

# Good Practice Note for Development Policy Lending

Development Policy Operations and Program Conditionality in  
Fragile States

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These Good Practice Notes are intended to provide guidance to staff in the preparation of development policy operations and are not mandatory policy documents. Their content will be updated periodically to reflect the lessons of experience. For further updates and other good practice notes, please check the Operations Policy and Country Services (OPCS) website under development policy lending.

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# GOOD PRACTICE NOTE FOR DEVELOPMENT POLICY LENDING:

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### A. INTRODUCTION

1. **Development policy operations provide rapidly disbursed financing in support of a program of policy and institutional actions with the objective of achieving sustainable reductions in poverty.** Development policy support is provided in the form of loans or grants to help a borrower address actual or anticipated financing requirements that have balance of payments or fiscal origins. Development policy operations are supportive of and consistent with the country's economic and sectoral policies. They build on solid foundations: a well-defined policy framework; strong national ownership, as reflected in a track record of program implementation; sound analytical work; and an understanding of the fiduciary risks and measures needed to ensure effective use of resources.<sup>1</sup>

2. **The purpose of this note is to provide guidance to task teams in applying development policy lending in the context of fragile states.** Recognizing that development policy lending is not always appropriate in the context of fragile states, the note focuses on the design and implementation of these operations where fragile states are undergoing transition, as countries emerge from crisis, stabilize and move towards a development trajectory. In designing program conditionality within the specific country circumstances of fragile states, this note builds on the Bank's experience of work during transitions in recent years. The note complements the *Good Practice Notes* on the design and implementation of development policy operations, drawing on the Bank's experience in a wide range of countries.

### B. THE RATIONALE FOR DEVELOPMENT POLICY OPERATIONS IN FRAGILE STATES

3. Fragile states are characterized by weak policies, institutions and governance, and may be in conflict or at risk of conflict, resulting in poor economic and poverty reduction performance.<sup>2</sup> Where the policy and governance environment has shown no improvement or deteriorated in recent years, a development policy operation is typically not an appropriate aid instrument (see Box 1). In these circumstances, lack of commitment to reform usually prevents the achievement of program objectives: injections of budget support in these

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<sup>1</sup> Refer to OP/ BP 8.60 (August 11, 2004) *Development Policy Lending* for policies and procedures applicable to all development policy operations. For additional good practice guidance, staff may refer to *Good Practice Note: Designing Development Policy Operations*, OPCS, October 2004, World Bank.

<sup>2</sup> Fragile states will usually have Country Policy and Institutional Assessment (CPIA) ratings of 3.0 or less. Although fragile states refer generally to a broad range of failed, failing, and recovering states, this note focuses only on the latter — those that are undergoing a political transition or can be characterized as gradual reformers.

### BOX 1. CHOICE OF INTERVENTION IN FRAGILE STATES

Fragile states encompass a wide range of country circumstances. Emerging operational practice in the Bank, supported by the Low Income Countries under Stress initiative, suggests a fourfold typology of fragile states, presented in the table below. This typology is not static: country circumstances may change fairly quickly, with countries shifting between categories. Fragile states may also have widely differing levels of income: resource rich countries may fall into any one of these four categories.

#### Prolonged Crisis

**Characteristics:** Countries that do not have normal relations with the international community. Some may face international sanctions. The governance and policy environment is particularly weak. There is little policy dialogue and little prospect of improvement in the short-term. The regime may be authoritarian and the political situation unstable, with continuing insecurity and conflict.

**Bank Interventions:** Analytical work and dialogue to prepare for possible reengagement; projects capacity building and “ring-fenced” social service delivery; and scenario-planning with other donors to coordinate country assistance strategies and send consistent messages to the government.

**Development Policy Operations:** Not appropriate

#### Deteriorating Governance

**Characteristics:** Countries where there is a marked deterioration in governance and policy environment, accompanied by political instability, an increasingly authoritarian environment and/or deteriorating security. There is little effective policy dialogue. The international community monitors its engagement closely, and may be restructuring or reducing its support.

**Bank interventions:** Monitoring early warning indicators; restructuring of country portfolio, with greater emphasis on capacity building, strengthening of national and local governance institutions and “ring-fenced” social service delivery; restoration of dialogue.

**Development Policy Operations:** Not appropriate

#### Gradual Reformers

**Characteristics:** Countries with weak governance and policy frameworks, where there is limited policy dialogue, lack of a coherent reform agenda and limited progress in the implementation of reforms. Improvements in governance usually trail economic and social reforms. Although there is international engagement, the government often does not encourage coordinated donor interventions.

**Bank interventions:** Identification of politically feasible reforms that can build momentum for future change; ensuring the right mix of national-level policy dialogue and sectoral projects; and undertaking capacity building in high-impact areas from leadership to local level.

**Development policy operations:** Programmatic operations focusing on a modest reform agenda may be feasible if there is strong ownership.

#### Political Transitions

**Characteristics:** Countries where a peace or national reconciliation process or a change in regime leads to a shift in policy direction, with significant improvement in the prospects for reform. The government engages in policy dialogue with the international community and other stakeholders. The reform agenda embraces governance as well as economic and social issues. There is strong international support as long as there clear progress. However, transitions may be accompanied by political instability and may be reversible.

**Bank interventions:** Support to a broad program covering political, security, economic, and social sectors; grant-financed institution-building, demonstration projects for early reforms, and investment projects; analytical work in support of reform agenda.

**Development policy operations:** Programmatic operations may be feasible from the earliest stage of the transition.

circumstances may even help perpetuate weak governance. However, the prospects for reform programs improve significantly during post-conflict and political transitions, such as those associated with a peace agreement or the creation of a new, reform-minded administration. These events often generate a burst of popular support for change, as well as contributing to greater political and social stability, improvements in the security situation, and reengagement by external partners. However, transitions are fragile and reversible. Governments will be expected to deliver early benefits, in terms of services, jobs and improvements in governance. Where revenue collections are weak, the stability of state institutions and improvements in service delivery will require budgetary support. A rapid response from the international community will be needed to maintain momentum.

4. **Experience has shown that the potential benefits of development policy operations during fragile transitions often justify the risks of engagement.** Risks frequently identified include: uncertainty regarding the “whole of government” commitment and capacity to implement reform; scant information on economic, social and political conditions; and concerns regarding the fiduciary environment. In some cases, the international community reaches a consensus that the benefits of stabilizing a fragile transition are worth the risks—Afghanistan, Sierra Leone, West-Bank Gaza and Timor-Leste are recent examples—and looks to the Bank to play a role in coordinating and channeling financial support in these countries (see Section L). The present note focuses on the design and implementation of development policy operations and program conditionality during such transitions. These operations usually support an extended state-building and recovery process following a programmatic approach. The note may also be of use in the case of “gradual improvers” where the international community is prepared to provide some policy-based aid in support of a narrower reform program.

5. **The Bank’s country assistance strategy provides a framework for determining whether and in what circumstances a development policy operation would be an appropriate financing instrument.**<sup>3</sup> The Bank’s country assistance strategy should assess the feasibility and likely impact of a development policy operation, taking into account: a country’s economic, social and political stability and potential risks; the country’s policy, institutional and governance framework; financing requirements; the strength of the country’s program (particularly as regards its impact on governance and poverty reduction); and the country’s commitment and ownership of the program as revealed by its track record. Commitment and performance are key criteria for determining a country’s readiness for development policy assistance. Preparation of a program of policy and institutional reforms is an important signal of the government’s intentions, but preparation of the program is not sufficient in itself. The Bank’s country assistance strategy should also assess whether the development objectives are more likely to be achieved by using alternative instruments. In the case of fragile states, these alternatives will include a range of interventions, from policy dialogue and analytical work, to emergency recovery operations and regular investment projects (see Box 1). Further considerations will include the role and expectations placed on the Bank by the international community. Engagement with fragile states calls for close collaboration between the Bank and other partners, particularly in those countries where there are on-going conflicts and potential spillover effects.

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<sup>3</sup> See BP2.11 *Country Assistance Strategies* and OP2.30 and BP2.30 *Development Cooperation and Conflict*, on the preparation of a Country Assistance Strategy (CAS) or Interim Strategy Notes (ISN).

6. **Development policy operations aim at supporting a program of policies and institutional actions which require a long term commitment.** While there are no minimum criteria, this implies that a number of key building blocks for a program should be in place when considering a development policy operation in a fragile state:

- Ideally, a legitimate Government should be in place and have developed some strategy. Development policy operations may be premature when formal authority is still vested in a transitional body, as under UN mandate or a Government of national unity (para. 51) which, by definition, cannot legitimately make a long term commitment. In such circumstances, financing projects or recurrent expenditures through international Trust Funds (with Fund-specific fiduciary standards) seem more appropriate. The policy dialogue expected to be carried out through development policy operations may be initiated through these Trust Funds.
- In order to implement a program of policies and institutional actions, the Government needs to have adopted a budget. (Where needed, emergency budgets can be established relatively quickly, sometimes through joint assessment missions). Program documents for development policy operations should clearly show the budget which is being supported, and the extent the operation helps finance the budgetary gap.
- The treasury system needs to be functioning and improving. It does not need to meet specific minimum standards, but it should represent an appropriate mechanism to channel funds, and report on their use on a timely and reliable basis. Where the treasury system is weak, capacity may be successively built through a small investment project or limited budget support that successively helps meet the government's priority expenditures. Analytic work on the country public financial management system—in urgent cases in the form of minimal fiduciary assessment as part of a joint assessment mission or preparation of the budget support program—is a key input into this consideration and helps identify the key fiduciary risks and risk mitigation measures (para.44).

7. **World Bank operational policy also offers some scope for the use development policy operations on an exceptional basis in countries that do not meet the requirements for regular development policy operations.** These exceptions refer specifically to (i) countries affected or at risk of being affected by a financial crisis, with substantial structural and social dimensions; and (ii) countries affected by conflict that require development policy support for urgent rehabilitation.<sup>4</sup> In both cases the justification for development policy operations lies in the need for an unusually quick response from the Bank for the operation to be successful. Such operations must demonstrate how the design considerations usually required of development policy operations will be addressed over time as the country situation stabilizes.

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<sup>4</sup> See OP8.60 Paras. 32-33.

### C. PROGRAM SCOPE AND APPROACH

8. **Discussions on the scope of the program should begin at an early stage of program formulation, highlighting the tradeoffs between comprehensiveness and selectivity.** In those countries that are undergoing a political transition, governments will often advocate new policies across a range of sectors. This is notably the case in countries that are recovering from the partial or total collapse of the state—as in Rwanda in 1994, Timor Leste in 1999 or Afghanistan in 2001—where the policy framework is built anew. During these transitions

#### BOX 2. THE TRANSITION AGENDA

Literature on fragile states, in particular conflict-affected countries, emphasizes the interdependence of political, governance, security, economic and social factors. A successful transition will usually require progress on a broad front under a government program that integrates political and security issues with the governance, economic and social issues that feature in conventional development policy operations. Measures intended to re-establish legitimacy of state, basic state functions, state authority and the rule of law, and state legitimacy will figure prominently on the state-building agenda. At the same time, citizens will expect the recovery process to bring early benefits, in terms of improvements in governance, national reconciliation and personal security, access to basic services and jobs. Implementation of this agenda will engage a wider range of actors beyond the state, including civil society organizations and the private sector. While the key issues in the transition agenda will depend on the country context, recent experience has highlighted a number of common themes:

##### State Building

Restoring state legitimacy	<ul style="list-style-type: none"> <li>• Holding of elections leading to a representative legislature</li> <li>• Establishment of consultative and oversight bodies</li> <li>• Rule-bound decision-making processes</li> <li>• Improvements in transparency</li> </ul>
Restoring basic state functions	<ul style="list-style-type: none"> <li>• Revenue collection</li> <li>• Civil service appointment, record keeping and discipline</li> <li>• Public expenditure management</li> </ul>
Restoring state authority	<ul style="list-style-type: none"> <li>• Demobilization and disarmament of militias</li> <li>• Security services</li> <li>• Physical access to and communications with regions and rural areas</li> </ul>
Restoring the rule of law	<ul style="list-style-type: none"> <li>• Police services and oversight mechanisms</li> <li>• Justice system, processing of criminal cases</li> <li>• Civil and property registration</li> </ul>

##### Economic and Social Recovery

Improving governance	<ul style="list-style-type: none"> <li>• Protection of media, rights of association and access to information</li> <li>• Protection of property rights and facilitation of economic activity.</li> <li>• Civil-society participation in decision-making at policy and community-levels</li> <li>• Recognition of civil society's role in service delivery</li> </ul>
Reconciliation and personal security	<ul style="list-style-type: none"> <li>• National reconciliation process</li> <li>• Demobilization and disarmament, recognition of former combatants</li> <li>• Presence of police with adequate oversight, response capacity for security services</li> </ul>
Restoring basic services	<ul style="list-style-type: none"> <li>• Restoration of services available under previous administration (access to utilities, education and health)</li> <li>• Improvements in transport, communications, water, education and health in rural areas</li> <li>• Facilitation of private and civil society provision of basic services</li> </ul>
Employment creation	<ul style="list-style-type: none"> <li>• Labor intensive public works programs</li> <li>• Access to credit, and micro-credit, in urban and rural areas</li> <li>• Simple, accessible business registration and administration requirements</li> <li>• Investment promotion, simple rules and level playing field for investors</li> </ul>

many important decisions will crowd the policy agenda, competing for decision-makers' time and attention (see Box 2). Governments cannot afford to neglect political and security matters in order to devote attention to the economic and social issues that are the usual focus of development policy operations. By capturing the broad range of policy challenges facing the government, the program can enhance coordination across the government and with external partners, and reflect an appropriate balance between competing demands on scarce government capacity. Within this broad agenda, a selective program can help focus attention on a narrower range of activities, which may increase the likelihood that these can be completed as scheduled. Decisions regarding program scope should be taken in consultation with the government and other key stakeholders, through a selection process informed by discussion of the broad range of development initiatives. This selection process helps identify and balance constituencies and defines national ownership as participation in decision-making rather than the inclusion of every constituency's particular priority in the program.

9. **A key consideration in determining the scope of the development support operation will be the availability of planning instruments that provide an adequate framework for the government's program.** While a broad, national development and poverty reduction strategy such as a PRSP would be the ideal, fragile states may be unable to develop such a complex planning instrument where there are acute information, capacity and time constraints. A simpler tool based on PRS principles, the Transitional Results Matrix or Transitional Calendar, has been developed in some countries to guide the transition process.<sup>5</sup> Where such instruments are in place and the government has identified its priorities, the development policy operation can support existing national programs, or part of these programs.

10. **Where the broad program has not been defined elsewhere, the development policy operation may come to assume the function of an "umbrella program"** until the government has articulated its strategy in other planning instruments. "Umbrella programs" will inevitably be much broader in scope and comprise a larger number of programmed actions than a conventional development policy operation (see Box 3). The program can also build on internal planning exercises, such as sector programs, shifting much of the work on program design and implementation to sector working groups. Where sector planning is robust, the policy agenda may best be carried forward through sector level interventions, with the "umbrella program" providing summary indicators to monitor progress.

11. **A programmatic approach, with a sequence of operations, is often appropriate for states in transition.** A programmatic approach signals commitment from the Bank and other external partners, as well as by the government, where a single operation may be interpreted as lack of confidence. A programmatic approach also offers some predictability in funding, providing a sounder basis for forward planning. By defining intended outcomes for the medium-term, a programmatic approach provides a sense of direction, allowing the government to look beyond its immediate problems and begin to address structural development constraints. Progress towards these outcomes can be mapped out in small steps through a sequence of operations. Since success is assessed in relation to the achievement of program outcomes, program milestones can be adjusted in line with implementation capacity and program components adjusted to changing circumstances. Used flexibly, the programmatic approach can accommodate uncertainties as regards implementation capacity and provide a framework for policy development.

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<sup>5</sup> *An Operational Note on Transitional Results Matrices*, World Bank, United Nations Development Group, 2004.

**BOX 3. BROAD V. FOCUSED PROGRAMS**

Components	Timor-Leste	Afghanistan	West Bank - Gaza
Oversight Institutions	X		X
Justice	X		
Police	X		
Public Expenditure Management	X	X	X
Revenue Policy & Admin.	X	X	
Natural Resource Management	X	X	
Civil Service Administration	X	X	X
Local Government	X	X	
Health	X	X	
Education	X	X	
Social Protection		X	
Veterans	X		
Power Sector	X	X	
Private Sector Development	X	X	
Agriculture	X	X	

Recent development policy operations in Timor-Leste, Afghanistan and West Bank–Gaza illustrate the contrasting approaches. All three programs benefit from substantial assistance from bilateral partners. The Timor-Leste Transition Support Program (see P83894, October 2004) and the Afghanistan Programmatic Support for Institution Building (see P078618, July 2004), are very broad in scope, covering both the state-building and recovery agendas. These programs built on and supported implementation of comprehensive national development plans, comparable to the PRSCs in other countries. In contrast, the operation in West Bank-Gaza (see SF-P088754, May 2004), which also supported a broader development strategy, addressed only one component of the broader program where the Bank was seen to have a comparative advantage.

While narrow in scope, actions under the West-Gaza program (such as measures to control recruitment, payment of security personnel salaries direct to bank accounts, restrictions on recruitment, and establishment of an independent audit institution) had significant political implications in the country context, shifting the balance of power between government agencies. In this way, the development policy operation supported a reform-minded institution in implementing key components of a broader governance agenda. This example illustrates how development policy operations in fragile states can address a complex governance issues through a few well-selected actions, as well as through a broader program of state-building.

12. **A programmatic approach can accommodate a process of policy development where the government's medium-term program is still being defined.** A well-specified medium-term program is normally seen as a pre-condition for a programmatic approach. For fragile states, policy development is often part of the transition process. Agreement on broad policy objectives is usually sufficient to guide the program whilst strategic plans are put in place. The first annual program would normally focus on short-term initiatives, identified on the basis of broad outcomes for each program component, whilst starting to put in place the policy process leading to the development of a more detailed medium-term program in subsequent years. Policy development may need to be prioritized and sequenced. Adequate time needs to be given to the policy process, ensuring that policies are built on analytical work,

consideration of alternatives and consultations with key stakeholders. Policy development will normally take several years, with policies and medium-term strategies put in place gradually, sector by sector, as the sequence of annual operations unfolds. Once policies and strategies have been defined, expected program outcomes can be adjusted accordingly.

#### **BOX 4. PROGRAM SCOPE IN A “GRADUAL IMPROVER” SITUATION**

Following the official end of the civil war in 1997, Tajikistan’s leadership sought to consolidate its authority. Attention has now shifted to economic reforms, strengthening of the administration and civil service and cautious engagement with the international community. A PRSP process is in place, with regular published updates. However, the PRSP is still too weak at this stage to provide a sound framework for the medium-term reform agenda.

Recognizing these constraints, the Policy Development Credit (PBC) currently in preparation, focuses on the more progressive elements of the Government’s agenda, supporting actions that build state capacity, such as civil service pay reform, and the decision making process for economic sectors. At the same time, the PBC supports improvements in state accountability, for example through implementation of annual ex-post compliance audits of the privatization process by an international auditor.

In order to increase the effectiveness of the Bank program in this low capacity environment, the Bank Group works closely with the Government and donors, focusing all available instruments (development policy operations, investment projects, technical assistance, community interventions, and analytic work) on a carefully selected set of key priorities, trying to “open many doors and windows to the same room”. The PBC (and PRSCs) will support budget reform measures to move towards per capita based funding in health and education, for example, since this is critical to the success of the sector programs. Similarly, it will support improvements in cost recovery in the energy sector, thereby helping to put the sector on sound financial footing and attract the foreign investments needed for the Government’s hydropower projects.

13. **It is advisable for the development policy operation to describe the government's overall strategy and present a matrix showing the Government's overall reform program.** This should include past actions, actions expected to take place in the coming year, and actions expected to take place in the medium term and outcomes. However, it is most effective to focus the development policy operation on a narrower set of issues within this large reform program. It is the responsibility of the task team to aim for selectivity and define a critical reform path within the overall government program. This implies selecting a few actions which are critical to the overall success of the government's strategy. In fragile states, a key objective of development policy actions is to build the financial management of the state and the public administration.

14. **In the case of “gradual improvers”, programs are likely to be selective, focusing on a modest reform agenda where there is sufficiently strong national ownership and reform measures are both politically and technically feasible.** In the absence of political change, policies and systems are likely to be entrenched and compounded by capacity constraints and risk aversion at all levels of the administration. In this context, wide-ranging reform is often unrealistic. At the beginning, development policy operations should probably be rather small in order to "test" the fiscal management of the state while supporting an improvement in fiduciary standards. A secondary focus of DPLs could be to progressively

ensure that public expenditures are better targeted to the social sectors and private sector development.

15. A useful approach is to combine development policy operations focused on a few measures with other sector projects or capacity-building initiatives which help make the reforms easier to implement. Experience has shown that combining development policy operations with sectoral projects helps create a focus on priorities. The development policy operation can help anchor the overall framework of budget allocations, policy and legislative actions—while sectoral projects help capacity and monitoring of these commitments. These programs may be financed by the Bank as part of a selective and integrated CAS, or they may be financed by other donors (see Box 4).

#### **D. PROGRESS ASSESSMENT AND CONDITIONALITY**

16. **Bank support should be based on a clear understanding of what the program is expected to achieve.** This is best expressed in terms of progress towards specific objectives and development outcomes rather than the completion of specific reform actions. Ideally, the results framework for the program will include indicators of agency performance, allowing the government and external partners to assess whether the program is contributing to improvements in the delivery of services. Furthermore, there needs to be a clear and early understanding of the Bank's financing intentions before the beginning of the budget year. Uncertainty about funding during budget execution should be avoided as it is likely to undermine sound expenditure planning, especially where external support covers a substantial part of the budget (see Para. 40). Progress in program implementation will be the determining factor in the Bank's decision to proceed with follow-up development policy operations and their size.

17. **Program performance should then be assessed broadly, in terms of progress towards the achievement of these program outcomes.** Delays in the implementation of specific actions should be expected and anticipated by the program design. Actions may have to be rescheduled, restructured and additional inputs mobilized to address implementation constraints. Some components are likely to proceed faster than others. Where there are repeated delays, the sources of resistance need to be identified and addressed. Where the component or actions are no longer feasible, they can be adjusted mid-course. If delays put the program at risk of running off-course, high priority actions can be signaled in program documents and discussions with the government to ensure that these receive special attention during implementation. Ultimately, program success or failure has to be assessed against the big-picture rather than a narrow set of specific actions: completion of one or two critical, politically difficult actions may weigh heavier in this assessment than delays in other areas of the program.

18. **Design of conditionality for development policy operations in fragile states should take into consideration the need for a broad assessment of progress.** Conditionality can be helpful if it bolsters the government's case for implementing policy measures to which it is already committed, and helps to operationalize its strategy. But the imperfect policy analysis of underlying transition programs, the fluctuating policy environment, implementation constraints, and high costs of disbursement delays all call for building flexibility into program design. This has several implications for the design of program conditionality in fragile states:

- *Programmatic Approach.* In general, conditionality based on completed prior actions (ex ante conditionality) in a programmatic series of single-tranche operations is likely to be more appropriate than multiple-tranche operations with legal conditions for subsequent tranche releases in (ex-post conditionality) (see Box 5).
- *Criticality.* Prior actions and indicative benchmarks for future support should focus on critical steps for progress in transition. They should be limited in scope and number to the extent possible. They should be technically feasible and adapted to the political economy.
- *Results-Orientation.* The multi-year program should outline clear expectations for progress in areas which are critical for the transition. Although the medium-term outlook in fragile states is typically characterized great uncertainty, multi-year programs should include specific expected results that would need to be adapted and updated when necessary.
- *Realism.* Conditionality must take account of the limited institutional and implementation capacity in fragile states. Many of the benchmarks in a policy matrix may be indicative and non-binding, and there may be good reasons for a wider coverage, including the operationalization of the government's broader sectoral agenda or harmonization of donor support (see Box 7). However, task teams should in all cases aim for realism and avoid an overloading of the policy agenda beyond what the government finds useful and is capable of implementing.
- *Predictability.* While the Bank should always aim for predictability of resource flows, there must be a clear understanding between the Bank and the authorities on the likely consequences of uneven country performance. If the spirit of this program is not followed, the responses may range from a delay of subsequent operations, to reductions in overall amounts and complete withdrawal of financial support. The risks in terms of delays in program disbursement and in follow-up programs, and the heightened tensions within government, or between the government and program partners, should be carefully—and explicitly—weighed against the benefits.
- *Assessment.* The Bank's response to uneven country performance should be based on an overall assessment of progress. In a programmatic setting, a limited set of triggers is typically helpful in indicating benchmarks for measuring progress. They should be an input into the overall judgment to proceed with subsequent operations, but not be treated as specific conditions.
- *Participation.* The government should clearly lead in the selection and formulation of conditionality, but close involve stakeholders. The often complex policy and institutional agenda associated with a development policy operation can only be adopted and implemented if it has sufficient political support within the country. A

### BOX 5. TRANCHE CONDITIONALITY IN FRAGILE STATES

The Post-Reunification Economic Recovery Credit in the Democratic Republic of Congo used floating tranche conditions as an incentive for the Government to implement discrete packages of reforms: improvements in utilities billing and payment; a civil service retirement program; and arrangements for repayment of the Government's internal debt to private creditors. This approach is intuitively appealing, particularly where financing is notionally earmarked to specific expenditures. However, DRC's experience highlights some of the risks of using tranche conditionality in fragile states. The Government was unable to implement the reforms without external technical assistance. Tranche release was delayed as this assistance was mobilized. The notional earmarking of budget support to specific expenditures proved unrealistic where the expenditures were to be executed over an extended time frame and the Government faced pressing demands for alternative applications of the funds. Indeed, the uncertainty regarding tranche timing may have aggravated the Government's difficulties in cash planning. The feasibility of shifting to a single tranche operation for the Third Economic Recovery Credit is currently under review. (*Democratic Republic of Congo, Post-Reunification Economic Recovery Credit, Report 27720.*)

well-implemented stakeholder participation strategy can help develop this support, as long as it appropriately reflects the specific country circumstances.<sup>6</sup>

19. **Fragile states may also require much more detailed programs than usually seen in other development policy operations.** Where the administration lacks an effective work planning and monitoring system it is unlikely that milestones will be achieved unless they are further broken down into actions and institutional responsibility is clearly assigned (Box 6). Detailed action planning helps the government and program partners track progress and adjust to delays in program implementation. Detailed action planning should not be confused with conditionality: milestones help guide a process of reform internally, but are not necessarily triggers or conditions. However, such detailed operational planning and reporting in the context of development policy operations is best seen as a transitional arrangement while internal management and reporting systems are put in place. Development of these systems should figure prominently in the program (see Section F below).

### E. SELECTION OF PROGRAM COMPONENTS AND ACTIONS

20. **The government will have to select priorities from its broad policy agenda in consultation with key stakeholders if it is to arrive at a manageable program.** In the case of states in transition, the prospective menu of development initiatives is extensive (see Box 2). Some of the key considerations in the selection of program components and actions in the context of fragile states in transition are identified below. The Good Practice Note *Designing Development Policy Operations* provides further guidance on the selection and design of actions and their presentation in the program matrix. The recent experience with conditionality in fragile states (Box 7) suggests that a variety of approaches in terms of scope, content and modalities can be used in different country circumstances as long as it is useful for policy makers and takes account of the country's implementation capacity.

<sup>6</sup> See *Supporting Participation in Development Policy Operations: Good Practice Note for Development Policy Lending*, OPCS, October 2004, World Bank.

### **BOX 6. PLANNING AND MONITORING IMPLEMENTATION**

From the Bank's perspective there is a marked preference for a short, focused program matrix that highlights the key reform measures to be implemented as prior actions for the proposed program, the actions corresponding to tranche conditions (if any) and the triggers for subsequent programs. In Timor-Leste, however, the Government chose to prepare a much more detailed action plan, identifying the key outputs under the Government program for the year ahead, and the corresponding actions to be implemented by agency by quarter, for its First Transition Support Program prepared at Independence in 2002. Quarterly progress reports were prepared by the Ministry of Planning and Finance for the Council of Ministers and shared with external partners. During the preparation of follow-up programs, some external partners and Bank staff argued that the detailed program document was over-intrusive and should be cut back, even though the detailed program actions were not linked to conditions or triggers. However, the Government disagreed, as the Prime Minister pointed out a detailed action plan was needed while the national systems were being put in place: "*TSP contributed greatly to reinforcing the Government's internal performance management systems ...It also enables us to strengthen the accountability of the Government through collaborative monitoring. The discipline this has placed on the Government is something we have come to appreciate*". (*Opening Remarks, TSP III Progress Mission, December 6, 2004*).

21. **Support transition agreements.** Transitions are often launched by agreements between conflicting parties, either through a formal peace process or power-sharing arrangements. These agreements will usually include provisions with policy implications. This may entail commitments to demobilize former combatants, establish specific governance structures, such as transitional administrations, or allocate resources to particular regions or groups. Compliance with these agreements is critical to national reconciliation, stability and a successful transition. In these countries, development policy operations should also be prepared in close consultation with bilateral and multilateral agencies which have responsibility for peace-building and peacekeeping. Development policy operations should be consistent with the spirit and specific provisions of these agreements. In some cases, the development policy operation may actively support their implementation; within the framework of partnership agreements which recognize the limits of the Bank's mandate or expertise (see Box 8).

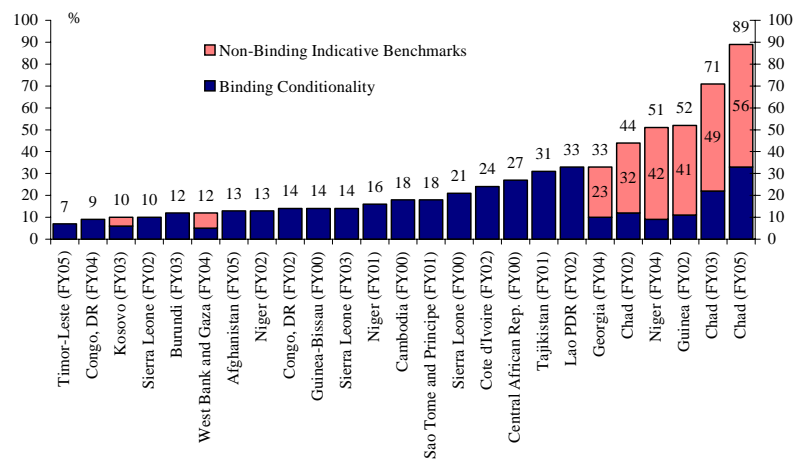
22. **Avoid exacerbating conflicts.** First, do no harm. Since stability is essential to a successful transition, the program should avoid actions that are likely to exacerbate social and political tensions. This may mean that measures needed to achieve economic and financial stabilization (such as reductions in subsidies or civil service staffing) or shift the balance of power (such as changes in the role of sub-national administrations) may have to be postponed until a later stage in the transition. These issues do not necessarily have to be dropped from the agenda. Preliminary analytical work may proceed under the program, providing an opportunity

### BOX 7. THE EMERGING EXPERIENCE WITH CONDITIONALITY IN FRAGILE STATES

The use of conditionality in World Bank-supported policy based operations for fragile states has changed in recent years.

**Numbers.** Overall, conditionality remains focused on a few reform areas, with binding conditionality (prior actions and tranche release conditions) contained to a few critical actions. However, there seems to be substantive growth in non-binding indicative benchmarks. This expansion is reflected in larger policy matrices that cover a wider range of sectors, mostly in single tranche loans. While these larger policy matrices facilitate donor harmonization and help policy makers operationalize their poverty reduction strategies and the broad range of government priorities, it raises questions over country capacity in fragile states. This trend, however, is not general across countries, but clearly limited to a small number of countries (Figure 1).

Figure 1. Conditionality in LICUS countries, FY95-05



Source: ALCID, World Bank.

**Content.** Conditionality in public sector governance areas has grown rapidly in recent years, while the relative share of conditionality in private sector development, social sectors, and rural/urban development appears to be declining. There are also some patterns in the content of conditionality which indicate deepening in reforms as country performance improves. Conditionality in LICUS countries often supports the strengthening of fiduciary systems and public financial accountability, typically with the following common elements:

- *Procurement:* developing a sound public procurement code, setting forth specific procedures on procurement plans, audit requirements and penalty rules in case of fraud;
- *Budget management:* preparation and execution of single year budget laws and directives, including reporting mechanisms and allocation/expenditure tracking in priority sectors, and evidence of multiyear budget programming (MTEF);
- *Monitoring and evaluation:* institutional set up or strengthening of monitoring and evaluation functions and systems with regard to cash management and public spending; and
- *Disclosure:* dissemination (in reports or websites) of procurement and of budget (allocation and execution) data on a regular basis.

**Type of conditions.** Among the different types of conditionality, process or design conditions have become more important, particularly in single tranche loans and in social sector and public sector governance. Implementing conditions are more prevalent in lower performing fragile states, and in the financial and private sector development areas. The reliance on outcome conditions in fragile states has been very limited to date.

for stakeholder consultation and policy development that will build the foundations for policy implementation at a later date.

**BOX 8. ADDRESSING ISSUES OUTSIDE THE BANK’S LEGAL MANDATE AND EXPERTISE**

**Rationale.** Development policy operations should consolidate and coordinate external financing partners around a common, government-led program. The government should be encouraged to cover the entire program in the documentation it provides to the financing partners. The Bank will usually support and monitor the entire program. However, specific high priority areas of this program may be outside the Bank’s legal mandate or expertise, such as those related to elections, security and some elements of the criminal justice system. Support, including technical assistance, for such areas, and monitoring of these parts of the program should be provided by other financing partners. They may not constitute triggers or conditions for the Bank’s financing, though they may inform the Bank’s consideration of the feasibility of the part of the program it will support.

**Documentation.** The government requests Bank support for its program in a letter that sets out its program, or in a covering letter to another document that sets out its program. If the letter is addressed to all financing partners, the entire program should be set out in the letter or attached document. This letter (together with any attachments) is known as the *Letter of Development Policy* (LDP), for purposes of Bank financing. If the program includes areas that are outside the Bank’s legal mandate or expertise, they should be clearly identified so that it is possible for the Government, the Bank and the other financiers to distinguish between those areas of the program that the Bank will support and monitor and those which will be supported and monitored by other financiers according to their mandate or comparative expertise. This division of labor among financiers may be set out in the LDP or in a separate Memorandum of Understanding (MOU) among the Bank, the other financiers and the Government. Alternatively, depending on how the LDP is drafted, it may be possible for the Bank to specify in its financing agreement with the Country those portions of the overall program which it will support and monitor (i.e., those areas which constitute the "Program" for purposes of Bank financing). Since the Bank may not make commitments on behalf of other financiers for those areas which the Bank may not support, support for these areas would require separate financing arrangements between the financier concerned and the Government. If the financier does not wish to provide funding directly to the Government for the actions it will support, this might be accommodated by channeling the financier’s funds through another agent that could assume responsibility for disbursement, monitoring or both.

23. **Improve transparency.** Publication of key documents—such as budgets, financial statements, laws, cabinet decisions and policy documents—is an obvious first step. Where there are extractive industries, disclosure of framework agreements and revenue yields is a natural progression. Building transparency and opportunities for consultation into decision-making process is equally important. In many fragile states this may entail introduction of a formal policy and legislative process, including requirements for dissemination and consultations at various stages. The financial cost of these measures may be modest but their impact in signaling improvements in governance can be significant.

24. **Promote private sector economic activity and employment.** In many fragile states, poor governance and insecurity have been accompanied by fragile economies, characterized by high levels of unemployment and restricted economic opportunities. For many of those outside the state, the immediate priorities for the transition are job creation and the facilitation of economic activity. Often this will entail a strong economic policy agenda including price liberalization, simplification of business and civil registration procedures, measures to ensure

security of property, improvements the services provided by utilities. Investment, employment generation and economic growth will be key indicators of program success.

25. **Recognize and use existing administrative structures and systems.** The administrative structures, legislation and the systems of previous regimes can provide a foundation for the new administration. Continuity will assist national personnel put systems back to work; avoids the huge cost and disruption of imposing new and unfamiliar systems and structures; and reduces the scope of programs during the early years of transition, since there is no longer pressure to reinvent every aspect of the administrative apparatus. Rather than rebuild the state in all its complexity, programs should focus on those critical state functions that are seen to be deficient and have lost credibility with citizens.

26. **Ensure that basic state functions are in place.** Effective personnel and financial management systems are essential for the functioning of all state institutions and should be seen as a priority. Attention should focus on ensuring that these functions deliver services to line agencies, so that: staff are recruited, placed in the field and paid on time; agencies receive predictable budget allocations, procurement and payment procedures allow them to spend their allocations and contractors are paid. Basic record keeping and reporting standards will need to be enforced, so that, for instance, there are up-to-date personnel files for all personnel and financial reports and statements are compiled regularly. Where there are concerns about the performance of these systems, quantitative indicators for these basic functions can be included in the program to help monitor progress.

27. **Keep it simple.** Capacity is directly related to the tasks that institutions are expected to fulfill: the more complex the task, the greater the organizational and human capacity needed to undertake the task successfully. Simple systems that can be managed by clerical staff with limited analytical skills should be put in place first. Preparatory work on more sophisticated systems may proceed in parallel but are cannot be implemented effectively until the building blocks are in place.

28. **Address service delivery and infrastructure provision.** Conventional development policy operations tend to focus on policy and institutional change, often taking for granted routine service and infrastructure provision. In fragile states, service and infrastructure provision is usually extremely weak. Including summary input and output indicators for service delivery and infrastructure in the program and program matrix—such as the number of health staff in the field, vaccination coverage, outpatient attendance—helps focus attention on the purpose of public institutions, rather than on the internal reforms and capacity building measures. Where there are information constraints, where the level and quality of services provided by key institutions is not known, the development of the necessary information systems should feature in the program.

29. **Deliver early benefits.** Programs that deliver early, tangible benefits to the public are more likely to build and maintain popular support. However, in a transition context, where basic management systems are ineffective and institutions have limited reach, particularly in rural areas, the challenge of delivering public services should not be underestimated. Where capacity is particularly constrained, as in a post-conflict situation, it may be wise to focus on a small number of highly visible deliverables, such as schoolbooks, basic medicines and personnel attendance for service delivery units. Early benefits may also come from less rather than more state intervention, such as through the demobilization of armed groups.

30. **Apply and enforce regulations.** Development policy operations in strong policy environments have a bias towards reforms led by changes in legislation. In fragile states, where enforcement capacity is limited, legislation-led reforms are unlikely to have a significant impact. Without an effective judicial system, changes in the regulatory environment for the private sector, for instance, will at best have a signaling effect. Where the intention is to change administrative behavior, much can be achieved by adjusting administrative procedures, with legislation following rather than leading practice. The programmatic approach provides scope for the government to pilot and experiment, formalizing procedures once they have been tested. If legislation is critical, the program should follow through to ensure that this legislation is implemented. The first annual program may see legislation prepared, the second implementing regulations and supporting administrative systems put in place, and the third year would see implementation.

31. **Reach out to communities and rural areas.** Fragile states often function as urban enclaves, as their authority and the services they provide having little impact in rural areas. Distance may be compounded by a top-down administrative structures and the centralization of resources. Communities rarely have a voice in decisions or access to public resources. Building systems that can extend the reach of the state requires significant organizational capacity. Some fragile states have sought to overcome these constraints by leap-frogging administrative structures and channeling resources directly to communities. The Bank's social development funds and UNCDF's local development funds have proved successful in establishing an institutional framework to achieve this goal. Service delivery agencies can achieve similar results by making small cash transfers to schools and health posts. Promotion of these initiatives through development policy operations is one of most effective ways of having an impact in rural areas during the early years of the transition.

32. **Look beyond the state for service providers.** Faced with the weak state capacity, there is a compelling case for providing services through non-governmental providers. In post-conflict settings, external funding is often channeled through NGOs. NGOs may be seen as more responsive, more efficient, and more trustworthy. Unfortunately, the government agencies often see NGO providers as competing for scarce resources. Early discussions on the role of the state and NGO providers in service provision at a policy level can pave the way to a more collaborative relationship in which the state supports multiple service providers. Where services are provided by international NGOs, the transition to country systems, through national non-governmental or public sector institutions, should be addressed from the outset. Where NGOs are important service providers attention will need to be given to the establishment of adequate monitoring and regulatory arrangements.

33. **Use and support projects.** Development policy operations are not designed in isolation: in most countries there are a wide range of investment projects and capacity building interventions supported by the Bank and external partners. By building on these interventions, making explicit linkages between projects and program actions, and aligning the Bank's interventions to the CAS the development policy operation can enhance its own chances of success and those of complementary projects.

## F. SUPPORTING NATIONAL SYSTEMS

34. **In fragile states, development policy operations and program conditionality should not be prepared as a parallel exercise that can undermine national systems.** Program

preparation and monitoring will usually absorb significant manpower and can distract attention from internal planning instruments. Consultations with and reporting to external partners can be seen as undermining the authority of national bodies, such as the legislature, which are often excluded from the program preparation process, making the government appear accountable to external partners rather than its own citizens.

35. **These risks can be mitigated by integrating program preparation and monitoring in the government's internal planning process as soon as possible.** This can in itself be an important capacity building exercise, helping government agencies identify and schedule their work programs. Use of government systems can also introduce more durable mechanisms for stakeholder consultation as part of the planning routines. Most importantly, the use of national systems legitimizes national institutions, reinforcing the authority and oversight role of the legislature and other collective executive and oversight bodies. Development of an effective,

#### **BOX 9. STRENGTHENING THE BUDGET PROCESS**

Preparation of a budget is a prerequisite for development policy operations. In emergency situations, budgets can be put together fairly quickly, as part of the work of assessment missions. Once in place, the routine and structure of the budget process can and should provide a framework for policy and operational decision-making. In Afghanistan, the FY2003 budget constituted a first attempt at expenditure prioritization, set benchmarks for revenue collection and established the government's macro-economic credibility. The bulk of expenditures were allocated to payroll and office rehabilitation: very little was allocated to service provision. In subsequent budgets, total and service oriented expenditures have increased, so too has the level of technical sophistication. Budgets have become more comprehensive and prescriptive. Budgets are increasingly used to determine priorities, serving as a catalyst for the discussion of major policy and institutional issues. Development policy operations have sought to reinforce this function, through synchronization with the budget process and a continued focus on strengthening the quality, coverage and agency engagement in the budget as part of the program (*Islamic Republic of Afghanistan, Programmatic Support for Institution Building, July 6, 2004. Report 28192-AF*).

inclusive and accountable policy and planning process is critical to the success of the state building agenda (see Box 9).

36. **This requires early synchronization with, and use of, planning and budget cycle routines.** Program priorities will need to be agreed at the start of the budget and planning process so that they are reflected in budget and planning circulars. If necessary, technical assistance can be mobilized to assist government agencies translate these broad guidelines into agency level work plans. Programs can then be appraised as the plans and budget documents are being finalized through negotiations between the core and line agencies. The program matrix should draw from agency level work plans, and if adjustments are negotiated at appraisal, the agency work plan can be updated before it is finalized. In this way, the program matrix summarizes more detailed and more comprehensive agency plans, highlighting the most important actions that will be monitored at a cross-governmental level. Ideally, the agreed program would be presented as part of the budget and plan documents which are submitted to the legislature for approval. Program reporting can, similarly, abstract from the government's internal progress reporting. As the transition proceeds, the program should gradually come to rely on the outputs of internal planning processes, rather than supporting the preparation of these plans.

## G. MOBILIZING FINANCING

37. **In fragile states, the financing rationale for development policy assistance is usually to support an increase in recurrent expenditures.** Typically, the aggregate level of public spending in fragile states is constrained by weak revenue performance; recurrent expenditures are insufficient to maintain and operate state institutions, let alone finance public services; and public investment largely depends on external financing. Most external assistance will be provided as project aid to support investments in infrastructure and capacity building. Project funds may also support some direct service provision, by providing inputs to government agencies or by financing non-governmental providers. However, projects are not an effective mechanism for financing recurrent expenditures across a large number of institutions. Development policy operations address this recurrent expenditure resource constraint: budget support allows the government to sustain a higher level of recurrent spending on government agencies and services to the public than would otherwise be possible.<sup>7</sup>

38. **The appropriate level of external financing should be determined within the framework of a fully financed, realistic and sustainable budget.** Decisions regarding budgetary aggregates and the appropriate financing package are likely to be reached through an iterative process. In poor-performing fragile states, the level of external financing available for budget support is likely to be modest and so financing will remain a constraint on the overall budget. For states in transition, where the international community is committed to the state-building and recovery process, it is often possible to mobilize significant bilateral grant co-financing for development policy operations (In Timor and Afghanistan external financing has covered more than 50 percent of expenditures executed through treasury). In these transition countries, the key determinants of the appropriate level of aggregate expenditure are often absorption capacity and the sustainable level of expenditures over the medium-term. In this context, it is important to recognize that countries that depend on external financing to cover significant part of their recurrent expenditures will be susceptible to external shocks. A strategy for aligning expenditures with sustainable levels of domestic financing will need to be put in place with a view to gradually closing the financing gap.

39. **The administration's capacity to use additional resources effectively should be carefully assessed.** Expenditures tend to accelerate at a much slower pace than anticipated during the transition, largely because public agencies need to have a clear idea of their work program and priorities and staff have to be familiar with procedures in order to spend money quickly. Annual increases in agency spending of twenty percent or more are likely to be wishful thinking, unless these are allocated to large items such as wage bill increases. Over-optimistic budgets may lead to an accumulation of budgetary reserves. Some accumulation of reserves should be encouraged to accommodate delays in the mobilization of financing and budgetary shocks. However, large shortfalls in expenditures during successive budgets, leading to unplanned increases in budget balances, will undermine the rationale for continued

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<sup>7</sup> Occasionally, the immediate purpose of development policy support may be to address balance of payments shocks, such as those arising from a collapse in exports. These operations will also increase budgetary financing as the domestic currency proceeds are credited to Government accounts. Very occasionally, where the operation has been preceded by a significant and unsustainable expansion of the money supply, the Government may be asked to sterilize these accounts in order to curtail inflationary impacts. The macro-economic dimensions of development policy operations should be addressed explicitly during program design.

budgetary support. Of greater concern is the risk that excess appropriations will encourage wasteful use of scarce funds, as agencies increase spending on administrative overheads to exhaust their budget balances. In this context, the feasibility of proposed increases in expenditures should be carefully assessed and adjustments negotiated where budget estimates are clearly unrealistic. During program implementation, budget execution rates will provide a clear indication as to whether programmed budget support has been too generous and whether adjustments in the financing package will be needed in subsequent operations.

40. **Expenditures, particularly recurrent expenditures, will need to be kept at a level that can be sustained.** Investment expenditures, driven by external financed projects, will usually surge in the early years of the transition and then tail off. The investment boom is particularly marked in post-conflict countries. For recurrent expenditures, the pattern is likely to be reversed, with expenditures increasing gradually as service delivery units are rebuilt, institutional capacity develops and service delivery picks up. An appropriate recurrent expenditure growth trajectory will need to be mapped out fairly early on to ensure that commitments to expansion of public services are based on a realistic assessment of resource availability over the medium to long-term. This should take into account realistic projections for growth in revenues and financing availability. It should also include an assessment of debt service obligations and the feasibility of debt relief, with a view to freeing domestic resources to support service delivery. The Bank's and external partners' financing should be consistent with this sustainable expenditure growth trajectory. Financing terms will generally give preference to grant financing—after all financing will largely support recurrent expenditures—which will usually require bilateral co-financing.

41. **Program financing strategies should ensure predictability, whilst providing some incentives for program performance and an appropriate exit strategy.** Where external financing covers a significant part of the budget, predictability is essential if the government is to plan ahead and avoid a start-stop pattern of expenditure on public services. This requires a programmatic approach and alignment of most external partners' financing commitments with the duration of program. Where the Bank and external partners intend to link part of their contributions to program performance, it is important to define the financing scenarios early on and plan for increases in financing above a low-performance base rather than cutting financing when the program slows. Appropriate incentives would cover not only key program actions, but also expenditure and revenue performance. Revenue performance incentives are particularly important where the intention is to gradually reduce external financing and there are concerns that external financing will discourage domestic revenue effort. Measures to improve revenue yields through improvements in administration and policy would figure prominently in the program. Incentives for the government to mobilize additional revenues from domestic sources can be included by limiting the programs financing trajectory to levels consistent with increasing revenue effort, additional financing could be provided where the government reaches specific targets. While it may be appealing to think in terms of revenue recovery providing exit strategy for the Bank, most transitions require extended periods of budgetary support. Consequently, forward expenditure estimates would usually include provision for continued—though declining—budgetary support in the outer years of the program and beyond.

## H. TARGETING RESOURCES

42. **Development policy operations and program conditionality may be designed to achieve specific resource allocation objectives.** This may reflect concerns that the existing and proposed allocation of resources is inconsistent with the program's broader development objectives. The objective may be, for instance, to gradually increase the share of spending on service delivery sectors relative to administration. Where appropriate, such targets could be included in the policy matrix supported by the operation as an indicative benchmark, trigger for a subsequent programmatic operation or, in the case of multi-tranche operations, as a condition for tranche release. In some cases, resource allocations are mandated under transition agreements, such as provision for demobilization or elections, or reductions in spending on security services. Where external financing covers a large part of expenditures, the allocation of additional resources to specific sectors—such as social services—may also figure prominently in external partners' rationale for providing budget support.

43. **Resource allocation objectives should be informed by analysis of the structure of public spending and the program's expenditure implications.** Such analysis should be based on a comprehensive assessment of public expenditures, including external assistance delivered through projects and off-budget mechanisms. Failure to take off-budget external assistance into account will tend to distort policy conclusions, particularly where external assistance concentrated in rehabilitation activities or substantial funding is channeled to the security sector. Off-budget recurrent expenditures and the induced costs of investments that will need to be integrated into future budgets merit particular attention. The policy consistency of these resource allocations should be assessed in relation to the country context and program objectives. During the early stages of the transition, internal security objectives and the imperatives of force integration prior to demobilization may call for a higher share of resources being allocated to core state functions, the police and defense than seen in comparator developing countries. Resource allocations for service delivery are likely to increase slowly, as the infrastructure and institutional capacity needed to deliver services are put in place.

44. **Resource allocation objectives can usually be addressed through the policy and budget process, by including specific targets and limits on budget allocations under the program.** Expenditure targets and limits may be applied to specific sectors (usually in relation to the responsible ministry or program) or components of expenditure (such as personnel costs). They may also be applied indirectly by, for instance, limiting staffing levels. Where external partners wish to link their contributions to specific components of expenditure, it may be sufficient to assess additionality in terms of increases in expenditures for priority sectors in relation to the previous year's budget or expenditure outturns. However, expenditure targets, limits and additionality requirements should be used sparingly, since these constrain flexibility in the budget process. Resource allocation issues will also need to be addressed early in program design, so that allocation decisions are reflected in budget circulars at the start of the budget process.

45. **Occasionally, arrangements may be put in place to track the application of the proceeds of the development policy operation and external partner' contributions.** As set out in OP8.60, the recipient is always required to provide an undertaking, documented in legal agreements, not to use the proceeds of development policy operations to finance ineligible items (the "negative list"). However, given the fungibility of budget resources, it is not

normally required to track the ultimate use of Bank funds in development policy operations. Exceptions to this policy may arise where restrictions on the application of budgetary support are part of a transition agreement or related to the Bank's agreed operational mandate, and tracking the application of funds provides reassurance that the Bank is complying with these agreements. Transition agreements may include, for instance, requirements for external financing to be channeled to support specific programs, such as demobilization, or exclude others. Tracking the application of Bank funds requires the establishment of additional fiduciary arrangements with significant cost and developmental implications. Notably, where the Bank agrees with the borrower on specified purposes for which the proceeds of Bank financing may be used, the Bank's policies on procurement—together with those on retroactive financing—would apply.

## I. ADDRESSING FIDUCIARY RISKS

46. **Analytic work on the country public financial management system should identify the key fiduciary risks and risk mitigation measures.** The Bank's principal instruments for such analytic work include Public Expenditure Reviews, Country Financial Accountability Assessments and Country Procurement Assessments. Diagnostics will usually include action plans aimed at improving the transparency, accountability and effectiveness of the government's financial management systems. Where possible, these instruments should be integrated to provide stakeholders with a comprehensive assessment of the fiduciary environment and the risks associated with channeling budget support through the government system. The appropriate risk mitigation measures for development policy operations should be defined on the basis of this assessment. Program documents should address the status of fiduciary assessments, the risk mitigation measures and indicators for measuring financial management performance.

47. **There is no minimum standard of public financial management that constitutes a pre-condition for development policy support.** The Good Practice Note "Financial Management Issues in Development Policy Support", argues that improved public financial management performance may be an outcome, rather than a pre-condition, of development policy support. Development policy support can be provided in a country that has a weak public financial management environment but has committed itself to an adequate program of public financial management improvement and there is reasonable evidence that improvements are occurring in a timely manner.

48. **Fiduciary risks are usually addressed through the implementation of measures to strengthen the government's financial management systems under the program.** These measures will usually follow-up on the recommendations of prior analytic work. Where the implementation of these measures requires technical support, this assistance should be programmed and adequate financing mobilized during program preparation. Program monitoring should assess progress in implementing the financial management reforms. Implementation of public financial management reforms is likely to be an important signal to external partners of the country's ability to use budgetary support effectively.

49. **Since fiduciary risks are generally high in fragile states, monitoring will generally be more intense than in more stable settings.** This may include, for instance, detailed reviews of control systems in high-risk areas such as personnel and procurement. In conducting these reviews, the Bank may request access to the underlying supporting

documentation to determine whether controls are properly and consistently applied. The purpose of monitoring is to provide feedback on program design and implementation rather than substitute for national oversight institutions.

50. **In some circumstances, additional fiduciary arrangements may be considered<sup>8</sup>.** This may include situations where:

- (a) the Bank has inadequate knowledge of the control environment in the recipient's central bank or the public financial management system, or audit reports indicate weaknesses in central bank or public financial management, and an acceptable plan to address these weaknesses has not been put in place;
- (b) there is a significant "reputational risk" that the proceeds of Bank operations could be identified with being used for ineligible expenditures (the "negative list");
- (c) there is a strong development rationale for tracking the proceeds of Bank operations, for example, to provide reassurance that the application funds are consistent with transition agreements.

In assessing the need for and potential effectiveness of any additional arrangements, the scale of financing relative to the country's overall budget and foreign exchange reserves should be taken into account. The Bank should also assess risks and risk mitigation measures with external partners providing co-financing for the program through Bank-administered trust funds. Use of additional fiduciary arrangements to channel financing may be appropriate where this allows the country to mobilize additional resources and fosters donor coordination. In some cases, the Bank may use additional fiduciary arrangements to channel bilateral co-financing whilst providing financing through conventional arrangements.

51. **The design of additional fiduciary arrangements should support the broader public expenditure management reform agenda.** As far as possible, the implementation of additional fiduciary arrangements should complement and use national systems. The Good Practice Note "Financial Management Issues in Development Policy Support", identifies the following mechanisms: a) deposit of the proceeds of Bank support into a dedicated account; b) an audit of the dedicated account; and c) agreements on the specific purposes for which loan proceeds may or may not be used. It is necessary to work very closely with the Bank's financial management experts before considering any modifications of the usual disbursement arrangements reflected in the standard legal model forms for loan/credit agreements.

52. **In some transition states, fiduciary arrangements for some budgetary support operations have included the use of external agents.** In one case, funds were transferred to the government on a reimbursement basis, following post-review of financial statements and supporting documentation an accounting firm to determine the eligibility of expenditures and compliance with basic procedures. Post-review has covered both central government and local government expenditures, with accounts of local government agencies subject to periodic review in situ. In other cases, expenditures have been subject to prior-review by an external

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<sup>8</sup> Development policy operations are intended to provide general budget support. As such, where additional fiduciary arrangements are considered necessary to prescribe and account for the application of funds, the feasibility of using alternative instruments – such as investment projects – should be reviewed.

agent, to determine that procurement procedures have been followed and that resources are applied only on agreed programs and expenditure items. While these arrangements may provide some reassurance that the application of funds complies with financing agreements, they cannot substitute for measures and capacity building efforts to strengthen the underlying national systems.

## **J. ANALYTIC FOUNDATIONS**

53. **Development policy operations should build on a foundation of analytic work.** In fragile states, the Bank's comparative advantage may well lie in providing quality, accessible analytic work in preparation for future development policy operations rather than launching into premature program design. Experience shows that early investments in policy development pay dividends in terms of improved program design, ownership and the more effective use of the typical surge in external resources mobilized during the transition. However, where operations are prepared in response to a crisis or transition there may not be time to develop and draw on adequate analytical work. In these circumstances, the basis for some policy decisions is likely to be weak, resulting in "quick and dirty" solutions to immediate problems. A parallel program of analytical work should be put in place to inform policy adjustments and to support the design of follow-up operations. Although the priorities for analytical work will depend on the country context, a number of core diagnostics should be considered: political-economy analysis; governance and institutional reviews; poverty assessments; and fiduciary assessments (see Para 46).

54. **It is useful to distinguish analytically the underlying sources of fragility from its symptoms and consider their implications for strategic priorities and programming in fragile states.** Fragility is generally manifested by financial crisis, economic instability, or weak governance institutions, conflict and ineffective or poor development programs in addressing poverty, or a combination of all of the above. These are symptoms whose underlying sources are likely to be the product of illegitimate and ineffective governance. Recognizing the difference can be useful for strategic planning and programming. Addressing the symptoms is important in the short term. It is, however, equally important that short-term interventions do not create incentives for not addressing longer-term structural reform. Experience suggests that without short-term visible and immediate outcomes of a secure and stable (politically and economically) environment, a fragile situation is likely to continue to deteriorate. At the same time, the urgent need for short-term interventions should be considered in the context of longer-term efforts to address the sources of underlying fragility and vulnerability. Making the distinction between symptoms and underlying sources helps underscore the strategic programming focus of linking achievements of a short-term nature to the longer-term priorities on sources of fragility. This may also facilitate the donor dialogue, especially with those bilateral donors that tend to focus on short-term gains for non-economic objectives to the exclusion of longer-term efforts.

55. **An understanding of the political economy of transition is critical in the design of successful operations.** The political process and identity and role of key participants can often be opaque in fragile states. Much of the political process may take place outside of formal political institutions and without formal policy agendas. In post conflict settings, key participants may include the military and former insurgent groups, which are reluctant to engage openly in policy debate. Political authority may be contested. Coalitions may be fragile

and opportunistic. The state itself may be fractured, with various groups assuming authority over government institutions and regions. In some cases, formal authority may be vested in a transitional body, as under a United Nations mandate or a government of national unity. All of these factors will play a role in determining a realistic policy agenda. At the same time, the development policy operation will need to support a state-building process leading the “normalization” of the political process, strengthening and legitimizing formal institutions and processes. This will have implications for the distribution of power. A successful program will need to take the program’s political implications into account through careful analysis. A clear understanding of the political economy dimensions can help in the selection of partner institutions, prioritization of components and sequencing of actions supported by the policy program. Political-economy analysis should inform the design of the state-building agenda, tracing a broad trajectory for institutional development and identifying potential “flash-points” that are likely to arise along the way. These issues will be of interest to a wider range of stakeholders. The country team would need to decide to what extent this kind analysis should be disseminated and subject to public debate as part of the program design process.

**56. Institutional and Governance Reviews can help guide the complex process of state-building.** A sound governance environment requires an appropriate and effective balance of powers between the executive, the legislature, the judiciary (and independent oversight institutions). During the transition, attention tends to focus on building the capacity of the executive, with the legislature, the judiciary and oversight institutions playing a secondary role. Governance assessments can help redress this balance, by raising the profile of these institutions, ensuring that capacity building strategies address their needs and providing these institutions with a role in program oversight from an early stage. Particular attention should be given to the decision-making process. Development of a formal policy and legislative process, providing opportunities for internal review and stakeholder consultation, is an important step in ensuring ownership and transparency. At the institutional level, assessments will need to focus on the basic administrative systems before more complex reforms are attempted.

**57. Poverty assessments will help highlight those policy interventions that are most likely to impact, positively or negatively, on the poor.** Poverty assessments may be constrained by the lack of adequate data from a recent census or household survey. While these exercises may figure in the transition program, the results may not be available to support initial program design. In some countries, use of Core Welfare Indicators Questionnaire (CWIQ) surveys and village surveys have provided more timely information poverty indicators such as access to education, health, employment, household assets, and housing.<sup>9</sup> Participatory assessments can also provide a useful source of information on development priorities.

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<sup>9</sup> Core Welfare Indicators Questionnaire (CWIQ) surveys are used to monitor development objectives through the use of leading indicators on access, use, and satisfaction with services. CWIQ surveys use a short questionnaire that can be administered quickly to large samples of households; these surveys can thus be especially helpful in the context of poverty reduction strategies requiring frequent monitoring and feedback to policymakers and program administrators. CWIQ surveys have been implemented in Kenya, Ghana, Nigeria, Tanzania, and Lesotho. For more information, visit the CWIQ web site at <http://www4.worldbank.org/afr/stats/cwiq.cfm> or write to [cwiq@worldbank.org](mailto:cwiq@worldbank.org).

58. **Beyond the core diagnostics, an extensive program of analytic work will be needed to support policy development across a wide range of sectors.** Where governments are faced with problems that require immediate attention and priority is given to reconstruction and restoring basic services, investment of scarce resources in policy development is often seen a luxury that can be postponed. However, experience has shown an early start in the definition of sector development policies can inform decision-making, avoiding some of the egregious mistakes seen in transition from emergency situations. Policy development also helps put government agencies in the driver's seat, allowing officials to make decisions regarding the scale, range and delivery mechanisms for public services. In the absence of a policy process, these decisions may be taken piecemeal, driven by projects, with little direct involvement of government decision makers. As far as possible, analytical work should be geared to the development of sector policy and strategies, and so internalized rather than developed as specific Bank products. Timeliness and a policy focus are critical. Policy development will need to proceed from broad principles, guided by a vision of the role state in the sector and the services it can provide and take into account likely resource availability. An open, inclusive policy process will take time. Sector analytical work can be sequenced to support a structured decision-making process and provide opportunities for policy debate with key stakeholders as these decisions are taken.

59. **Country specific analytical foundations should include monitoring and evaluation of progress as well as, to the extent possible, early warning indicators of fragility.** Monitoring and on-going assessment is of critical importance, especially in Development Policy Operations or program-based approaches with performance-based measures or conditionality. This allows timely adjustments based on realities on the ground and help harmonize assistance and donor coordination, especially in cases where there are non-economic objectives, such as political, security or strategic interests of certain donors. Using a reliable, objective, and realistic monitoring and evaluation plan together with some kind of early warning system in place can facilitate program execution and rational mid-course adjustments when necessary.

## K. ENGAGING STAKEHOLDERS

60. **Given the risks of exacerbating tensions in fragile states, design of a stakeholder participation strategy should be discussed with government at the early stages of program design.** The key elements of this strategy should ultimately be reflected in program documents. In those countries where the government has prepared a Transition Results Matrix, the development policy operation will usually build on the stakeholder participation strategy that is already in place. Guidance on the design of participatory strategies is provided in a separate Good Practice Note.<sup>10</sup>

61. **The participation strategy should support the program's state-building agenda: reinforcing the role the legislature, strengthening ownership within the administration and facilitating civil society's engagement in the policy process.** While attention inevitably focuses on the engagement of civil society in policy debate, the engagement of the various independent state bodies and the administration cannot be taken for granted. Similarly, rather than simply focusing on participation in the design and monitoring of the program, the strategy

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<sup>10</sup> *Good Practices in Supporting Participation in Development Policy Operations*, OPCS.

should promote more durable, institutionalized mechanisms for participation that can be sustained over the longer term.

**62. Development policy operations can best reinforce the role of the legislature by integrating program design and monitoring with the government's budget and planning process.** Annual plans and budgets are subject to legislative review and approval. Adequate time should be made available at the end of the budget and planning calendar for the legislature's review to be effective. Since key policy decisions will have been taken by this stage, governments can facilitate the legislature's engagement by adopting a two-stage process, whereby the key policy initiatives are discussed with legislature's specialist committees at the start of the budget process, before budget and planning circulars are issued. The role of the legislature in review and approval of multi-year planning instruments varies between countries. In some cases, governments are required to present a program at the start of their mandate; in others planning instruments may not be linked to the electoral cycle and may not require formal legislative review. The government's guidance should be sought on an appropriate process for engaging the legislature in the review and approval of medium-term programs. Again, the objective should be to foster an inclusive and transparent process and promote the executive's accountability to the legislature.

**63. Programs will be more realistic and have stronger ownership where the political leadership and civil servants responsible for program implementation take the lead in program design and monitoring.** Program preparation can provide an opportunity for dialogue between civil servants and politicians. This is particularly important where the transition brings in new leadership, which has little experience of public administration and may be distrustful of civil servants appointed under the previous regime. Ministerial endorsement of the sector components of the program is essential. High-level, cross-governmental meetings—ideally through the Council of Ministers—will help ensure an appropriate balance in the program, facilitate coordination and secure broad ownership. Ongoing involvement of political leaders can be encouraged by using simple planning and monitoring formats, such as the Transitional Results Matrices, that allow the Council of Ministers to track progress in program implementation. Ad-hoc program supervision units may help generate this information but are not a developmental solution. Again, there is a strong preference for using national systems, encouraging agencies to generate summary information on their programs that can be used by the Council of Ministers to monitor progress across the government's broad program.

**64. Civil society engagement should be encouraged and geared to the establishment of permanent, institutionalized consultation mechanisms.** Where the government is reluctant to consult with civil society, design of a specific strategy for civil society participation together with the government can help identify highlight the benefits and risks, and appropriate mechanisms. In some cases, this may lead to consultation events focused around the program and mission schedules. Ideally, these consultations would be complemented by program actions geared to putting in place transparent and inclusive mechanisms for policy formulation and monitoring, whereby civil society consultations are embedded in government procedures (see Box 10).

## L. COLLABORATING WITH EXTERNAL PARTNERS

65. **Development policy operations provide an opportunity to consolidate and coordinate external partners around a common, government-led program.** This is particularly important during a transition, which is often characterized by significant increases in the volume of external assistance, a heavy policy agenda and limited government capacity to manage external partners effectively. Design of a common program, backed by a wide range of external partners, can help the government assert its leadership and reduce the risk of policy drift arising from multiple bilateral discussions. By engaging a wide range of external partners, governments may be able mobilize resources from bilateral partners that would be unable or reluctant to provide budgetary support on a bilateral basis. Both the government and external partners benefit from reduced transactions costs, by undertaking joint missions and sharing fiduciary and analytical work. Within the common program, the government may be able to benefit from external partners taking the lead in specific components according to their areas of specialization and interest. Engagement of external partners in program design makes it easier to link policy initiatives to projects and mobilize the technical assistance needed to support program implementation. For external partners, the development of a common program may also reduce perceived risks, not least by increasing leverage on key policy issues.

66. **While coordination is the government's responsibility, selection of a lead partner facilitates this task.** Multilateral institutions usually assume this role, often the Bank. This will entail organizing joint missions and preparing supporting documentation, including program documents and supervision reports. The lead partner may also assume responsibility for mobilizing and administering program financing, by channeling bilateral funding through trust funds. Where the Bank assumes this role, the administrative overheads for program preparation and supervision are likely to be significantly higher than under stand-alone operations.

67. **All external partners should be encouraged to participate actively in program design and implementation, irrespective of their financial contribution to the program.** External partners financing the program will usually participate in missions and will often be willing to co-finance background analytic work. However, other external agencies that do not contribute directly to program financing—such as the UN specialized agencies—should also be encouraged to attend program meetings. Most external partners will have regular policy-level meetings, often at a high level, with the government, as well as being influential in the view formed of the country externally. Broad participation of key external partners in the process helps ensure consistency in messages to the government on key policy issues, provides an opportunity to forge a consensus where differences of approach emerge between partners, and convey these priorities consistently to the government and other stakeholders. Broad participation also provides an opportunity to align operations in support of the policy agenda, facilitating the government's efforts at coordinating disparate external interventions.

68. **Discussions between the government and external partners tend to be most constructive when they focus on how they can jointly support program implementation and policy debate addresses a few controversial issues.** Close collaboration between external partners in the design and implementation of development policy operations can be a daunting prospect for transition governments. Inevitably, donor coordination and consensus, particularly on sensitive policy issues, can be construed as “ganging-up” and undermine

ownership. Unless carefully managed, large donor meetings can end up with external partners monopolizing dialogue and a cacophony of conflicting opinions. Preparation is the key to successful coordination. It is important that government institutions have adequate time and technical support to formulate a program that reflects the government's policy concerns before engaging in detailed discussion on policy and implementation issues with external partners. External partners should jointly identify those areas where there are significant differences in policy stance and try to achieve a consensus. Bank and external partners support for the government's program does not mean that they have to endorse all the government's objectives and every action presented in the program. Again, the Bank should take the broad view during appraisal, assessing whether on balance the program merits the Bank's support.

69. **The policy program supported by development policy operations can serve as the basis of a “compact” between the government and external partners.** Meetings between the government and external partners to review program design and preparation tend to be most constructive where they focus on how to support implementation of the government's program. Policy debate should focus on those areas that are considered critical to the success of the state-building agenda. One possible approach - in particular in early post-conflict transitions where donors have a high degree of authority over reconstruction decisions and financing - is to use the Development Policy Operation not simply to agree on a series of actions for which the government is responsible, but rather to develop a compact between the government and donors. This may involve—as in Timor Leste—agreeing on amounts and timing for bilateral provision of technical assistance in support of government's program.

#### M. ADDRESSING CAPACITY CONSTRAINTS

70. **Effective capacity building in fragile states has to address structural constraints at the institutional, organizational and human levels.** The institutional framework of fragile states is characterized by lack of transparency and weak oversight and accountability structures. Rule of law and formal administrative procedures may be supplanted by informal practices and rent-seeking. Administrative authority may have limited reach and lack credibility in the absence of means of enforcement. Institutions often lack the financial, material and human resources needed to fulfill their mandates. Decision-makers and civil servants may lack the experience and technical skills needed to formulate, communicate and implement policies. Low levels of pay may have eroded incentives for compliance and performance throughout the public sector.

71. **Capacity building measures should be seen as central to the state-building agenda during the transition.** Typically, the program will focus on building institutional and organizational capacity. The program may also address human capacity constraints, by promoting the design and implementation of comprehensive, long-term training and staff development programs for key institutions. This helps raise the profile of the capacity building agenda at a time when attention is likely to be focused on implementation and human resources development is seen often seen as a secondary concern. Since training is likely to show results in the medium- to long-term, an early start is critical. At the same time, the success of the program may require that adequate technical skills are available to support program design and implementation.

72. **The program provides a framework for mobilizing technical assistance needed to support program design and implementation.** Program preparation is a capacity building

exercise. Bank teams should schedule sufficient time to allow adequate discussion of policy and implementation issues with counterpart institutions. Governments may also appreciate independent advisors, to assist them in development of their policy positions during Bank missions. The United Nations Development Programme has provided this kind of assistance in some countries. Technical assistance inputs to support program implementation should be scheduled, with the corresponding financial support, during program design and, ideally, reflected in the program matrix. In some cases such assistance can be provided under on-going projects, in others this may require new financial commitments.

73. **Tight coordination is required to ensure effective provision of technical assistance.** It is possible to provide too much technical assistance as well as too little: many high profile post-conflict countries have seen costly and uncoordinated technical assistance which became a burden on the government. Joint scheduling of technical assistance inputs and program action plans strengthens the compact between the government and external partners to support program implementation. Coordinating the programming of technical assistance inputs helps identify and reschedule actions that do not have the support needed for effective implementation—as well as identifying overlaps and duplication in technical assistance plans.

74. **Technical assistance may also be needed to support the routine functioning of key institutions.** Where the administration lacks the staff needed to manage core functions, such as personnel and financial management and in the judiciary, suitably qualified staff may have contracted to support these institutions during the transition. Provision of in-line technical assistance is now common under transitional administrations, particularly under UN mandates in post-conflict situations. Experience has shown that such in-line personnel are often not effective in transferring skills and should be complemented by parallel capacity building initiatives from the start. Transition programs can support this process by including capacity building and succession strategies, to ensure that all key stakeholders plan a phased transfer of responsibilities to national personnel. For external partners faced with a resource constraint, there may be a trade-off between funding of technical assistance personnel and funding of budgetary support. These trade-offs can be addressed openly during program design, helping the government determine an appropriate mix of technical and financial support.

## N. PROGRESSIONS, PLANNED EXITS, AND SUSPENSION

75. **As the transition proceeds, program design should progress towards the characteristics of operations in more stable and mature settings.** Program design should improve as the key policy instruments are gradually put in place and stakeholders gain familiarity with consultation mechanisms and program preparation. Program scope can be expected to narrow as sector planning initiatives take on the task of coordinating program components. The program will become less detailed, as internal planning routines take on the task of consolidating a government-wide program and coordinating external support. Where there is some discussion about direction that program design is likely to take at the outset, this progression can be planned and reflected in program actions.

76. **Planned exits should address both the developmental and financing rationale for development policy assistance.** Once an appropriate policy and institutional framework is in place and domestic revenues cover programmed expenditures, Bank financing may be better applied in support of investment projects than through further development policy assistance. For most fragile states this is a distant prospect. In resource-rich fragile states, however, the

financing rationale for development policy assistance may be addressed well before an appropriate policy and institutional framework is put in place. In this context, it is important for the Bank and other external partners to sustain dialogue on the policy agenda whilst continuing to support institutional development. Financing is likely to revert to project modalities. Close collaboration between external partners will help leverage the policy agenda. This can be achieved through project co-financing arrangements, use of sector-working groups to drive the sector policy agenda and regular external partner meetings on the broader program. Ideally, donor interventions would be coordinated within the framework of a broad, cross-governmental medium-term program, such as a PRSP (see Para 8). Where a significant increase in domestic revenues is anticipated, development policy operations should schedule program components and actions so that these mechanisms are in place before development policy assistance ends.

77. **Development policy operations may have to be suspended where program implementation makes little progress or country conditions deteriorate significantly.** Suspension sends a strong signal that the government's program has collapsed and may thereby further exacerbate political and social tensions. As such, suspension is a last recourse. The measures needed to bring the program back on track; options for disengagement and timing will need to be discussed with the government and external partners. Where the program is suspended, the Bank will need to explain the circumstances in which the program can be resumed. Furthermore, the Bank will not disengage completely. Background analytical work, project interventions and dialogue on the policy agenda should continue in order to position the Bank to respond when conditions permit.