

Conditionality: Under What Conditions?

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Abstract

Traditional conditionality in policy-based lending is often criticized as being ineffective, intrusive, and corrosive. Disillusionment has led to proposals to replace ex ante conditionality with ex post conditionality and to focus on ownership, selectivity, and partnerships. This paper reviews experiences with conditionality in the World Bank's policy-based lending and explores the benefits and drawbacks of various approaches. It argues that conditionality should play a central role in policy-based lending—but cannot substitute for country ownership and good policies. Moreover, an exclusive focus on conditionality based on ex ante commitments or ex post results may not be practical or useful for the Bank's policy-based lending. Thus a key recommendation is to use conditionality selectively, tailored to country circumstances. Indeed, an eclectic mix of traditional and new approaches is already being used—with programmatic policy-based lending offering a particularly promising way to reconcile the debate between the traditional ex ante approach and the aspirations of a results-based approach to conditionality.

Policy-based lending has inspired much debate, with much of the controversy revolving around the use of conditionality—the conditions attached to funds disbursed by international finance institutions. With research on aid effectiveness highlighting the importance of good policy and institutional environments and country ownership, the shortcomings of traditional conditionality have become increasingly apparent. Selectivity, partnerships, and outcome orientation have been suggested to address these shortcomings.

Under what conditions is conditionality still useful? With donors focused on achieving the Millennium Development Goals, what type of conditionality remains useful and relevant? This paper reviews experiences with conditionality in the World Bank’s policy-based lending in light of the ongoing debate between the traditional approach to conditionality based on ex ante commitments to reforms and recent calls for a results-oriented approach stemming from the literature on aid effectiveness.¹

The article finds that approaches to policy-based lending and conditionality have evolved considerably over the past decade and that conditionality has a central role to play when tailored to country circumstances. Country-specific conditionality requires a careful mix of traditional ex ante elements and new approaches. But this type of programmatic adjustment lending offers a promising way to reconcile tensions between country ownership and commitment to donors, and between a medium-term strategy and flexibility.

Adjustment lending was originally conceived as a way of financing short-term balance of payments support—and to improve the policy environment for traditional project lending. Although the World Bank’s Articles of Agreement envisage the provision of project finance as the Bank’s primary activity, adjustment lending was introduced in 1980 under “special circumstances” allowed in article IV. (Though in fact, the Bank’s first loans were program—that is, nonproject—loans.) But in response to changing borrower

¹ Conditionality is defined here as conditions attached to policy-based lending, although conditions are sometimes involved indirectly in other lending activities—such as investment lending or triggers defined in Country Assistance Strategies or programs for Heavily Indebted Poor Countries—here. “Policy-based lending” is used as a generic term for the World Bank’s adjustment lending, which is proposed to be renamed ‘development policy lending’ in FY05.

needs and broader reform agendas, new approaches to adjustment lending have evolved over the past two decades.

As a result adjustment lending has become an important tool for supporting social, structural, and sector reforms, and is increasingly focused on long-run structural, social, and institutional issues. The narrow focus in the 1980s on achieving short-term stabilization and addressing distortions gave way in the 1990s to a more developmental perspective, with growing attention to reducing poverty, building institutions, and implementing complex social and structural reforms. This included an explicit focus on good governance, with strong support for public sector management reforms.

The Bank's adjustment lending now provides quick-disbursing policy-based financing based on actual or anticipated external financing gaps in the balance of payments or fiscal accounts (World Bank 1996). Policy-based lending is used to:

- Provide a cushion against economic shocks.
- Deliver external financing that generates local counterpart funds in support of government development programs
- Promote policy reforms.

These three goals are often pursued concurrently. But there has been an evolution in the mix, with a shift away from short-term balance of payments support toward increased emphasis on medium-term external financing of government spending and support for social and structural reforms.

Over the years World Bank policy-based lending has stirred substantial controversy. It has been the subject of extensive research and numerous internal Bank reviews (World Bank 1986, 1990, 1992b, 1994; Thomas and others 1991). The Bank has been considering its experience with adjustment lending and conditionality as part of its periodic reviews of operational policies and lending instruments in support of country strategies and programs (World Bank 2001c, 2002c). The mixed performance of

adjustment lending has been well documented (Mosley, Harrigan, and Toye 1991). A more recent evaluation of developments in adjustment lending examined its appropriate use and the design of conditionality within the Bank's menu of lending instruments (World Bank 2001b). Based on several country studies, the Structural Adjustment Participatory Review Initiative drew broader conclusions on specific areas of policy reform, including privatization, agriculture, and the public sector (SAPRI 2002; World Bank 2001a).

This article first discusses critiques of traditional conditionality, along with evidence on the validity of such criticisms. It then assesses new approaches to conditionality in the context of World Bank experiences. After that the article discusses how suggestions for greater emphasis on country ownership and selectivity play out in real lending decisions. The article then reviews the implications of new approaches to conditionality, followed by an examination of a partnership approach to conditionality. The final section provides a summary of lessons on the use of conditionality.

CRITIQUES OF TRADITIONAL CONDITIONALITY

Conditionality is central to policy-based lending, linking financial support from donors to policy reforms considered critical for a country's economic and social development. The Bank memorandum introducing adjustment lending defines it as an agreement with a borrower to implement structural changes over a three- to five-year period, with financial support and technical assistance provided throughout (World Bank 1980).

Adjustment lending starts with the Bank and the borrowing government agreeing on needed policy reforms. The Bank then provides financing conditional on the implementation of specific reforms. This approach provides assurances to both parties—to the Bank that the reforms will be implemented and to the country that compliance will make financing available. Thus conditionality also involves monitoring of whether country programs achieve their goals.

Conditionality has generated many contentious debates in the development community. The two biggest questions are: Does conditionality influence policy choices? And have the policies associated with adjustment lending led to better outcomes?

When assessing the effects of conditionality and adjustment lending, it is difficult (if not impossible) to devise appropriate counterfactuals and attribute outcomes to specific operations—especially because Bank adjustment lending often accounts for a small portion of government resources. To interpret results correctly, the effects of adjustment programs must be separated from the dire economic conditions that prompted them. It is also useful to distinguish World Bank adjustment lending from adjustment efforts supported by the International Monetary Fund (IMF), multilateral development banks, and other institutions. But methodological problems are compounded by the complexity of distinguishing the effects of different adjustment measures on different groups. For example, a currency devaluation may benefit poor rural farmers producing cash crops, but its inflationary effect may hurt poor urban workers.

Notwithstanding these empirical difficulties, assessments of conditionality have been mixed and inconsistent. Critiques generally fall into the following areas:

- *Efficacy and enforcement.* Traditional ex ante conditionality has been described as a failed instrument for promoting reform and growth—one that is useless and potentially damaging (Collier 1997; Easterly 2001). Its usefulness is undermined by difficulties in monitoring compliance and by incentives for donors to continue disbursing funds despite lax reform efforts. Because borrowers do not see the withholding of funds as a credible threat, they may not follow through on program commitments. The usefulness of conditionality is further diminished when donors engage in defensive lending—that is, grant new loans to help countries pay off old ones—regardless of whether the countries have implemented reforms.
- *Sustainability.* Another critique of conditionality questions the sustainability of externally induced reforms. Many analysts argue that once financing for a donor-supported adjustment program ends, reforms are often reversed or abandoned.

- *Process.* Conditionality is often seen as infringing on the sovereignty of borrowing countries. Some critics also question the legitimacy of the World Bank and the IMF, describing them as unelected and unrepresentative bodies that force countries to adopt policies that are not in their best interests. In addition, there are concerns that agreements on conditionality are reached in nontransparent discussions between small groups of government officials and World Bank (and IMF) representatives without due consideration and participation by stakeholders, including civil society
- *Content.* Some critics suggest that the main problem is the content of conditions, not conditionality itself. In this view conditions are often based on best practices and theoretical fixes, with no objective investigation of their actual economic effectiveness and no consideration of political, social, cultural, and environmental features and limitations (Wood and Lockwood 1999). Policy-based lending is thus seen as the handmaiden of the supposedly malignant “Washington consensus.” For example, Milanovic (2003) asks why—despite numerous adjustment loans and IMF programs—Africa’s per capita income is the same as it was 20 years ago.
- *Proliferation of conditions.* Critics also charge that that recipient countries have been micromanaged by conditions that are too numerous, too detailed, and too intrusive. Wood and Lockwood (1999) argue that more conditions have been placed on more areas of government policy, yet the central focus of reform programs has not changed. There is also concern that the number of conditions has increased as more bilateral donors have moved from project lending to policy-based lending in areas where they have an interest, including efforts to promote human rights, combat corruption, and build social capital.

Efficacy, Enforcement, Sustainability, and Process

Criticisms of conditionality in World Bank policy-based lending suggest an inconsistent perception of its influence on country policies. On the one hand there is widespread

concern about its intrusiveness. On the other hand attention is drawn to the limited effectiveness of traditional Bank adjustment lending.

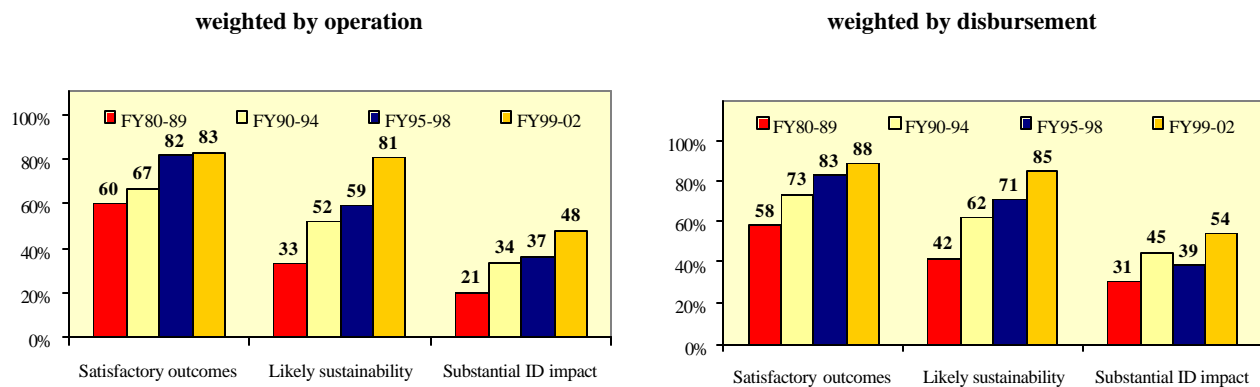
Yet several country studies have found that conditionality has been useful, with reformers welcoming it and using the associated external commitment to push through reforms—especially when conditionality focuses on a few important measures to which governments were already committed. For instance, government officials in Ghana and Uganda welcomed conditionality that helped them identify, implement, and cement reforms (Devarajan, Dollar, and Holmgren 2001). Kenya, Tanzania, and Zambia offer less effective examples of the positive role of adjustment lending in supporting reforms (Burnside and Dollar 1997). But in other countries commitments to reform have been delayed, not carried out, or were implemented but subsequently reversed.

Disappointing economic performance and uneven progress in policy reforms have been variously interpreted as failures of adjustment or as failures to adjust (World Bank 1994, 2001a). A clear verdict is thwarted by the serious identification problems inherent to evaluations of conditionality. Still, it is instructive to consider the regular evaluations of adjustment operations conducted by the World Bank's independent Operations Evaluation Department (OED). These evaluations assess projects' outcomes, likely sustainability, and institutional development impact (Figure 1). Projects are considered to have satisfactory outcomes if they achieve or exceed their main goals; in the case of adjustment operations this includes the relevance of and compliance with conditionality (World Bank 1999a).

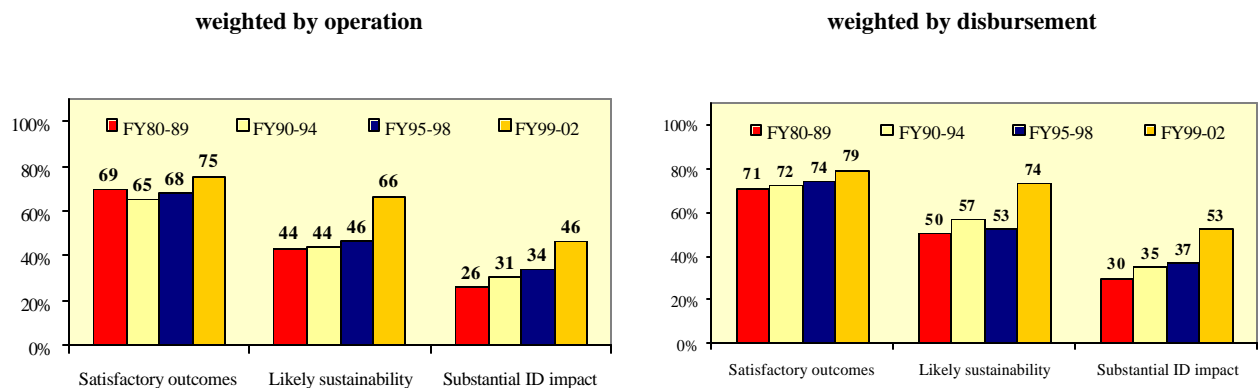
These ratings may be subject to methodological biases due to the problem of attributing outcomes to projects and given that evaluations are undertaken shortly after the funds are fully disbursed, before long-term results can be observed. Nevertheless, the evaluations indicate that most World Bank adjustment operations seem to meet their development objectives, are likely to be sustainable, and have significant impacts on institutional development—with significant improvements in the 1990s. OED outcome scores for adjustment lending increased from 60 percent satisfactory in the 1980s to 67 percent in fiscal 1990–94, then rose to 83 percent in fiscal 1999–02.ⁱ

The likely sustainability of adjustment operations also increased considerably, from 33 percent in the 1980s to 81 percent in fiscal 1999–2002, as did their institutional development impact, which rose from 21 percent to 48 percent. For all three indicators the findings for adjustment lending exceed those for investment lending. And as discussed further below, most ex ante conditions in World Bank adjustment loans have been met.

Figure 1. Quality of World Bank Lending, FY80-02
Adjustment Lending (percent)



Investment Lending (percent)



While most examples of involving civil society in the preparation or implementation of conditionality have emerged on an informal basis, recent adjustment programs based on the participatory processes involved in preparing Poverty Reduction Strategy Papers have increasingly recognized the importance of building consensus among stakeholders (World Bank 2001b). Thus, in contrast to the failures in efficacy,

enforcement, sustainability, and process claimed by many critics, a systematic evaluation suggests that policy-based lending has on balance yielded measurable benefits for recipient countries.

Content

Criticisms of conditionality often claim that a standard blueprint—presumably based on the Washington consensus—is used in all borrowing countries regardless of their circumstances (Wood and Lockwood 1999). Although the Bank’s current operational policy contains prescriptive passages, this interpretation ignores the profound changes in World Bank policy-based lending over the past two decades (World Bank 2001b). The Bank’s update of its operational policy on adjustment lending suggests refraining from using any blueprint for country-specific policy reforms (World Bank 2002b). Moreover, the validity of adhering to the Washington consensus has been called into question, including by the Bank’s former chief economist (Stiglitz 1998).

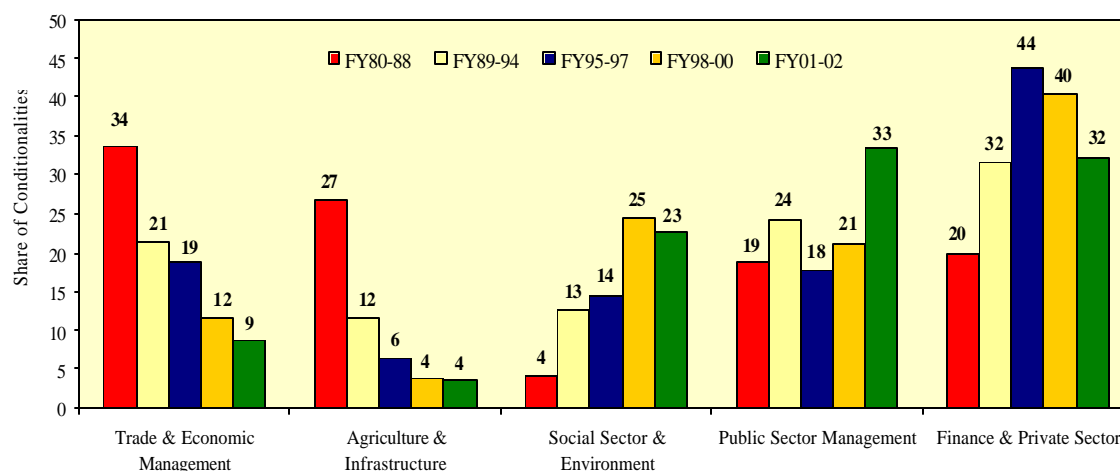
The nature of conditionality in adjustment lending has evolved in line with the content of policy-based lending, reflecting the changing reform agenda in borrowing countries. Since being introduced in 1980 to help developing countries adjust their balance of payments after the 1979 oil shock, the Bank’s policy-based lending has shifted from an early focus on supporting fiscal adjustment in response to external shocks to removing obstacles to growth and helping countries grow out of debt (figure 2). In the early 1990s policy-based lending began focusing on adjusting relative prices that had been distorted by decades of import-substituting industrialization policies.

Today policy-based lending more often supports institutional reforms in public sector management and in the financial and social sectors. Many borrowing countries have moved beyond first-generation reforms involving the removal of economic distortions and are predominantly engaged in more complex reforms—building capacity and developing institutional infrastructure. As a result the share of policy conditions applied to agriculture and infrastructure reforms fell from 27 percent in fiscal 1980–88 to 4 percent in fiscal 2001–02. During the same period the share of conditions for public

sector reforms increased from 19 percent to 33 percent, and for financial and private sector reforms from 20 percent to 32 percent. Across all sectors, the reforms supported by adjustment lending are increasingly long-term, institutional, and microeconomic.

Figure 2 Conditions Applied to World Bank Policy-based lending, Fiscal 1980–2002

Percentage of all conditions applied



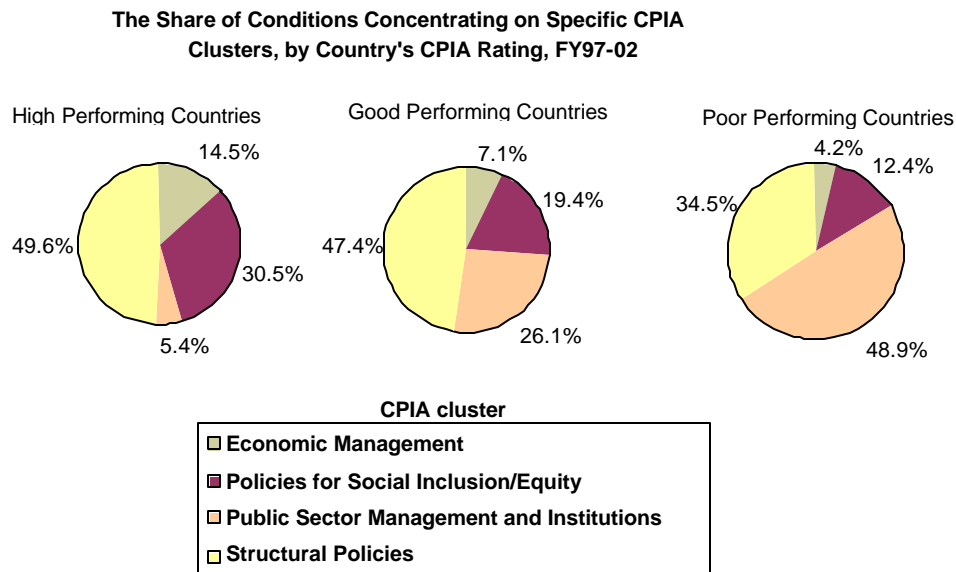
Source: World Bank ALCID database.

The content of conditionality used in World Bank policy-based lending does not follow a standard blue print, but differs by type of country. Conditionality in the better performing countries² (those with a CPIA rating of 4.0 and above) focuses largely on structural polices (such as financial stability, financial sector depth, competitive environment for the private sector, trade and environmental sustainability). By contrast, conditionality in the poor performing countries (those with a CPIA below 3.0) has a stronger focus on

² The unofficial groupings of high, good and poor performers were made using CPIA (Country Policy and Institutional Assessment) ratings over the period between fiscal years 1996 and 2003 (see worldbank.org/IDA/Resources/CPIA2003.pdf). A country with a CPIA rating of 4.00 and above are assigned to the “high” performing group, those countries given a rating between 3.00 and 3.99 are assigned to the “good” performing group, and the countries with an overall CPIA rating 2.99 and below are included in the “poor” performing group. These groupings have been made exclusively for this exercise, and are not in line with any official World Bank classifications.

public sector management and institution building, including property rights, quality of budgetary and financial management, efficiency of revenue mobilization, quality of public administration and transparency, accountability and corruption in the public sector (Figure 3).

Figure 3 Type of Conditionality in Different Country Contexts, Fiscal 1997–2002



Source: World Bank ALCID database.

Proliferation of Conditions

Disillusionment with traditional conditionality tends to focus on the number of conditions imposed, often calling them excessive (Wood and Lockwood 1999). There is no “right” number of conditions: according to the World Bank’s operational policy, a priori limits on the number of conditions are undesirable because they restrict the number of reforms that can be supported.

Moreover, determining actual conditions in adjustment loans is often not straightforward. Not only do policy agendas often contain a multitude of conditions, they

also tend to mix reform measures, desired actions, and detailed processing steps. The average number of conditions in adjustment operations has fallen significantly—from above 36 in the late 1980s to below 18 in fiscal 2003 (Figure 3a).ⁱⁱ If non-binding conditions or desired actions are included,³ the total number has fallen from around 60 to 42 — somewhat above previous years’ averages (34 in FY01 and 27 in FY 02). However, since the overall number is of course higher the more tranches an operation has, it is more relevant to look at the number of conditions per tranche. The average number of conditions tied to a single tranche operation (which now accounted for 45 percent in FY99-03) has declined from 39 in fiscal year 1995 to an average of 14 conditions in FY03 (Figure 3b).

Figure 3. Average Number of Conditions

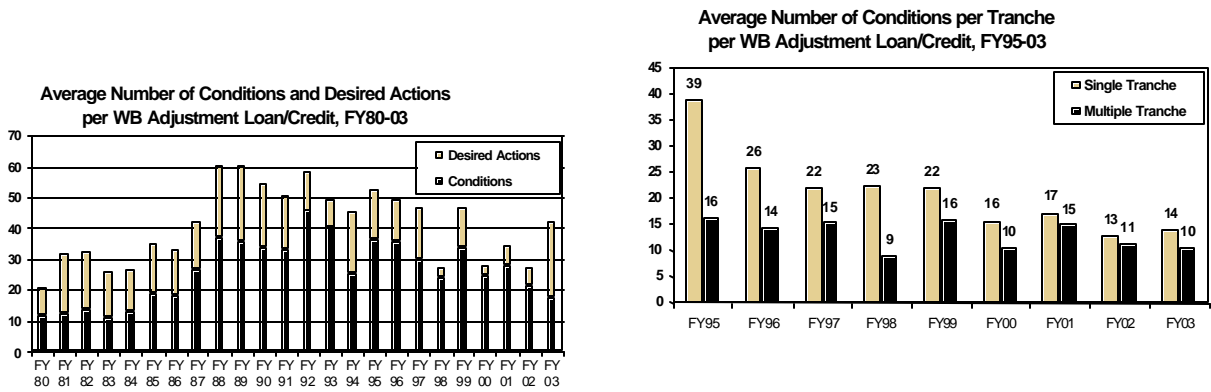
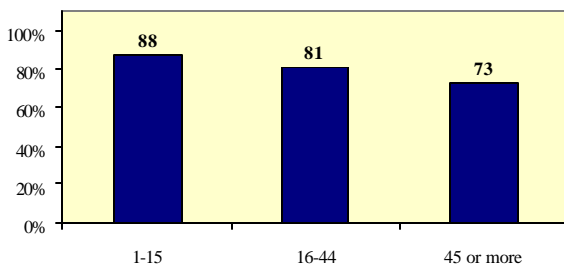
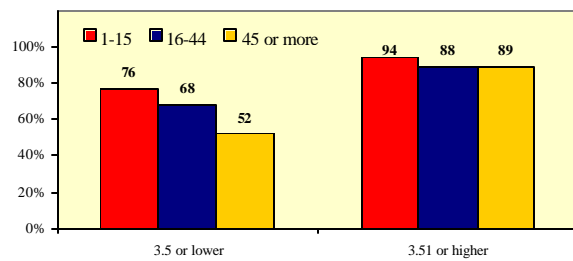


Figure 4. Share of Adjustment Operations with Satisfactory Outcomes, FY90-02

By number of conditions



By number of conditions and country performance (CPIA)



Source: World Bank ALCID database and staff calculations

³ Non-binding conditions are other desired actions included in the loan documentation but not included in the legal agreement. Client government compliance with these actions is not tied to the release of funds.

Fewer conditions tend to be positively correlated with higher quality, as measured in the percent of satisfactory outcomes ratings for adjustment loans (Figure 4a). Efforts to address performance deficiencies and capacity limitations through a larger number of conditions are generally ineffective.

This holds especially in countries with weak policies and institutions, as measured by the World Bank's annual Country Performance and Institutional Assessment (CPIA). Adjustment operations were less successful in countries with weak policy performance subject to more conditions, while countries with stronger performance did well regardless of the number of conditions (figure 4b). This suggests that a country's policies and institutions are typically more important than specific design features—such as the number of conditions—in determining the success of a program.

At the same time, reflecting the growing focus on the long-run structural and institutional aspects of country reforms, conditionality has grown more complex (from 73 percent of adjustment operations in fiscal 1990–94 to 86 percent in fiscal 1999–2000, as rated by OED), demanding (from 82 percent of adjustment operations in fiscal 1990–94 to 93 percent in fiscal 1999–2000) and risky (from 72 percent in fiscal 1990–94 to 81 percent in fiscal 1999–2000) (World Bank 2001b).ⁱⁱⁱ Adjustment operations considered complex also tended to have more waivers and lower ratings for outcomes and sustainability.

These results can be largely explained by the fact that the number of conditions tends to be higher and complexity a greater challenge in countries with weak policy performance and institutional capacity, where adjustment lending is less successful. For example, in fiscal 1998–2003 adjustment operations in countries with low policy performance (CPIA ratings of 2.0–2.5) had an average of 47 binding conditions, compared with 23 in countries with high policy performance ratings (CPIA rating of 4.5 or higher) (Figure 5).^{iv} In sum, country conditions are decisive for the likelihood of success, as underlined by the general observation that the share of satisfactory outcome ratings tended to be higher in countries with a better policy environment (figure 6).

Figure 5. Average Number of Conditions per Adjustment Operation by Country’s CPIA Rating, FY98-03

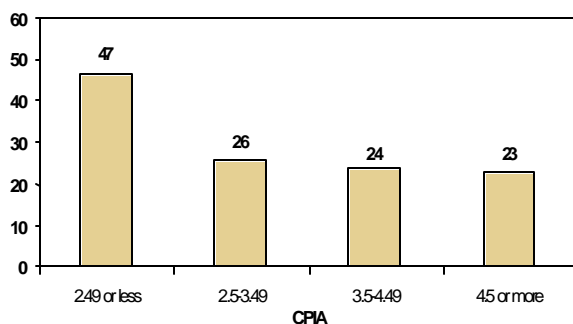
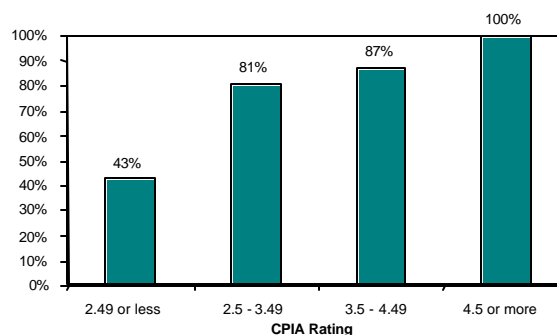


Figure 6. Share of Adjustment Operations with Satisfactory Outcomes by CPIA Ratings, FY96-03



SUGGESTED NEW APPROACHES TO CONDITIONALITY

Because traditional conditionality has not been entirely successful, many critics have wondered whether it should be dropped altogether. Various new approaches have been suggested to address the inherent tensions in conditionality:

- *Increasing country ownership and selectivity.* One issue involves the potential conflict between country ownership and a lender’s due diligence and enforcement of loan conditions. The importance of strong policies and institutions for successful reform, as highlighted by the literature on aid effectiveness, has also given rise to calls for selectivity in favor of better-performing countries.
- *Improving the design of conditionality.* Because the traditional approach to policy-based lending—using ex ante conditionality based on promised actions—has been perceived as useless (at best) and even corrosive, an approach based on reputation and results has often been advocated.

- *Strengthening partnerships on conditionality.* A renewed focus on partnerships and coordination—between recipients and donors, and among donors—has gained currency in response to traditional conditionality perceived as overly intrusive.

Increasing Country Ownership and Selectivity

Many debates on conditionality have focused on the importance of country ownership—that is, commitment to aid-supported reforms by country authorities and a majority of domestic stakeholders. Country ownership has always been a central concept in development aid, on the assumption that it makes the policy and institutional changes associated with lending operations more likely to be implemented even in the face of political opposition. But in recent years the literature on aid effectiveness has increased the emphasis on ownership, driven by the proposition that donors can only advise and support but cannot buy or induce economic reforms (World Bank 1998a). Thus government willingness to reform—ideally supported by a broad consensus among members of civil society—is considered essential to successful adjustment programs.

The World Bank has long recognized the importance of country ownership and readiness to reform as critical factors for effective policy reforms and sustained development (Johnson and Wasty 1993). In light of the past two decades of policy-based lending, the Bank now shares the view that conditionality can reinforce country ownership—but cannot substitute for it (World Bank 2001b).

More recently, the Bank has made concerted efforts to form results-oriented partnerships for development to reflect three main lessons highlighted at the 2002 UN Conference on Financing for Development (held in Monterrey, Mexico). First, good development outcomes require appropriate policies and institutions. Second, sustained development progress requires that policies and institutions be country-owned and country-specific. And third, when these conditions are in place, development assistance can be highly effective (World Bank 2002a).

Country ownership and reform readiness are difficult to assess. Several conceptual frameworks have been developed to assess the level and quality of country ownership (box 1). Each of these approaches has merits and limitations (Morrow 1999). The challenge is identifying robust indicators for judging whether policy-based lending is appropriate in a specific country situation. These might include the authorities' willingness to prepare an action plan outlining the government's reform intentions and the extent of consultations with and participation of civil society in designing and implementing reforms.

A country's track record of policy performance is among the most robust predictors of whether reforms will be implemented. But some countries with weak track records have managed to turn themselves around fairly quickly. Such cases require a judgment that the risks of failure are outweighed by the potential rewards of continued engagement.

Decisions on policy-based lending cannot overlook the tensions between limited country ownership and the use of conditionality to ensure that reform objectives are achieved. If a country's commitment or implementation capacity is weak, conditionality is unlikely to be effective. By itself conditionality cannot lead to the adoption of better policies if there is no consensus for reform. When there is commitment and capacity to reform, adjustment lending can accelerate, broaden, and deepen it, enhancing its impact and hopefully contributing to growth and development. But in the absence of such commitment, adjustment lending may fail to support improvements in policies and institutions—and indeed, may contribute to delays in reform and leave the country burdened with debt.

Box 1. Conceptual Frameworks for Assessing Country Ownership

Leadership analysis assesses senior policymakers in terms of their initiative in formulating and implementing reforms, their level of intellectual conviction, their expression of political will, and their efforts to build consensus among various constituencies (Johnson and Wasty 1993). Leadership is important for successful reform, but senior policymakers may underestimate difficulties in securing support from other political actors and sustaining institutional efforts.

Stakeholder analysis focuses on understanding the power relationships, influences, and interests of stakeholders affected by policy reforms, including those in government (Heaver and Israel 1986). This analysis also captures the extent to which stakeholders can make their voices heard, participate in decisionmaking, reach consensus, and accept short-term costs in exchange long-term gains and uncertainties in the distribution of benefits.

Reform readiness analysis captures the commitment and performance of key policymakers and interest groups and so requires detailed knowledge of a country's political situation (Haggarty and Matuda 1999). Based on findings that successful reforms must be politically desirable, feasible, and sustainable, this approach examines institutional arrangements for policymaking and analyzes the political rationale for particular policy decisions.

One way to bolster country ownership is to forgo ex ante conditionality in favor of ex post allocations of policy-based loans based on the policies a country adopts. Although successful adjustment can deliver significant long-term benefits, research on aid effectiveness suggests that these benefits can be realized only if a country's policy environment is favorable (World Bank 1998a). This suggests that policy-based lending should focus on countries where it is most likely to be effective—those with good policies and high poverty.

Empirical studies emphasize that policy changes are driven primarily by domestic political economy, not by foreign assistance or policy-based lending (Devarajan, Dollar, and Holmgren 2001). Alesina and Dollar (1998) find that there is no tendency for surges in finance to lead to policy reforms. In fact, policy is generally quite persistent, and sharp policy changes are the exception, not the rule.

Greater selectivity in World Bank lending, based on country performance, is among the main suggestions for increasing aid effectiveness (World Bank 1998a). Taking that argument further, the Meltzer commission on international financial institutions advocated limiting policy-based lending to countries with good policies (Meltzer and others 2000). Despite several obvious shortcomings, these proposals have been influential.

First, although many advocates see it as a way of avoiding traditional ex ante conditionality, selectivity based on judgments of country performance may implicitly result in similar bargaining between the Bank and borrowing countries. Unless selectivity is based on a few measurable, objective indicators (such as spending allocations), assessing a country's performance is inherently subjective—particularly if it involves judging the relevance and effectiveness of a country's policy choices.

Second, selectivity would not eliminate the tensions between country ownership and donor intrusiveness. Instead the bargaining process would shift from conditionality to policy assessments.

Finally, there is no reasonable basis to objectively distinguish countries with good policies (where policy-based lending would make sense) from countries with bad policies (where it would not). Most of the Bank's borrowing countries fall between these two extremes, with mixed performance resulting in rather subjective judgments and lending decisions. Moreover, the countries in this heterogeneous middle ground are home to most of the world's poor people. If selectivity meant that adjustment loans went only to the small handful of countries with unquestionably good policy performance, these poor people would not benefit from any policy-based lending, however ineffective.

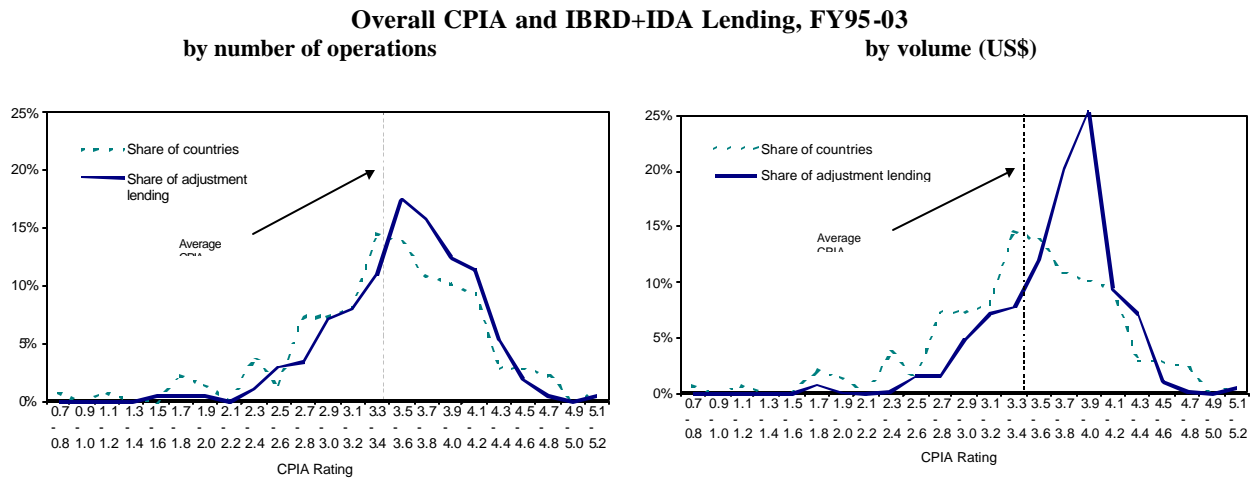
Aid allocations based on country performance are not a novel idea for the Bank. It already uses CPIA ratings in determining the relative country financing shares from the International Development Association. In addition, its Country Assistance Strategies include different lending scenarios based on triggers typically driven by country

performance. Moreover, in recent years considerable selectivity has emerged in decisions on adjustment lending.

The World Bank’s policy-based lending has been selective, favoring better-performing countries. Since the mid-1990s most—though not all—adjustment lending has gone to countries with above-average policy performance, for sectors with good track records and for issues with adequate supporting analytical work. In fiscal 1995–2003 borrowers with above-average CPIA ratings received 76 percent of adjustment loans by volume (amount) and 65 percent by number (Figure 7).^v

Where adjustment lending has gone to countries with poor track records, assessments of potential risks and rewards have typically argued that such loans were needed to exploit brief windows of opportunity for long-overdue reforms. But some less successful examples—such as adjustment lending to the Russian Federation shortly before it defaulted on its foreign debt in 1998—show that despite the best intentions, it is extremely difficult to assess such situations.

Figure 7. Selectivity of World Bank Adjustment Lending



IMPROVING THE DESIGN OF CONDITIONALITY

Recognizing the importance of country ownership, the country's policy and institutional environment and the changing nature of policy programs, what are the implications for the design of conditionality? Some analysts have called for a results-oriented approach to conditionality based solely on outcomes and for the use of different loan disbursement procedures to align conditionality with country performance rather than promises.

Should Conditionality be Outcome-Based?

Disillusionment with ex ante conditionality has led to suggestions that loan disbursements be linked to outcomes rather than policies. It is argued that specifying the desired results of reforms rather than policies on how to achieve them would signal that donors are concerned with the destination rather than the journey. Giving country authorities more discretion in achieving agreed outcomes is an attractive proposition that could eliminate intrusive donor micromanagement of policy and institutional reforms. Freed from the principal-agent problem of bargaining with donors, countries would have greater scope to define their policies and so have greater ownership.

But linking disbursements to outcomes creates several problems (Gunning 2000): First, outcomes result from many factors other than policy choices. Moreover, the link between government actions and outcomes is often not clear—as exemplified by the complex relationship between social spending and social outcomes (Filmer, Hammer, and Pritchett 2000; Thomas and others 2000). Thus countries might suffer if disbursements are withheld based on inadequate outcomes beyond the government's control. Collier, Guillaumont, and Guillaumont (1997) suggest correcting for this bias by identifying important determinants of outcomes beyond the government's control (such as landlockedness and ethnolinguistic fractionalization). But this approach is limited to a few indicators and presupposes a good understanding of determinants and available data.

Second, it is harder to monitor outcomes than policies, and data on outcomes are often not available or are fraught with methodological problems. Finally, even if there is a clear link between government actions and outcomes and data on outcomes are

available, outcomes typically change slowly and can be monitored only over the medium term—implying that current governments would be held responsible for the actions of their predecessors. Linking disbursements to outcomes would also be impractical for policy-based lending, which usually involves disbursements over periods of less than three years.

Outcome-based conditionality has been tested in a few countries. Under the leadership of the European Commission, the Special Program of Assistance for Africa—sponsored by a group of multilateral and bilateral donors—experimented with a pilot approach in Burkina Faso that linked the release of funds to program outcomes rather than policy reforms. This effort involved joint evaluations by all donors of overall results rather than individual conditions (Emblad and Gilles 2000). Preliminary evaluations suggest that this approach increased country ownership and donor coordination (SPA Task Team on Contractual Relationships and Selectivity 2000), with implementation issues revolving around the choice of outcome indicators, realistic targets given time lags, and the quality of data (European Commission 2001).

In World Bank policy-based lending, conditionality based on outputs and outcomes has been used increasingly in recent years. Such conditionality does provide more flexibility to countries and makes conditionality more effective—provided outcome-related benchmarks are quantifiable, narrowly defined, and complemented by action-based conditions where appropriate. Benchmarks should also be clearly linked to measures over which policymakers have discretion, to reduce borrower uncertainty about the release of financing. These indicators should be agreed at the outset of lending programs, with a clear understanding of which ones (primarily those related to policy actions) are within government control.

Options for Phasing and Tranching

Debates on the best approach to conditionality also involve the timing and phasing of performance benchmarks supported by policy-based lending. When adjustment loans

provide fast-disbursing financial support in response to economic distress, they tend to focus on problems amenable to short-term solutions—such as stroke-of-the-pen reforms of tariffs and regulations.

But when policy-based lending supports complex structural reforms in areas such as public sector management, privatization, and the financial sector, there is a tension between the rapid provision of financing and the often slower pace of intensive reforms. To reflect these timing considerations, adjustment loans are disbursed in tranches—that is, portions of funding are withheld until certain conditions are met. Tranches have typically been designed based on ex ante conditionality, though in principle they could be used for ex post approaches. Among 452 World Bank adjustment loans approved in fiscal 1990–2002, 85 percent fully disbursed all tranches as planned (World Bank ALCID database). Thus the majority of operations did not experience waivers, restructuring, or cancellations, suggesting that a common criticism of traditional conditionality—that it leads to frequent noncompliance with policy conditions—has limited validity.

Still, appropriate phasing of policy-based lending to support countries' growing focus on complex medium-term structural and institutional reforms involves difficult choices among various options:

- *Multiple tranches.* The World Bank's traditional approach using ex ante conditionality has typically been based on multiple tranches to support reform commitments as they are achieved in a single operation. Multiyear and multitranche operations have been used to demonstrate country commitment and to lock in reforms through conditionality covering future actions. It is largely this type of ex ante conditionality that has given rise to charges of noncompliance, corrosion of sovereignty, and low efficacy. But in several countries this approach has been welcomed by reformers, strengthening their hand against vested interests, or served as a signaling device (Devarajan, Dollar, and Holmgren 2001). In principle, multiple tranches can also clarify future commitments when a country's track record is weak. But in practice, multiyear and multitranche operations account for the bulk of implementation difficulties that occasionally

hamper adjustment programs. For example, during fiscal 1990–99, 39 percent of all approved two-tranche operations and 63 percent of three-tranche operations involved waivers or cancellations (World Bank ALCID database). Such problems are especially pronounced in multiyear operations due to the challenge of setting out during negotiations a detailed policy plan covering actions to be taken a few years later.

- *Floating tranches.* The Bank has increasingly used floating tranches—that is, tranches disbursed when specific conditions are fulfilled rather than according to a set schedule. This approach can be appropriate for clearly defined discrete reform actions with uncertain timing, such as privatization of public enterprises. Preliminary evidence suggests that floating tranches for different parts of a reform program can increase the credibility of loan conditionality. Floating tranches generate complementarities and synergies among reform measures and avoid delays in specific reforms holding up progress in the overall program. In addition, OED evaluations of the Higher Impact Adjustment Lending initiative in Sub-Saharan Africa have found that floating tranches provided considerable flexibility in timing and increased country ownership—especially when combined with fewer but well-focused conditions (World Bank 1998b, 1999b).
- *Single tranches.* Single-tranche operations have become more common. During fiscal 1998–2000 the Bank approved 36 single-tranche adjustment operations worth \$12.8 billion, and by fiscal 2000 single-tranche loans accounted for nearly 40 percent of the number and volume of adjustment operations. Experiences with single-tranche operations have been encouraging, with OED evaluations for fiscal 1990–2002 showing higher ratings than for multitranches in terms of satisfactory outcomes (88 percent compared with 78 percent) and likely sustainability (72 percent and 63 percent; figure 3). (The higher ratings may partially reflect the wider use of single-tranche operations in countries with better policies and less need for conditionality.) Although single-tranche operations received slightly lower ratings in terms of their impact on institutional development, this may reflect their shorter disbursement periods. Indeed, concern

about the sustainability of single-tranche operations is the main reason for the Bank's operational policy provision that such operations may be appropriate in environments of high uncertainty—provided there is adequate ex ante conditionality and a satisfactory medium-term program in which the operations can be evaluated (World Bank 1996). Again, country conditions matter for effective conditionality design. In countries with below-average policy and institutional performance, single-tranche operations are associated with better outcomes and fewer waivers, while higher-performing countries achieve good outcomes regardless of the number of tranches.

- *Programmatic adjustment lending.* Over the past few years the Bank has increasingly used a programmatic approach for its policy-based lending. This approach involves a series of single-tranche operations that are subsequently presented to the Bank's Board of Executive Directors, with a medium-term framework specified at the outset—including completed prior actions, monitorable progress indicators, and expected prior actions for subsequent operations. To the extent possible, programmatic approaches align disbursements with the borrowing country's annual budget cycle. By building on completed actions specified and agreed to in advance (instead of future promises), a programmatic approach combines country ownership with systematic reform implementation. Programmatic lending is usually used to support complex medium-term institutional reforms. Poverty Reduction Support Credits (PRSCs) are emerging as a vehicle that incorporates these principles, basing social and structural reforms in IDA countries on the poverty reduction strategies articulated in these countries' Poverty Reduction Strategy Papers (World Bank 2001b)

Country experiences suggest that an exclusive focus on conditionality based on ex ante commitments or ex post results may not be practical or useful for World Bank policy lending. The tranching and phasing options described above are not appropriate in every country or sector. Traditional multiyear, multitranche designs may still be useful, especially for supporting in-depth sector reforms. Floating tranches can help with discrete reforms with uncertain timing, without holding up the rest of the program. For strong

performers with good track records—such as Brazil, Latvia, Mexico, and Uganda—the programmatic approach has been used to provide sustained, flexible, and predictable support to credible medium-term reform programs. The programmatic approach has also been useful in countries with sound reform programs but weaker capacity or track records or in countries emerging from crisis or instability—such as Jamaica, Peru, Turkey, and Ukraine. Early experience suggests that the programmatic approach is well suited for its goals of fostering country ownership, providing reliable financial support for successful medium-term programs, and accommodating the uncertainties inherent in medium-term reforms (World Bank 2004).

MONITORING RESULTS

Debates on conditionality implicitly emphasize the importance of monitoring its development impact, using specific indicators to judge its effect on the borrowing country's compliance (in the case of ex ante conditionality) or performance (in the case of a results-based approach). Borrower implementation and Bank supervision of lending operations have been key issues for the World Bank—especially since the Wapenhans Report stressed their importance (World Bank 1992a). Past efforts to strengthen monitoring and evaluation of the Bank's loan portfolio focused on investment lending (World Bank 2000).

For policy-based lending, monitoring has typically focused more on compliance with ex ante conditionality than on progress, outcomes, and poverty impacts. All programs supported by policy-based lending, whether based on an ex ante or an ex post approach, involve implicit assumptions about the expected effects of certain actions on economic performance and incentives, social conditions, poverty reduction, and the environment. But it is difficult to define and apply performance indicators that compare actual and expected outcomes and allow for program corrections. Linking policy measures supported by conditionality and their associated financing to specific economic and social outcomes entails several problems:

- Reform programs have complex economywide repercussions.

- Poverty reduction and economic performance are influenced by many other factors.
- Reliable and timely data are often not available.
- Changes in countrywide economic, social, and environmental trends may be realized only with a considerable lag.

Evaluations of policy-based lending are further complicated by the difficulty of specifying counterfactuals—that is, what would have happened without the operations.

The Millennium Development Goals—the product of the UN Millennium Declaration adopted by the international community in 2000—pose a new challenge for increasing the focus on results (IMF and others 2000). Tying adjustment lending to development outcomes is a critical part of the Bank’s commitment to align country and sector strategies with the eight development goals (World Bank 2001d). These goals provide an ambitious yardstick against which to measure the contribution of conditionality to alleviating poverty, increasing school enrollments, reducing child and maternal mortality, expanding access to reproductive health services, eliminating gender disparities, and improving environmental management.

Aligning conditionality with the Millennium Development Goals requires realistic timeframes, intermediate goals, and measures differentiated by countries and regions. Country programs for policy and institutional reforms should monitor clear performance targets over the medium term while maintaining scope for adapting reform efforts to changing country circumstances. Programmatic adjustment lending offers a promising way to do both.

Still, it has been challenging to develop a road map for policy-based operations that allows meaningful assessment of reform progress and goes beyond mere compliance with policy conditions, whether *ex ante* or *ex post*. Policy reform plans must spell out a practical framework that links strategies to results using monitorable progress indicators. (For programmatic operations, such indicators should complement the actions selected as expected prior actions—or “triggers”—for subsequent operations.) It is no trivial task to

define performance indicators precise enough to guide implementation and enable unambiguous monitoring of results—but pragmatic and flexible enough to allow for the inherent unpredictability of institutional reforms over the medium term (see World Bank 2001b for a discussion of performance benchmarks).

Regardless of whether an ex ante or ex post approach is chosen, conditionality will yield results only if its design reflects a country's institutional capacity. Clear monitoring arrangements are integral to effective implementation, including by local governments and civil society where appropriate. In addition, governments must build domestic capacity for monitoring economic, social, poverty, and environmental outcomes.^{vi}

STRENGTHENING PARTNERSHIPS ON CONDITIONALITY

Increased partnerships and collaboration between donors and borrowers and among donors have been part of the response to the claim that traditional ex ante conditionality is overly intrusive. It is hoped that transparent partnerships between donors and countries will encourage true country ownership of reforms. The most sweeping proposal in this area is to channel all development assistance through a common pool instead of financing individual programs and projects—augmenting the general budgets of poor countries less obtrusively (Kanbur and Sandler 1999).

The World Bank supports coordination and harmonization efforts, which attempt to combine partnerships with a focus on results—most recently in the Rome Declaration on Harmonization (World Bank 2003). The Bank's Comprehensive Development Framework advocates a long-term holistic approach, with borrowing countries owning and directing their development strategies and stronger partnerships among governments, donors, civil society, the private sector, and other development stakeholders in implementing the strategies. The goal is to make aid more effective through coordinated support for country programs and to benefit from synergies and avoid duplication among

different development partners, including the IMF, other multilateral development banks, and bilateral donors.

Applying these principles to conditionality requires aligning the design and implementation of policy-based lending supported by the Bank, the IMF, and other multilateral development banks, which have traditionally provided the bulk of policy-based lending. Efforts to coordinate policy-based lending aim to strengthen government ownership by reducing the scope and number of conditions, making policy-based lending more effective in supporting poverty reduction efforts, reducing burdens on country capacity, and enhancing the predictability of aid flows. In addition, as bilateral donors shift away from projects toward direct budget assistance supporting poverty reduction strategies their support needs to be coordinated with country processes and other donors.

One risk of these partnership approaches to conditionality is that they tend to ignore tensions between stakeholders with different incentives. It is in the choice of conditionality where potential conflicts between ownership and intrusiveness are played out, when the agenda of donors diverges from that of reluctant reformers. And because few countries are monolithic, policy choices reflect the various influences that domestic stakeholders and competing vested interests have on policymakers. The political economy of borrowers might also create incentives for policy reversals after an adjustment program has been concluded.

Moreover, because the effectiveness of donors such as the World Bank is measured as much by lending volumes as by program outcomes, such donors tend to overestimate the likelihood of successful reforms in borrowing countries. In addition, different donors may have different agendas, potentially leading to conflicting incentives. If these complexities are not addressed, the partnership approach to conditionality risks generating similar disenchantment as traditional conditionality.

Coordination of Conditionality with the IMF

Efforts to coordinate conditionality among multilateral development institutions have focused on the World Bank and the IMF—the largest providers of policy-based lending.

The Bank and the IMF have distinct but complementary responsibilities and expertise for supporting member countries' adjustment programs. Both institutions have long had a framework for collaboration to help ensure that their advice is consistent and fully exploits each institution's expertise and financial resources—as reflected in the so-called joint guidelines (World Bank and IMF 1998).

Poverty Reduction Strategy Papers and the Heavily Indebted Poor Countries (HIPC) initiative have contributed to more systematic arrangements for Bank and IMF collaboration in many low-income countries, with each institution's conditionality focused on its areas of primary responsibility. Extending similar principles to other countries, the Bank and the IMF have been strengthening their collaboration in supporting country development efforts through more coherent, streamlined conditionality (World Bank and IMF 2001). Based on the premise that increased collaboration on conditionality would strengthen program designs, a "lead agency" concept was introduced to deal with specific policy issues, along with systematic information sharing and monitoring. Enhanced collaboration is being operationalized through increased interaction between the staff of the two institutions and through transparent reporting in Board documents of each institution's views on borrowing countries' reform priorities, program conditionality, and progress in program implementation (World Bank and IMF 2002, 2004).

Among the forces driving increased Bank and IMF collaboration are ongoing efforts by the IMF to streamline its conditionality and increase country ownership of the programs it supports. In the past the extended use of structural benchmarks in IMF-supported programs contributed to significant overlap in the structural conditions of IMF and World Bank-supported programs (World Bank 2001b, IMF 2001a). By contrast, conditionality in the Bank's policy-based lending has tended to focus on structural reforms in areas within its mandate, with a general provision that countries receiving adjustment loans maintain an adequate macroeconomic framework. The main aim of the IMF's review of its conditionality was to focus it on measures critical to monitoring and achieving the macroeconomic objectives of IMF-supported programs, and to apply it sparingly outside the IMF's core areas of responsibility (IMF 2001a, b, 2002).

The Boards of the IMF and the Bank stressed that the streamlining of IMF conditionality should result in an overall reduction in the conditions imposed on borrowing countries—and not just shift them from one institution to the other. In addition, enhanced reporting on conditionality to the boards of both institutions is designed to ensure that areas no longer covered by IMF conditionality will be adequately addressed by the Bank or other institutions.

Success in both institutions' efforts to streamline and focus conditionality hinges on effective collaboration. The staffs of both institutions must develop a shared vision of their support for each borrowing country, with a clear division of labor based on each institution's areas of expertise and frequent dialogue and information sharing.

Donor Harmonization on Conditionality

The problems of donor-driven project proliferation are well-known, including the stress it imposes on country capacity, the potential substitution of donor-driven agendas for country ownership, and the fragmentation of country budget processes. In response, donors (especially bilateral donors) have sought to enhance the effectiveness of their aid programs by replacing or supplementing traditional project financing with direct budget support—particularly in low-income countries developing Poverty Reduction Strategy Papers. Recent recipients of such support include Ghana, Tanzania, and Uganda.

Whether intended or not, this type of aid resembles the policy-based lending provided by the World Bank, the IMF, and other multilateral development institutions. While the objective is typically to provide predictable and less intrusive financing and greater country ownership, by its nature budget support implies that conditionality explicitly or implicitly guides donor decisions.

The shift from project to nonproject financing may raise a host of new issues, including concerns about:

- Poverty Reduction Strategy Papers that are not specific on programs, action plans, and output indicators, with weak or no links to the budget cycle or medium-term spending framework.
- Discrepancies between poverty reduction strategies and donor programs.
- Contradictions or overlap between the budget support provided by different donors.

Moreover, instead of facilitating the alignment of donor support with the borrowing country's budget cycle, there is a risk that discordant donor priorities or processes may excessively strain country capacity. Even the goal of predictable resource flows could be undermined if donor decisions on disbursements are based on different performance criteria.

These issues call for much closer coordination of policy-based lending, with explicit recognition of the need for a systematic approach to conditionality. Such efforts may involve coordinating the timing, content, and process of donor negotiations with governments, assigning clearer divisions of labor or even lead agencies for specific areas, and focusing conditionality on a small set of country priorities and plans developed by the borrowing country. Such approaches would make it possible to better integrate sector programs and capacity building with countries' regular budget processes. While donors would maintain distinct accountability for their decisions, they would aim to increase the predictability of resource flows through coordinated assessments of borrowing countries' performance against agreed benchmarks.

CONCLUSION

Development financing in support of country policies has become more important as donors increasingly recognize the need for strong country policies and institutions and shift away from narrow project financing. Yet conditionality remains controversial, and is often considered intrusive, ineffective, or even harmful. Disillusionment with traditional *ex ante* conditionality has led to proposals for more results-orientated approaches focused on ownership, selectivity and partnerships.

These approaches have merits and drawbacks in the reality of World Bank lending decisions. Moreover, many of their elements have already been incorporated into the Bank's policy-based lending—and the improving quality of adjustment lending suggests that Bank conditionality reflects some of the lessons from the past two decades of experience. In the future these approaches should be made more systematic and transparent by spelling out how the policies and institutional reforms they support will contribute to the achievement of country objectives. In addition, monitoring of the poverty outcomes of policy-based lending should include indicators linking conditionality to progress toward the Millennium Development Goals wherever possible. Developing such indicators will require concerted diagnostic and analytical work.

Overall, policy-based lending remains a useful tool for supporting government reforms. Conditionality is integral to policy-based lending—whether explicitly included *ex ante* or implicitly recognized *ex post*. But while conditionality can be a useful commitment device, it cannot substitute for country ownership. Conditionality should be used with judicious selectivity and tailored to country circumstances. Moreover, its limitations and opportunities must be recognized in designing a new generation of conditionality.

Because economic policies are driven primarily by domestic political processes, conditionality is appropriate only if there is commitment and capacity to reform. Research on aid effectiveness emphasizes the importance of focusing adjustment support on countries with good policies and institutions. Building capacity and providing advice based on analytical work are better ways of nurturing reforms in their early stages. Moreover, while country ownership of reforms is critical, it is difficult to assess. A country's track record is among the most robust indicators of its readiness and capacity to reform. But though there are exceptions, the history of policy-based lending is littered with inaccurately assessed windows of opportunity for reform.

Enhancing the development effectiveness of policy-based lending also requires making judicious use of the various design options that allow conditionality to be customized to country circumstances, including in terms of the number and nature of

conditions and the phasing and tranching. Most attempts to address performance deficiencies and capacity limitations through a larger number of more complex conditions have been ineffective. Thus conditionality should focus on priorities grounded in country ownership and capacity, and be limited to policy and institutional actions under the control of the executive branch.

Although research on aid effectiveness encourages phasing and tranching based on performance rather than promises, a pure outcome focus is fraught with practical difficulties: expected results may evolve over time; results are often subject to exogenous factors; information on results measurement/indicators often comes with a considerable time lag; and identification of meaningful intermediate indicators (on which to base disbursements) is often very difficult. An outcome focus cannot be a substitute for conditionality, for which policy actions over which the government has meaningful control remain relevant. Good practice also suggests the need for a clear medium-term framework for policy-based lending linking policy actions, progress indicators, and expected outcomes. In addition, conditionality customized to country circumstances implies strengthening countries' capacity to monitor and evaluate progress toward development objectives.

These principles are embedded in the programmatic approach to policy-based lending, which recognizes the importance of country ownership through increased flexibility, reflects countries' track records, and supports sustained engagement for complex medium-term institutional and policy reforms. This approach to conditionality does not just involve providing financing, it also serves as a vehicle for policy dialogues that typically involve transfers of advice and knowledge. Programmatic policy-based lending calls for a prudent mix of government policies, intermediate benchmarks, and ultimate outcomes embedded in a medium-term policy framework and involving a series of operations linked by specific but flexible triggers. Thus it has emerged as a promising way to reconcile the debate between the traditional ex ante approach and the aspirations of the results-based approach to conditionality.

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Notes

ⁱ World Bank Operations Policy and Country Services calculations based on OED data.

ⁱⁱ World Bank Operations Policy and Country Services calculations based on World Bank ALCID database.

ⁱⁱⁱ OED defines *demandingness* as the extent to which the project could be expected to strain the economic, institutional, and human resources of the government or implementing agency. *Complexity* refers to such factors as the range of policy and institutional improvements contemplated, the number of institutions involved, the number of project components and their geographic dispersion, and the number of cofinanciers. *Riskiness* refers to the likelihood that the project, as designed, would be expected to fail to meet relevant project objectives efficiently.

^{iv} World Bank Operations Policy and Country Services calculations based on World Bank ALCID database.

^v World Bank Operations Policy and Country Services calculations based on World Bank ALCID database and OED data.

^{vi} An important factor that allows borrowers to take on responsibility for monitoring reform implementation is to assign performance indicators to specific government agencies—ideally the same agencies responsible for implementing the program or its components. The importance of adequate monitoring is reflected in the proposed update of the Bank’s operational policy on policy-based lending (World Bank 2002b).