debt overhang has been said to work as a low-growth trap for highly indebted countries. The existence of this phenomenon is however subject to debate.

**Debt service** - the payments of both interest and principal required on a debt over a given period of time, e.g. annually. Suppose country A has an outstanding debt of USD 100 million in nominal (face value) terms to country B, repayable over a period of 10 years with a grace period of 5 years and a nominal interest rate of 2 percent. In the first five years, the debt service that country A has to pay is only interest payments of 2 million a year; from the sixth year on, it repays both interest and principal, amounting to 22 million in the sixth year, and somewhat less in the following years (because interest is paid only on the amount of principal still outstanding).

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103 Terms highlighted in bold within the text refer to separate entries.
**Debt service relief** – reduction of debt service due to a debt relief or debt cancellation operation. Using the same example as for the debt service entry, relieving country A of its debt service will then free up just USD 2 million in the first 5 years and USD 20 million plus (diminishing) interest payments on the outstanding principal in each of the following 5 years. The gains of debt service relief thus only materialize over time for country A. Simply summing all these debt service gains from the debt relief over the lifetime of the loan gives the total nominal debt service relief. This has to be distinguished from the **net present value (NPV)** of debt relief.

**Default** - failure to make the required debt payments on a timely basis or to comply with other conditions of an obligation or agreement.

**Defensive lending** - Practice in which new loans are issued to highly indebted countries to allow them to stay current on debt service payments. In the past, both bilateral and multilateral donors have been accused of defensive lending.

**Discounted debt** - debt which is traded at a price below its nominal (face) value in the secondary market and gives a return closer to face value at maturity.

**Donor Proliferation** - a situation in which the number of donor channels through which Official Development Assistance (ODA) is delivered to a particular recipient country is large.

**Fiscal space** - room in a government’s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy.

**Fungibility** - a situation in which aid recipients reduce their own resources in the sector or for the projects that receive aid and use them elsewhere. Almost all aid is fungible to a certain degree, although fungibility is believed to be most pronounced in instances of micro-earmarking. Donor efforts can also be said to be fungible, for instance when debt relief is compensated by reduced ODA spending elsewhere.

**Heavily Indebted Poor Countries (HIPC) Initiative** - an agreement among official creditors, jointly launched by the IMF and World Bank in 1996 and designed to help the poorest, most heavily indebted countries to bring down their external debt to sustainable levels. The HIPC Initiative was extended and streamlined in 1999 with the introduction of the Poverty Reduction Strategy Paper.

**Micro-earmarking** - refers to the desire of the donor to micro-determine and monitor the use of the funds. Typically, funds are placed in jointly managed counterpart funds, sometimes outside the government budget, using non-aligned (separate) implementation and monitoring mechanisms, bypassing the government's public system. Micro-earmarking can be considered part of the ‘old’ aid paradigm of project support (as opposed to sector and budget support).

**Multilateral Debt Relief Initiative (MDRI)** - an initiative launched in 2005, after G8 leaders pledged to cancel the multilateral debt of the world’s most indebted poor countries. Under the MDRI, the IMF, World Bank, the African Development Bank and the Inter-American Development Bank committed themselves to cancel 100 percent of their (remaining) debt
claims on countries that have completed the **Heavily Indebted Poor Countries Initiative** process.

**Net present value (NPV) of debt service** - the stream of future debt service payments, discounted at a market-based interest rate, most appropriately that interest rate at which the debtor country can raise these funds on its domestic market. NPV calculation takes into account the time value of money (the value of having to pay one dollar today is not the same as of that of having to pay it only in ten years time) and is the standard method to appraise transactions that involve a long-term cash flow. In case the discount rate used is equal to the interest rate on the debt, the NPV of debt service will be equal to the face value of the debt. When, however the discount rate is higher than the contractual interest rate on the debt (say for **concessional debt**), the NPV will be lower than the face value of the debt. The calculation of the NPV of debt service will allow comparing the cost of debt service for the debtor country of, say, debt titles with the same face value, but different repayment terms/interest rates.

**Net present value (NPV) of debt relief** – refers to the net present value (NPV) of debt service gain from a debt relief of debt cancellation operation, based on discounting all the debt service gains to the value of today, to take into account the time value of money. Allows to calculate correctly the gain for the debtor country of having this debt service cancelled, and allows to compare correctly the gain for the debtor (and the cost to the creditor) of, say, the cancellation of debt titles with the same face value, but different repayment terms/interest rates.

**Official Development Assistance (ODA)** - refers to concessional financial or technical resources (grants, concessional loans and technical support) extended by government agencies of developed countries or official multilateral institutions to developing countries, with promotion of economic development and welfare as the main objective. ODA statistics are compiled by the Development Assistance Cooperation (DAC) of the OECD and used to compare and evaluate the generosity of donors.

**Paris Club** - an informal group of official creditors whose role is to find coordinated and sustainable solutions to the debt service difficulties experienced by debtor countries. The name results from the fact that the meetings of this group are often chaired by an official from the French treasury department.

**Policy alignment** - the principle of basing donor support on the national development and sector strategies of the country receiving the support. Policy alignment aims at increasing country ownership and improving the sustainability of the programmes and projects supported.

**Poverty Reduction Strategy Paper** - a document setting out in detail a developing country’s macro-economic, structural and social policies and programmes that will be pursued in the medium term. It is meant to be the result of a consultative process in which the developing country government, civil society and external development partners all participate. Since 1999, the preparation of a PRSP is a precondition to qualify for debt relief under the **Heavily Indebted Poor Countries (HIPC) Initiative** and gain access to concessional IMF/World Bank loans.

**System alignment** - the principle of relying on the aid recipient’s own institutions and systems for budgeting, managing, implementing, monitoring and evaluating development
programmes and projects. System alignment is aimed at strengthening the public sector and long-term capacity building in the recipient country. It however requires that the donor has sufficient trust in the national system.
Annex II: Schematic overview of a typical debt-for-education swap construction and its critical issues

(1) The creditor cancels (part of) its bilateral/multilateral debt claims in hard currency.

**Critical issues:**
- Would the debt have been repaid in the absence of a debt relief operation?
- Is the debt cancellation additional to other ODA interventions?
- What is the size of the cancelled debt in relation to the overall debt stock of the debtor country?
- What is the concessionality of the cancelled debt?

(2) The debtor deposits the local currency equivalent of the cancelled debt (normally with a certain discount) in a counterpart fund which is managed by a Political and Technical Committee and sometimes an international financial institution as third party.

**Critical issues:**
- How does the timing of the counterpart payments compare to the original debt service schedule?
- What is the discount rate granted by the creditor on the counterpart payments?
- To what extent is there participation and decision-making on part of the debtor country’s Ministry of Education and civil society?

(3) The counterpart fund is used to finance education sector programmes and projects that are implemented by debtor and/or creditor country companies and NGOs.

**Critical issues:**
- Is education sector support resulting from the swap additional to domestic budgetary resources already reserved for education spending in the debtor country?
- Is education sector support resulting from the swap aligned with the debtor country’s policies and systems?
- Is education sector support resulting from the swap harmonised with other bilateral and multilateral education support arrangements?
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