

organizational reforms deepen, it is an appropriate juncture to review IDA's financing arrangements in fragile states, to ensure that these reflect the lessons emerging from country experience, research and policy debates.

#### IV. FRAGILE STATES AND IDA'S FINANCING ARRANGEMENTS

49. **Background.** IDA allocates the bulk of its resources to partner countries using the Performance-Based Allocation (PBA) system. This system rests on research which shows that aid funds are better used in poor countries with better policies and institutions. Fragile states, with CPIA ratings at 3.2 or below, have weak policies and institutions and are therefore allocated relatively less aid per capita. Some recent studies have questioned whether sufficient aid is going to meet the needs of countries with weaker policies and institutions.<sup>48</sup>

50. **IDA balances country performance with needs in allocating aid.** In general, IDA strikes a balance between performance and needs of fragile states in three ways. First, needs are stressed by targeting IDA resources mainly to countries that have low per capita incomes below \$1,025 per capita.<sup>49</sup> Second, although a majority of IDA countries are poor, IDA's allocation formula has an additional bias towards needs through the population and GNI per capita elements in its formula. Third, allocations to countries like India, Indonesia and Pakistan are capped at levels well below what their performance would warrant because they have access to other sources of financing. This releases resources to meet needs of the remaining PBA-based countries. *More specifically*, IDA takes country needs into account by deviating from the PBA formula in some specific instances involving fragile states where special considerations call for more aid than warranted just by the countries' policy and institutional performance.

51. **Purpose and layout.** This section reviews IDA's financing arrangements in fragile states, identifies gaps in these arrangements, and proposes ways of enhancing them. Section A provides an overview of IDA's assistance to fragile states over the past decade. Section B reviews IDA's current financing arrangements in fragile states, identifies gaps and recommends ways to better assist fragile states. Section C looks at the impact of these recommendations on performance-based allocations.

##### A. Overall IDA Resource Flows to Fragile States

52. **IDA resources to fragile states over the past decade.** IDA allocated SDR 11 billion to fragile states (corresponding to 19 percent of total IDA resources) over the past decade. Fragile states, with an estimated 261 million poor people living on less than a dollar a day, were allocated around SDR 2.3 per capita per annum over the past decade. During the same period, non-fragile IDA countries (excluding capped blend countries), home to around 324 million

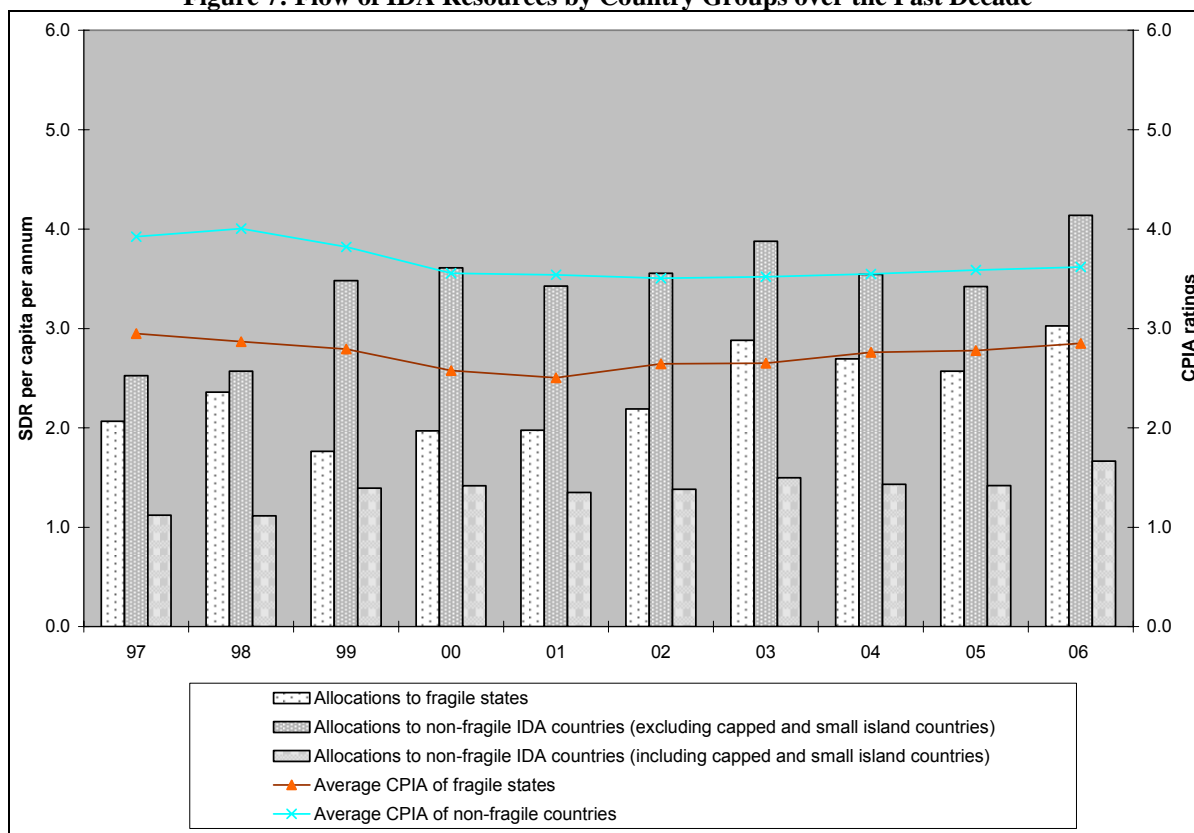
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<sup>48</sup> In their paper entitled "*The Forgotten States: Aid Volumes and Volatility in Difficult Partnership Countries (1992-2002)*", Dollar and Levin use elements of IDA's PBA formula – CPIA, population, and GNI per capita – to establish a benchmark against which they examine *overall* aid flows to fragile states and conclude that difficult partnership countries "receive around 40 percent less aid than predicted by their policy and institutional strength ... primarily due to disproportionately low flows from bilateral donors." While this study may have implications for overall aid flows, IDA already allocates resources to a majority of countries – including many fragile states – in line with their policy and institutional strength using the PBA formula.

<sup>49</sup> Excluding the small island economies and gap countries which have incomes above the IDA operational cut-off, average per capita income of all IDA countries is around \$495 (Atlas GNI) in 2005.

people earning less than a dollar a day were allocated around SDR 3.4 per capita per annum. Therefore, on average, fragile states received around 70 percent of the per capita annual allocation of non-fragile IDA countries, excluding capped countries. If capped-blend countries are included, non-fragile states with an estimated 724 million people living below a dollar a day received SDR1.4 per capita per annum. See Figure 7 and Table 3.

**Figure 7: Flow of IDA Resources by Country Groups over the Past Decade**



**Table 3: IDA Allocations Per Capita and Number of People Living Below a Dollar a Day**

	Fragile States <sup>1</sup>	Non-Fragile IDA Countries	Non-Fragile Countries (Excluding capped countries and small islands)	Capped Countries <sup>2</sup>
Number of people living below a dollar a day <sup>3</sup>	261 million	724 million	324 million	400 million
IDA allocations per capita (SDR)	SDR2.3	SDR1.4	SDR3.4	SDR0.7

Notes:

1/ Countries with CPIA ratings of 3.2 or below

2/ India, Indonesia and Pakistan

3/ Approximations based on staff estimates.

53. **Terms of IDA assistance to fragile states.** Fragile states have benefited from the increased concessionality of IDA assistance that has resulted from the introduction of grants in IDA13 and IDA14. Around 30 percent of resources committed in fragile states during IDA13 (FY03-05) were in the form of grants compared to 15 percent in non-fragile states. This pattern has strengthened in IDA14 (FY06-08), when 57 percent of resources committed to date in fragile states have been in the form of grants compared to 8.5 percent of resources in non-fragile states. See Table 4. This is because grants are provided on the basis of the countries' risk of debt distress under the IDA14 policy framework (also see paragraph 58).

**Table 4: FY07 List of Fragile States, Financing Status, Debt Relief and Grant Eligibility**

	IDA Financing Status	MDRI/HIPC eligible?	Eligible for grants in FY07?
<b>Severe</b>			
Afghanistan	Post-Conflict	HIPC-eligible	100%
Central African Republic	Re-Engaging	HIPC pre-DP	100%
Comoros	PBA	HIPC pre-DP	100%
Cote d'Ivoire	Arrears	HIPC pre-DP	100%
Liberia	Arrears	HIPC pre-DP	100%
Myanmar	Arrears		-na-
Somalia	Arrears	HIPC pre-DP	-na-
Togo	Arrears	HIPC pre-DP	-na-
Zimbabwe	Arrears		-na-
<b>Core</b>			
Angola	Post-Conflict		50%
Burundi	Post-Conflict	HIPC DP	100%
Chad	PBA	HIPC DP	100%
Congo, Dem Rep	Post-Conflict	HIPC DP	100%
Congo, Rep	Post-Conflict	HIPC DP	100%
Eritrea	Post-Conflict	HIPC pre-DP	100%
Guinea	PBA	HIPC DP	100%
Guinea-Bissau	PBA	HIPC DP	100%
Haiti	Re-Engaging	HIPC DP	100%
Kosovo <sup>1</sup>	Special Provision		100%
Lao PDR	PBA		100%
Solomon Islands	PBA		100%
Sudan	Arrears	HIPC pre-DP	100%
Timor-Leste <sup>1</sup>	Post-Conflict		60%
Tonga	PBA		100%
Uzbekistan	PBA		0%
<b>Marginal</b>			
Cambodia	PBA		100%
Djibouti	PBA		100%
Gambia	PBA	HIPC DP	100%
Mauritania	PBA	HIPC CP	0%
Nigeria	PBA		0%
Papua New Guinea	PBA		0%
Sao Tome and Principe	PBA	HIPC CP	100%
Sierra Leone <sup>1</sup>	PBA	HIPC CP	100%
Vanuatu	PBA		0%

1) Kosovo receives special allocations from IDA because it is an UN administered territory, Timor-Leste's grant percentage was set during the IDA14 replenishment discussions and Sierra Leone received post conflict allocations until FY06. **Notes:** Marginal LICUS countries are identified for monitoring purposes only. (Also see [http://www.worldbank.org/ieg/licus/licus06\\_map.html](http://www.worldbank.org/ieg/licus/licus06_map.html)). DP stands for Decision Point and CP stands for Completion Point.

54. ***Debt relief from IDA.*** Twenty fragile states are eligible for debt relief under the Enhanced HIPC initiative. Of the twenty, three have already reached the HIPC completion point, eight have reached the HIPC decision point and are receiving interim debt relief from IDA, and nine have yet to reach the decision point. The three countries (Mauritania, Sao Tome and Principe, and Sierra Leone) that reached the completion point have also received full cancellation of their debts outstanding to IDA under the Multilateral Debt Relief Initiative (MDRI). Such assistance will also be extended to the other eligible countries once they reach completion point. Total HIPC and MDRI assistance delivered as of mid-June 2007 to fragile states is around \$13.4 billion in NPV terms.

## **B. Diverse Fragile States and IDA's Financing Arrangements**

55. ***IDA's PBA system continues to be the basis for IDA allocations, with some key exceptions.*** IDA financing is provided primarily through the Performance-Based Allocation (PBA) system which, while emphasizing performance, also factors in country needs.<sup>50</sup> This system has been continuously refined over the last 30 years and has allocated greater resources to countries achieving the best development outcomes.<sup>51</sup> There are a few carefully ring-fenced exceptions for some types of fragile states, which were introduced over the recent replenishments to address the specific *needs* of clearly identifiable sub-categories of fragile states.

56. ***Defining fragile states from a financing perspective.*** Given that fragility is a continuum<sup>52</sup> and that countries move in and out of fragility,<sup>53</sup> using fragile states as one category is not an appropriate basis on which to allocate IDA resources. In addition, the current definition of fragile states is too broad<sup>54</sup> and encompasses countries with very diverse characteristics for IDA to have a uniform financing arrangement for all of them. Therefore, for financing purposes, IDA groups fragile states in four categories: (i) countries receiving allocations based on IDA's PBA system; (ii) countries receiving exceptional post-conflict allocations; (iii) countries receiving exceptional allocations upon re-engaging with IDA after a prolonged period of inactivity but which did not qualify for post-conflict assistance; and (iv) countries that do not receive IDA financing because they are in arrears on IDA repayments. Figure 8 below shows the country categories, shares of estimated IDA14 funding, and diverse types of financing arrangements that meet the needs of fragile states.

57. ***Mapping strategic and financing classifications.*** While countries cannot be automatically "cross-mapped" between the operational (described in paragraph 27) and financing classifications, some overlapping patterns emerge. There is, hence, a high probability that countries in a prolonged crisis or impasse may also be countries that do not receive IDA financing because they are in arrears to the World Bank Group. Similarly, countries that are experiencing gradual improvement or deteriorating quickly may be receiving funding based on

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<sup>50</sup> IDA (2007). "IDA's Performance Based Allocation Formula: Options for Simplifying the Formula and Reducing Volatility."

<sup>51</sup> IDA (2007). "Selectivity and Performance: IDA's Country Assessment and Development Effectiveness."

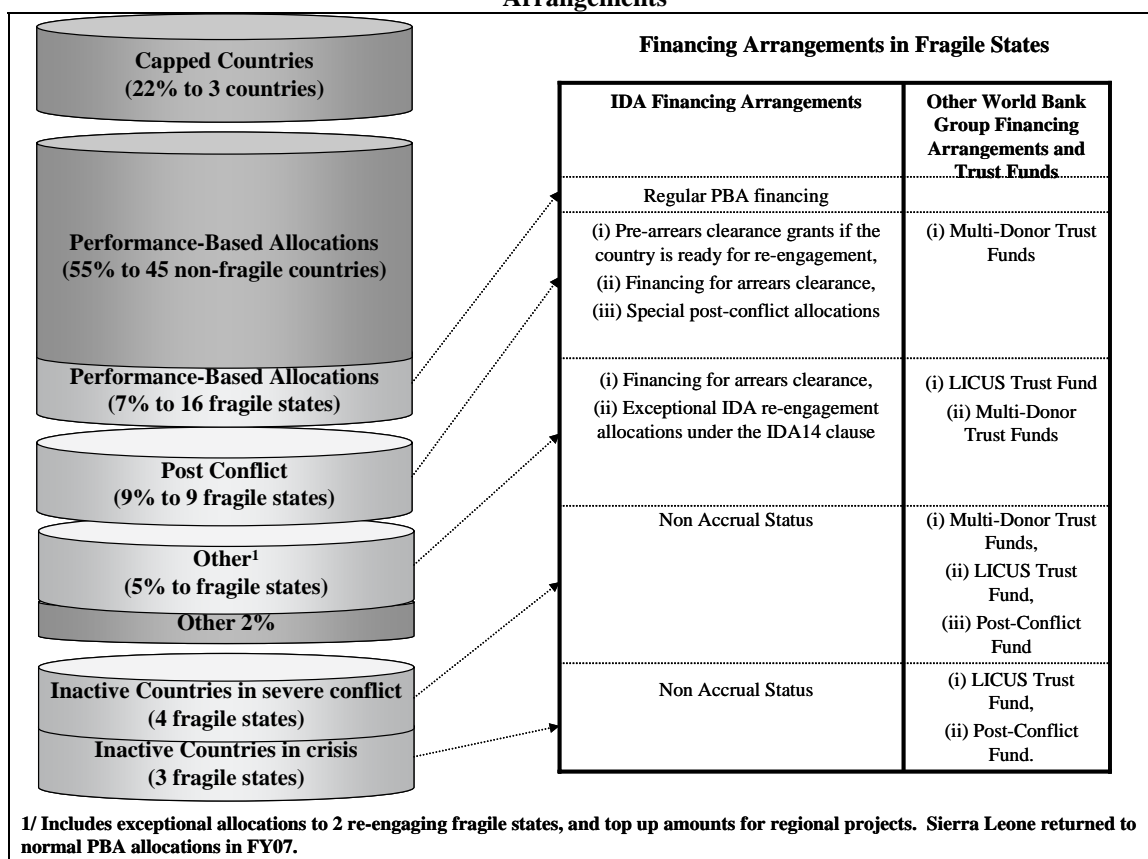
<sup>52</sup> There is no clear threshold above which a country ceases to be fragile – this is especially true since CPIA ratings are subject to a margin of error.

<sup>53</sup> Over the past decade alone, around 11 countries have moved in and out of the fragile states classification.

<sup>54</sup> Includes 40 percent of IDA countries each year. Over the past 15 years, about three-fourths of the IDA recipients have been classified as fragile at some point.

PBA allocations, which take into account such changes at the country level. Finally, countries in the post-conflict category could be benefiting from special allocations.

**Figure 8: Fragile States: Broad Financing Categories, Estimated Share of IDA14 Resources, and Financing Arrangements**



## B1. Fragile States Receiving Financing through the PBA System

58. **Fragile states and PBA allocations.** Some fragile states receive IDA financing through the PBA system. Modifications made to the PBA system in the recent IDA replenishment rounds had important implications for fragile states. These modifications include: the grants system in IDA13 and IDA14, MDRI, and base allocations for small states.

- During IDA13, grants were provided to the poorest countries, debt-distressed poorest countries, post-conflict countries, and for HIV/AIDS and natural disasters. Many of these provisions benefited fragile states.
- Starting in IDA14, grants are being provided based on a country's risk of debt distress. Policy-determined debt burden thresholds were established based on the idea that countries with better policies and institutions can carry more debt. Because fragile states have weak policies and institutions, they also have lower debt-carrying capacity and therefore receive allocations mostly in the form of grants to meet their special needs.

- During IDA14, the MDRI led to the cancellation of debt from IDA, AfDF and IMF for all countries reaching HIPC completion point, thus freeing resources to help these countries meet their developmental needs. Three fragile states have already benefited from debt cancellation through this initiative and another 17 HIPC-eligible fragile states will also benefit from debt cancellation upon reaching completion point.
- Some fragile states are also small, and benefit disproportionately from the base allocations.

59. **Poor policy and governance performance.** Of the 34 fragile states in FY07, 17 received allocations through PBA system mainly in the form of grants.<sup>55</sup> In this year, PBA allocations to these countries ranged from SDR1 to SDR4 per capita, excluding small countries which typically have higher per capita allocations.<sup>56</sup> Fragile states receive lower allocations through the PBA system in line with their lower absorptive capacity.<sup>57</sup> Moreover, these countries typically have poor governance environments, with average governance ratings of 2.7 on CPIA governance cluster (compared to 3.4 for non-fragile states).<sup>58</sup> As discussed at the IDA14 Mid-Term Review,<sup>59</sup> governance is important for improving the development performance in partner countries as well as for mitigating risks to aid funds. The PBA system calibrates assistance to fragile states in line with their governance and policy performance and making exceptions for all of them would seriously undermine IDA's PBA system.

## B2. Post-Conflict Countries

60. **Selected deviations from PBA system.** In some carefully ring-fenced cases, IDA makes exceptional allocations to fragile states to meet special needs. One such case is the exceptional post-conflict allocation. IDA re-engages with countries emerging from conflict if there is a credible, internationally-recognized window of opportunity for peace. In addition to pre-arrears clearance grants, countries emerging from conflict have received exceptional post-conflict allocations since IDA13. The rationale for these exceptional allocations is to help countries meet their special reconstruction needs following a conflict. Preliminary research also shows that aid is "atypically effective" in augmenting growth in post-conflict settings.<sup>60</sup>

61. **IDA resource flows to post-conflict countries.** Around 9 percent of total IDA allocations are estimated to go to post-conflict countries during the IDA14 period. During the first four years of exceptional allocations, post-conflict countries receive on average around SDR 6 per capita per annum, which is much higher than allocations warranted by their policies and

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<sup>55</sup> These are: Cambodia, Comoros, Chad, Djibouti, Gambia, Guinea, Guinea Bissau, Lao PDR, Mauritania, Nigeria, Papua New Guinea, Sao Tome and Principe, Sierra Leone (starting FY07), Solomon Islands, Tonga, Uzbekistan, and Vanuatu.

<sup>56</sup> If small countries are included, the range of PBA allocations to fragile states extends to SDR11 in FY07.

<sup>57</sup> IDA (2007). "*Selectivity and Performance: IDA's Country Assessment and Development Effectiveness.*"

<sup>58</sup> These countries also rank low on governance using external governance indicators.

<sup>59</sup> IDA (2006). "IDA's Performance Based Allocation System: A Review of the Governance Factor."

<sup>60</sup> Collier, P., and A. Hoeffler (2003). "Aid, Policy and Growth in Post-Conflict Countries," *European Economic Review*, 48 (2004), pages 1125-1145. This research is preliminary and the authors caution that since their study is based on limited observations, "the degree of confidence in the results must be correspondingly discounted."

performance using the regular PBA formula. Interestingly, they have absorbed resources rapidly, committing around 95 percent of the resources made available to them in comparison with the remaining fragile states that committed only around 77 percent of IDA resources allocated to them over the past decade.

62. ***Criteria for re-engagement and qualification for post-conflict assistance.*** The methodology for providing exceptional allocations to post-conflict countries was adopted in IDA13, after having been piloted during the last half of the IDA12 period.<sup>61</sup> With respect to the timing of re-engagement this approach relies on established World Bank policy, in particular Operational Policy (OP) 2.30, which sets out four conditions: (i) sufficient reduction of conflict to allow implementation of IDA-supported activities, (ii) reasonable expectation of continued stability, (iii) presence of an effective Government counterpart and (iv) evidence of strong international cooperation.<sup>62</sup> In terms of eligibility for exceptional support, the methodology relies on three indicators of conflict impact: (i) extent of human casualties directly or indirectly caused by the conflict, or (ii) proportion of population that is either internally displaced or in exile, or (iii) extent of physical destruction. Impact must be judged high against any *one* of these indicators for a country to qualify for exceptional post-conflict allocations.

63. ***Duration and pattern of post-conflict assistance.*** When the post-conflict window was set up in IDA13, it was envisaged to provide 5 years of exceptional allocations, including 2 years of phase out to normal PBA allocations. At the IDA13 Mid-Term Review, the duration of exceptional allocations was increased to 7 years, including 3 years of phase out to normal PBA allocations (Figure 9). This modification in duration of allocations was based on research by Collier,<sup>63</sup> which concluded that it may be desirable to have somewhat lower early allocations but to provide exceptional post-conflict assistance over a longer period of time. Therefore, at the IDA13 Mid-Term Review, the post-conflict allocations were stretched over 7 years, while the overall amount of post-conflict allocations was left unchanged.<sup>64</sup>

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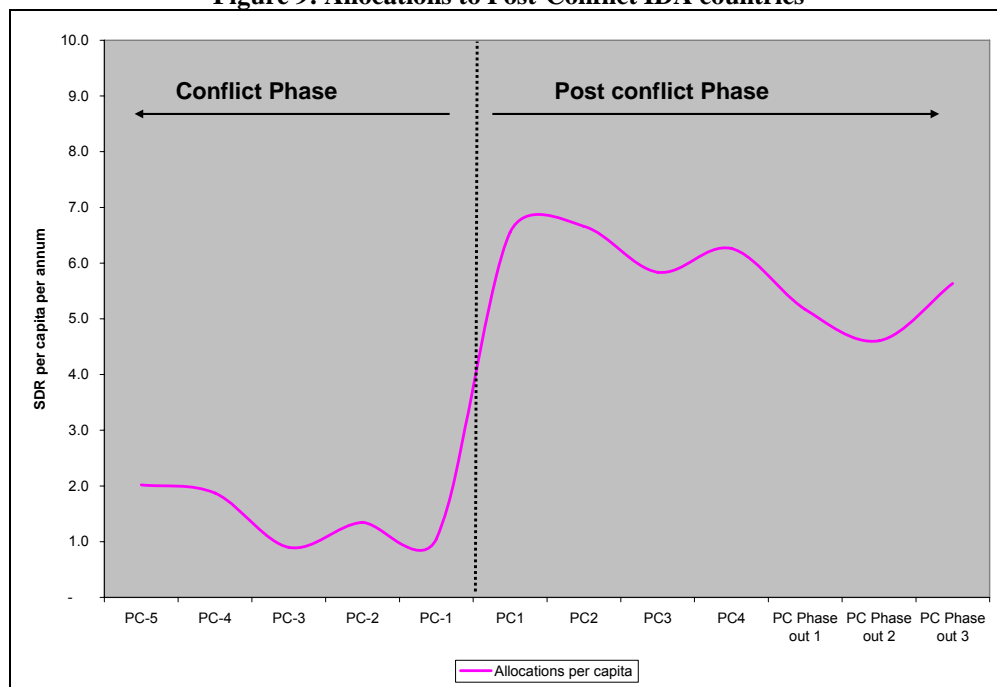
<sup>61</sup> IDA (2002). “*Additions to IDA Resources: Thirteenth Replenishment. Supporting Poverty Reduction Strategies.*” and IDA (2001). “*Adapting IDA’s Performance Based Allocations to Post-Conflict Countries.*” The criteria for eligibility for assistance under the post-conflict window are laid out in Annex 2 of this report.

<sup>62</sup> See OP 2.30 – Development Cooperation and Conflict, January, 2001.

<sup>63</sup> World Bank (2003). “*Breaking the Conflict Trap: Civil War and Development Policy.*”

<sup>64</sup> IDA (2003). “*IDA’s Performance Based Allocation System: Current and Emerging Issues.*”

**Figure 9: Allocations to Post-Conflict IDA countries**



64. **Post-Conflict Performance Indicators.** These exceptional post-conflict allocations are provided on the basis of Post Conflict Performance Indicators (PCPI) (see Annex 1 for PCPI criteria) and portfolio performance ratings where available. In some respects, the PCPI indicators cover the same areas as the CPIA, although the expected performance is less ambitious. In addition, the PCPIs measure progress in areas that are critical for transition processes but are not captured in the CPIA – security, demobilization and reintegration of ex-combatants, political and reconciliation processes, and reintegration of displaced populations. PCPI ratings are used to set the allocation levels using the following table as a guideline, which was put in place at the IDA13 Mid-Term Review (see Table 5).

Post-Conflict Performance Indicator (PCPI)	Allocation Maximum (\$ per capita per annum)
2.0 to 2.5	3.4
2.5 to 3.0	6.0
3.0 to 3.5	8.5
3.5 to 4.0	11.9
4.0 to 4.5	14.4
4.5 to 5.0	17.0

65. **Determining allocations in the phase-out period.** As mentioned in paragraph 63, exceptional allocations are provided for a period of seven years. For the first four of the seven years, the level of exceptional allocation is determined based on the table above.<sup>65</sup> In the

<sup>65</sup> In addition to the table above, allocations in the first year to post-conflict countries involve some judgment based on: (i) prospects of peace, (ii) country needs, capacity and resources, (iii) government commitment to

remaining three years, exceptional allocations are gradually phased down to the levels determined by IDA's PBA formula. To calculate allocations during each year of the phase-out period, the post-conflict premium (calculated as a difference between allocations computed using the PCPI and those computed using the PBA formula) is gradually reduced. The country is allocated the PBA amount plus three-fourths of the post-conflict premium in the first phase-out year. In the second phase-out year, it receives the PBA amount plus half the post-conflict premium and in the third phase-out year, it receives the PBA amounts plus one-fourth of its post-conflict premium and finally reaches PBA allocations in the fourth year at the end of the phase-out period.

66. **Looking ahead.** 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 PCPI ratings and prepare for eventual disclosure; and (iii) lengthen the duration of post-conflict allocations. Each of these is discussed below.

67. **First, link post-conflict allocations to changes in size of IDA envelope.** When the size of IDA replenishment changes between replenishment periods, allocations of all PBA-driven countries are affected. However, since post-conflict allocations are based on a fixed conversion table, their allocations are not affected by changes in the overall IDA envelope. So if the size of a replenishment were lower, post-conflict countries would still be allocated the same per capita allocations as determined by the table above, thus reducing the envelope available for the remaining countries. Therefore, the share of post-conflict allocations in the total IDA envelope would increase relative to that of PBA-driven countries. The opposite is true if the replenishment size were to increase. This raises issues of equity of treatment compared to the rest of the IDA countries, especially in comparison to the capped-blend countries, whose low per capita allocations – determined as a share of the total IDA envelope – vary with the size of the replenishment.

68. Management proposes modifying the post-conflict allocations to account for changes in the overall envelope. For example, if the PBA envelope increases by 20 percent, overall post-conflict allocations would be revised upwards by the same proportion. This would ensure that the share of post-conflict countries relative to the PBA countries does not change (unless countries enter or leave the post-conflict pool in which case the overall share going to post-conflict countries would be adjusted accordingly). The post-conflict countries would compete for this share based on performance as measured by their PCPI.<sup>66</sup>

69. **Second, strengthen review of PCPI ratings and prepare for eventual disclosure.** Although a large volume of IDA resources are allocated based on PCPI ratings, they receive

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sustainable development, and (iv) moral hazard considerations. For more detail, see IDA13 Deputies report (page 49) as well as Attachment I (page 52).

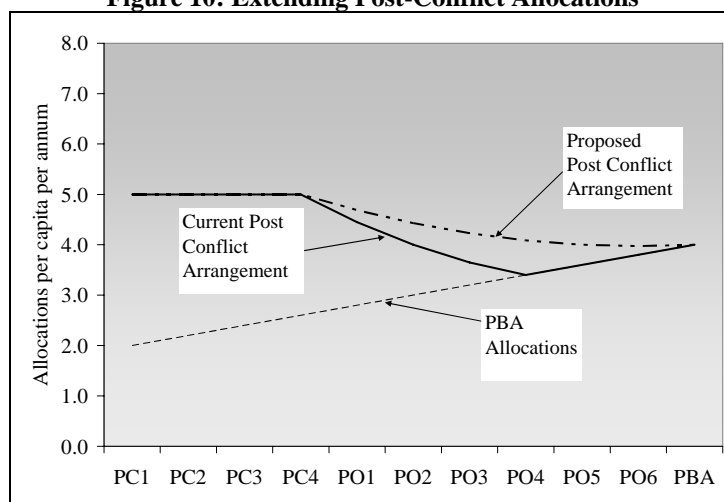
<sup>66</sup> For example, assume an overall replenishment of SDR100 million, of which post-conflict allocations account for SDR20 million. So the share of post-conflict countries is 20 percent. Now assume that the overall replenishment doubles to SDR200 million. To ensure that the increase in the replenishment size is distributed equitably, the share of post-conflict allocations must also be doubled to SDR 40 million, for which the post-conflict countries would compete based on their PCPI.

relatively less scrutiny than the CPIA ratings. To enhance the robustness of PCPI ratings for the purpose of IDA resource allocation, Management proposes the following:

- *Strengthen the internal review process.* The PCPI ratings exercise would be strengthened through an enhanced World Bank-wide review similar to the current CPIA process. Since the CPIA and PCPI share some similar criteria, Management will also seek better coordination of the two processes.
- *Prepare for eventual disclosure.* As was done with the CPIA during IDA14, an external panel should be set up to review the PCPI ratings and methodology. Such a review by an external panel to check the robustness of the ratings could precede eventual disclosure of PCPI (either externally or to the Board for information) by the end of the IDA15 period.

70. **Third, lengthen the duration of exceptional post-conflict allocations.** Since post-conflict allocations are designed to be exceptional and above the PBA norms, there will inevitably be a drop in allocations as they are phased out to reach PBA norms. However, the current three year phase-out period results in a relatively sharp drop-off in IDA allocation, which can be disruptive for country programs – an issue that a number of country teams have highlighted as a cause for concern. Extending the phase-out period would thus help to prevent sharp reductions in IDA assistance. Apart from implementation experience, current emerging research also suggests that exceptional post-conflict allocations should be provided for around ten years to increase the chances of reinforcing economic recovery in these countries.<sup>67</sup> In light of this, management proposes extending the duration of exceptional allocations up to ten years by doubling the phase-out period from three to six years. See Figure 10.

**Figure 10: Extending Post-Conflict Allocations**

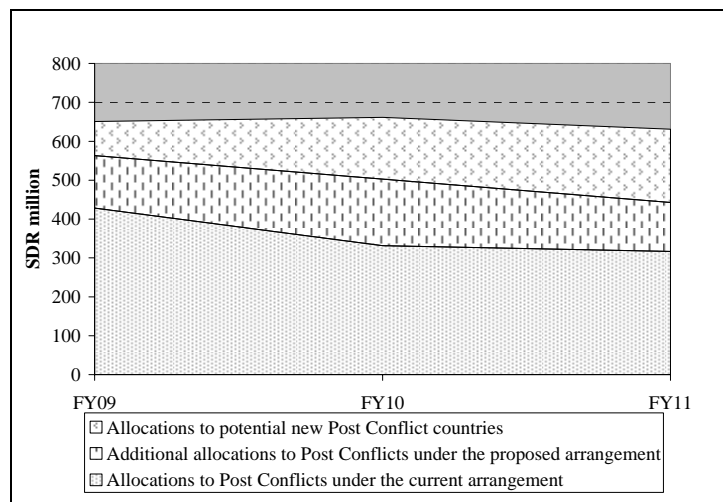


71. **Impact of the proposed change.** A simulation shows that the cost of increasing the phase-out period from 3 to 6 years implies an additional SDR 430 million during the IDA15

<sup>67</sup> For example, Collier and Hoeffler (2003) argue in their paper “*Aid, Policy and Growth in Post-Conflict Societies*” that “...the pattern of aid disbursements should probably rise during the first four years and gradually taper back to normal levels by the end of the first *post-conflict decade* [emphasis added].”

period for countries currently eligible for post conflict allocations.<sup>68</sup> Potential new entrants into this window could add a further SDR430 million (Figure 11), assuming that there is a 50 percent probability that Sudan will re-engage during IDA15.

**Figure 11: Impact of the Proposed Change**



72. **Early graduations.** While management proposes extending post conflict allocations to up to ten years, under certain circumstances, countries would revert to regular PBA allocations before the end of the ten-year period. These circumstances would include, for example, (i) attaining “gap” country status, which would mean that per capita income would have exceeded IDA’s operational cutoff; (ii) attaining “blend” country status, which would suggest creditworthiness and access to other sources of financing; or (iii) violation of IDA’s non-concessional borrowing policy.

73. In IDA15, it is proposed that the following changes for post-conflict allocations would be made:

- Link the share of post-conflict allocations in overall allocations to changes in the overall replenishment size.
- Extend the phase-out period for post-conflict allocations from 3 to 6 years, without reducing the post-conflict premium, bringing the duration of exceptional post-conflict allocations up to 10 years.
- Retain additional flexibility in deciding post-conflict allocations in the first year as agreed during the IDA13 Replenishment discussions.
- “Graduate” some post-conflict countries earlier than 10 years based on criteria described above.
- Tighten existing review process for PCPI and appoint an external panel to review the PCPI ratings and to prepare them for eventual disclosure.

<sup>68</sup> Assuming that IDA15 envelope is the same as IDA14 envelope in nominal terms.

### **B3. Countries Re-engaging with IDA after a Prolonged Period of Inactivity**

74. ***Ring fencing exceptional allocations.*** To avoid undermining IDA's PBA system, Deputies had previously limited access to IDA resources outside the PBA only to exceptional post-conflict allocations. The IDA13 Replenishment report clearly stated that "this access needs to be properly ring-fenced with eligibility criteria so that perennial poor performers with some record of conflict can be distinguished from countries that are making a determined effort to emerge from a protracted and highly destructive conflict" (see Annex 2 of the IDA13 report).

75. ***Current financing arrangements.*** During the IDA14 Replenishment discussions, an additional exception to the PBA was introduced for countries re-engaging with IDA after a prolonged period of inactivity. The IDA14 policy framework provided for these exceptional allocations to last for a period up to three years. According to the IDA14 Replenishment Report,<sup>69</sup> "additional allocations may be provided on a one-time basis to countries that are in the process of re-engaging with IDA after a prolonged period of inactivity on the basis of a strong transition plan with concerted donor support. This exception will be used after all other options have been exhausted, and its use is expected to be very limited in the IDA14 period. The level of resources made available will be less than what is typically provided under the post-conflict allocation system, and the duration of exceptional allocations will not exceed two years, with one further year's support possible subject to strong performance" (page 48).

76. To date, Haiti and the Central African Republic have received such "re-engagement" allocations. On per capita terms, the financial assistance provided under the IDA14 clause has been between three to five times their PBA allocations. During the IDA15 period, management estimates that two more countries, Togo and Zimbabwe, could access exceptional re-engagement financing allocations. A third potentially eligible country, Myanmar, is not likely to engage during the IDA15 period. In view of the requirement for eligibility that there has to be a prolonged period of inactivity, management does not consider it likely that other countries would be eligible during IDA15.

77. ***Looking ahead.*** Three gaps have been identified in the current financing arrangements for countries re-engaging with IDA after a prolonged period of inactivity. *First*, the criteria for eligibility need to be elaborated. *Second*, the additional resources directed to these countries were determined flexibly during the pilot phase in IDA14. Clearer guidelines for determining the size of exceptional allocations have to be established. *Third*, experience has shown that the drop in going from exceptional allocations over the three year period back to an allocation determined solely by the PBA has been sharp.

78. Management proposes sharpening the criteria for qualifying for this window, establishing clearer guidelines for top-off amounts, and extending the duration of exceptional allocations up to 5 years.

79. ***Sharpening the eligibility criteria.*** Eligibility criteria for exceptional allocations under the re-engagement window include: (i) evidence of partial collapse of the state, but ineligible for

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<sup>69</sup> IDA(2005). "Additions to IDA Resources: Fourteenth Replenishment. Working Together to Achieve the Millennium Development Goals."

IDA post-conflict assistance; (ii) existence of a strong transition plan supported by concerted donor support, (iii) and disengagement from IDA for a *prolonged period* and accumulation of *sizeable* arrears to the World Bank Group. With respect to the timing of re-engagement, as with post-conflict countries, all relevant World Bank policies would apply<sup>70</sup> and eligibility is not automatic. The continuation of exceptional support through this window would be predicated on evidence of improvement in performance.

80. ***Establishing guidelines for determining lending volumes and duration.*** Countries that qualify for this window often experience social and economic deterioration, although of smaller magnitude and intensity than the one experienced in post-conflict countries. Management proposes that the allocation to these countries be made using the PCPI using Table 5, but halving the per capita amounts at each level of the PCPI ratings.<sup>71</sup> At the same time, because of the lower intensity of crisis, Management proposes to limit the exceptional treatment up to five years, including two years of exceptional allocations and three years of phase out to normal PBA allocations by the sixth year.<sup>72</sup> This would require an additional SDR110 million during IDA15, assuming Togo and Zimbabwe re-engage.

81. In IDA15, it is proposed that the following changes for countries re-engaging with IDA after a prolonged period of inactivity would be made:

- Sharpen the eligibility criteria and determine lending volumes based on PCPI, but halve the per capita amounts at each level of the PCPI rating.
- Provide exceptional allocations for a period of five years, including two years of exceptional assistance and three years of phase out to reach PBA allocations by the sixth year.
- Retain some additional flexibility in deciding allocations in the first year.
- Continue to “graduate” some countries earlier than 5 years, if performance is not improving as mentioned in the IDA14 Replenishment report.

#### **B4. Countries in Non-Accrual Status**

82. ***Unable to access IDA resources.*** World Bank policies do not allow provision of regular IDA financing to countries while they are in non-accrual status.<sup>73</sup> However, countries in non-accrual status need to be supported in limited ways that are carefully tailored to their specific circumstances. These countries can access limited grant financing from the Post Conflict Trust Fund and the LICUS Trust Fund, as well as through donor-financed trust funds.

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<sup>70</sup> For a more detailed discussion of applicable Bank policy see IDA (2007). “*Further Elaboration of a Systematic Approach to Arrears Clearance.*”

<sup>71</sup> Note that the countries that qualify for such re-engagement allocations could also qualify for exceptional support for arrears clearance.

<sup>72</sup> As in the case of post-conflict allocations, allocations to re-engaging countries could involve some judgment in the first year based on the relevant factors described in footnote 65.

<sup>73</sup> Loans and credits are placed in non-accrual status when the oldest payment arrears are six months overdue – that is, when the second consecutive payment is missed on the loan/credits with the oldest arrears. In order to be eligible for new credits/grants, the country concerned must clear all payment arrears in full. Once all arrears are cleared, all loans/credits to, or guaranteed by, the country are generally restored to accrual status.

83. **Re-engagement imminent?** Furthermore, once a credible window of opportunity for peace materializes, IDA can provide limited grant financing even before arrears are cleared and the country is restored to accrual status. Such grant funding is subject to a number of conditions and has only been available to countries that are eligible for exceptional post-conflict IDA allocations.<sup>74</sup> To date, Afghanistan, the Democratic Republic of Congo and Liberia have received such pre-arrears clearance grants.

### **C. Implications of the Proposed Changes on Overall Shares of IDA Resources**

84. Under the proposed modifications, an additional four percent of overall IDA resources are expected to be redirected to post-conflict and re-engaging countries from the PBA pool. Of this four percent, two percent is due to the reactivation of Cote d'Ivoire, Liberia and Sudan (with a 50 percent probability), and is unaffected by changes in the duration of the phase out period. This redirection of resources would happen regardless of the proposed changes to the post conflict arrangements. Therefore, the real additionality comes from the two percent attributable to the extension of the post conflict phase out period for the existing countries.

85. The financing requirements associated with proposed modifications in post-conflict and re-engagement allocations<sup>75</sup> add to the IDA15 financing requirements as mentioned in the accompanying paper entitled, "*The Demand for IDA15 Resources and Strategy for their Effective Use.*" As discussed in section 1.7 of that paper, without the proposed increase in IDA15 commitment authority, the implementation of these changes will not be feasible as it would take away resources from the PBA pool.

### **V. THE ROLE OF TRUST FUNDS IN FRAGILE STATES**

86. Trust funds of various types have grown into a significant source of support for fragile states in recent years, and have become an important tool for rapidly scaling up donor support, particularly in post-conflict settings. While the bulk of the World Bank's support for fragile states as a group continues to be channeled through IDA, in some fragile states donor resources are channeled through World Bank-managed trust funds. This is especially notable in Afghanistan, which receives the bulk of the aggregate resources for fragile states, and also in countries where IDA activities are constrained by the presence of arrears, such as Sudan. The trust funds are often used to finance recurrent costs and therefore complement IDA's financing that primarily focuses on financing crucial investment expenditures (e.g. in Afghanistan).

87. Over the past five years, contributions to trust funds aimed at fragile states have seen a six-fold increase, from \$136 million in FY02, to \$821 million in FY06 (see Table 6). There has been a parallel growth in disbursements, which rose from \$130 million in FY02 to \$679 million in FY06, to an aggregate five year total of over \$2.2 billion. The bulk of these resources were channeled through so-called Recipient Executed Trust Funds (RETFs) which, like regular IDA operations, enable recipients to execute or spend resources on various development activities

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<sup>74</sup> IDA (2005). "*Additions to IDA Resources: Fourteenth Replenishment. Working together to achieve the Millennium Development Goals.*" Paragraph 75, p. 27.

<sup>75</sup> If the proposed changes are accepted and the anticipated IDA15 financing under the base scenario materializes, then consideration would be given to modifying the FY08 allocations (final year of IDA14) of the affected countries after notifying the Board.