

# OPERATIONAL APPROACHES AND FINANCING IN FRAGILE STATES

## EXECUTIVE SUMMARY

1. **Purpose.** At the first meeting of the IDA15 replenishment negotiations, the IDA Deputies requested that IDA's role in fragile states be addressed as one of the three special themes for the replenishment. Specifically, they asked that the following issues be addressed: "IDA's strategy, instruments and operational response in supporting fragile states; IDA financing for fragile states; and a systematic approach to arrears clearance."<sup>1</sup> This paper responds to this request, with the exception of the systematic approach for arrears clearance, which is described in a separate paper.<sup>2</sup>
2. **The critical challenge of fragile states.** Fragile states, characterized by weak institutions and vulnerability to conflict, have increasingly become an area of focus for the development community in recent years. Fragile states represent a critical challenge for IDA: while they are home to less than 19 percent of the total population in IDA-eligible countries, they account for over one third of the extreme poor, almost two fifths of all child deaths, and one third of 12 year olds who did not complete primary school in 2005.
3. **High risk-high reward.** Development assistance is inherently risky in these environments, where weak policies and institutions correlate with a lower probability of successful project outcomes. Despite the risks, there is a strong rationale for engagement: the impact of well-designed and supervised aid-financed programs can potentially be very high, because these countries start from a very low level of achievement of the Millennium Development Goals (MDGs). A successful exit from fragility also has positive spillover effects on neighboring countries. A strong response from IDA in fragile states is therefore in the interests of all its members, as progress in these environments will also enhance and protect the development gains made in the stronger performers.
4. **Differentiated operational strategies.** In line with other donors at the OECD-DAC, the World Bank is focusing on its comparative advantage in different types of fragile states and situations by differentiating its assistance strategies and its role based on the direction and pace of governance change. Within this framework, the World Bank has a significant contribution to make by adapting its traditional economic and service delivery competencies to weak capacity environments and by tailoring its technical expertise to support the lead of the UN and other partners in efforts to consolidate peace and stability. In this regard, the World Bank's partnership with the UN in fragile states has strengthened significantly in recent years, and will be further bolstered by the adoption of a common recovery planning process and agreed fiduciary framework for collaboration in post-crisis situations.
5. **Operationalizing policy and institutional reforms.** The continued implementation of organizational, policy and procedural reforms recently endorsed by the Board of Executive Directors is important for realizing the full potential of the World Bank's contribution in fragile states. In particular, strengthening operational support and building on lessons learned, together

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<sup>1</sup> Chairman's summary from the first IDA15 meeting in Paris, March 5-6<sup>th</sup>, 2007.

<sup>2</sup> IDA (2007): "Further Elaboration of a Systematic Approach to Arrears Clearance."

with strengthening field presence and enhancing human resource systems to attract high quality staff and reward strong performance in these tough environments, will be critical.

6. **IDA's overall financial assistance.** Over the past decade, IDA allocated around SDR11 billion or 19 percent of its overall resources to fragile states, i.e. countries with Country Policy and Institutional Assessment (CPIA) ratings at or below 3.2. In addition, a majority of fragile states have benefited significantly from debt relief having received \$13.4 billion of relief in NPV terms by mid-June 2007 under the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiatives (MDRI) initiatives. They also benefited from increasingly concessional resources through the provision of IDA grants (receiving 57 percent of IDA funds as grants to date in the IDA14 period as compared to 8 percent for non-fragile states).

7. **Fragile states financing classification.** From a financing perspective, IDA classifies fragile states into: (i) those receiving IDA resources through the Performance-Based Allocation (PBA) system; (ii) those qualifying for exceptional post-conflict allocations; (iii) those qualifying for exceptional allocations upon re-engaging with IDA after a prolonged period of inactivity; and (iv) those in non-accrual status.

8. **Gaps in current exceptional financing arrangements.** Of the 34 fragile states in FY07, 17 receive IDA allocations using the PBA system in line with their policy and institutional performance. In some carefully ring-fenced situations established during past replenishment rounds, IDA has deviated from the PBA system to provide exceptional allocations to post-conflict and re-engaging fragile states. While these exceptions have generally been working well, experience so far reveals some need for improvement. With respect to **post-conflict allocations**, three areas for improvement have been identified. These include the need to: (i) link post-conflict allocations to changes in the overall size of the IDA envelope; (ii) strengthen the review process of Post-Conflict Performance Indicators (PCPI) ratings on which these allocations are based and prepare for eventual disclosure of these ratings; and (iii) lengthen the phase-out period of post-conflict allocations. With respect to **countries re-engaging with IDA** after a prolonged period of inactivity, but which did not meet the qualifying criteria for exceptional post-conflict allocations, the following areas for improvement have been identified: (i) criteria for eligibility need to be elaborated; (ii) clearer guidelines for determining the size of exceptional allocations have to be established; and (iii) the drop in exceptional allocations has to be smoothed.

9. **Financial implications of the proposals.** In IDA15, it is proposed that the gaps in the current exceptional financing arrangements be addressed mainly by modifying the duration, pattern and volume of resources to post-conflict countries and those re-engaging with IDA after a prolonged period of inactivity (see Section IV for details). These proposed changes have financial implications for the IDA15 period estimated at an additional: (i) SDR430 million for current recipients of exceptional post-conflict allocations; (ii) SDR 430 million for potential new entrants into this window; and (iii) SDR110 million for countries re-engaging with IDA after a prolonged period of inactivity.<sup>3</sup> These proposed modifications are dependent on the availability of the expected IDA15 commitment authority as discussed in section 1.7 of the accompanying IDA paper entitled, "*The Demand for IDA15 Resources and Strategy for their Effective Use.*"

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<sup>3</sup> Assuming that the nominal size of the envelope is unchanged in IDA15.