

Policy-Based Lending, Conditionality, and Development Effectiveness

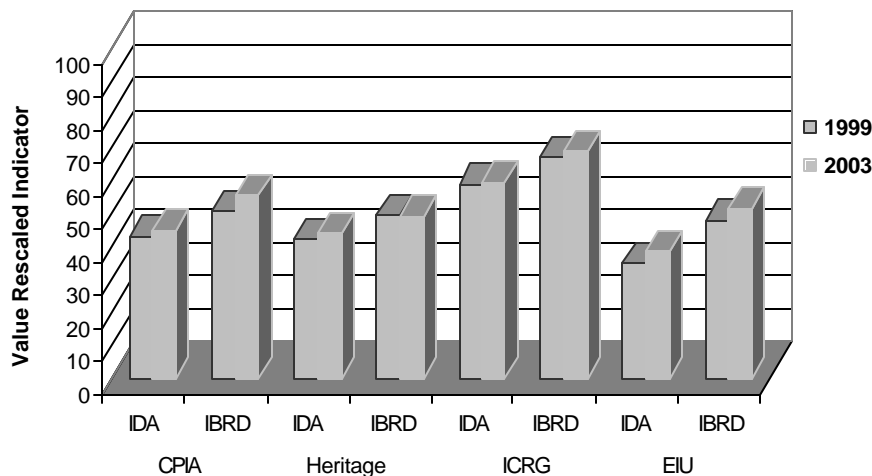
The Operations Evaluation Department (OED) is an independent unit within the World Bank that reports directly to the Bank's Board of Executive Directors. It provides an objective assessment of the Bank's work and its clients' performance, thereby ensuring accountability in the achievement of Bank objectives. Every year, OED draws upon recent evaluation and research findings to examine a current development effectiveness issue. This year's Annual Review of Development Effectiveness (ARDE 2003) examines the effectiveness of World Bank support for policy reform.

My presentation will provide a context for the discussion on conditionality, although by itself it doesn't go very deeply into the issue of conditionality. We have also recently completed a joint review with the IMF's independent Evaluation Office of the PRSP process, and I will mention very briefly one or two preliminary findings on that. My remarks will touch on three points: first, I will review the evidence bearing on recent trends in developing countries policies in general; second, I will review the role of the World Bank in support of developing countries' policy reforms; and, third, I will comment on the effectiveness of policy-based lending and conditionality in the much broader context of policy change that we see taking place in developing countries.

Recent Trends in Developing Countries Policies

OED's assessment found that policies have improved modestly in roughly two out of every three countries; that policies have improved in all regions of the world; that improvements were registered in almost all areas of policy; and that countries with good and improving policies grew more rapidly than countries with bad and deteriorating policies.

Figure 1 Developing Countries Have Made Gradual But Definite Progress in Improving their Policies



ARDE 2003 examined four different indicators of developing countries' policy over the period 1999-2003. The Bank's Country Policy and Institutional Assessment (CPIA), is the Bank's internal policy index and is used mainly to allocate IDA resources.¹ Figure 1 illustrates improvement in average CPIA ratings between 1999 and 2003, in both low-income countries that are eligible to borrow from IDA and middle-income countries that are eligible to borrow from IBRD. It also demonstrates that other indicators, external to the Bank, including the Heritage Foundation/Wall Street Journal's Index of Economic Freedom, the Political Risk Services Group's International Country Risk Guide (ICRG), and the Economist Intelligence Unit's Index of Country Risk (EIU), show a broadly similar pattern. This indicates that the Bank's own internal indicator is doing a good job of evaluating country policies.

Figure 2 Policies Improved in All Regions

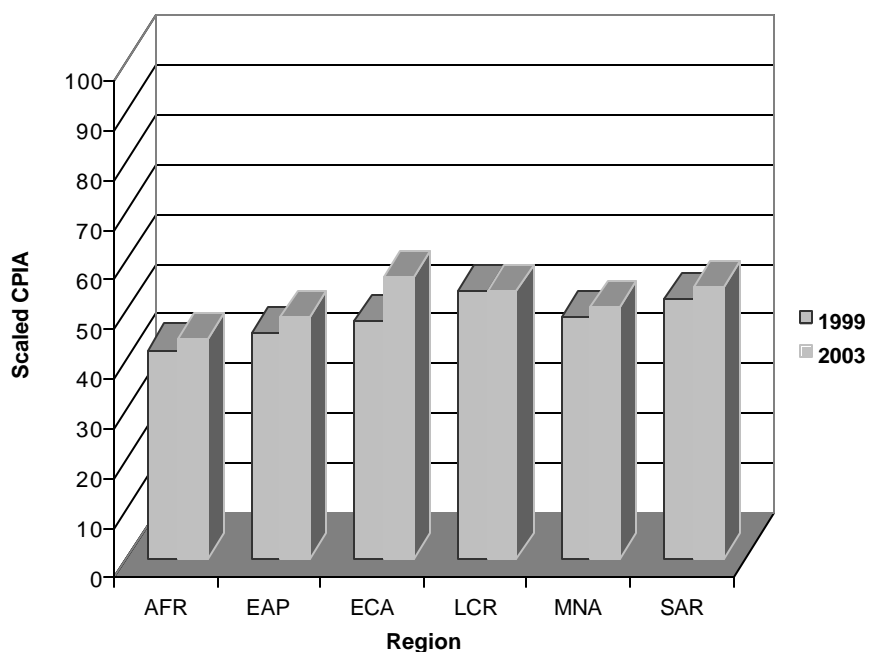
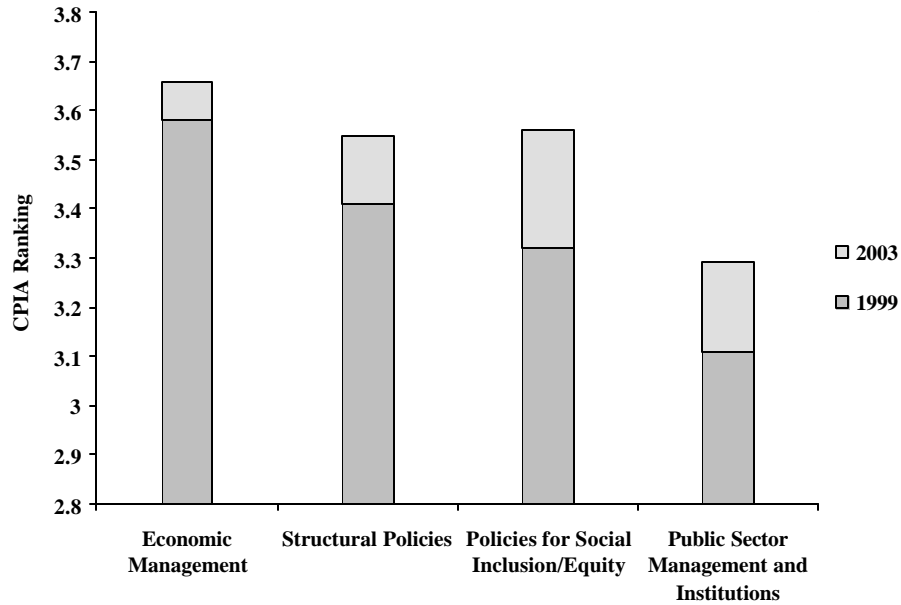


Figure 2 shows that the improving trend in policies has been widespread geographically, with improvements – albeit to differing degrees - in all regions of the world. When we classify the CPIA into four broad categories of economic management, structural policies, policies related to equity, and public sector management and institutions, we find that the improvements took place in almost all categories (see Figure 3).

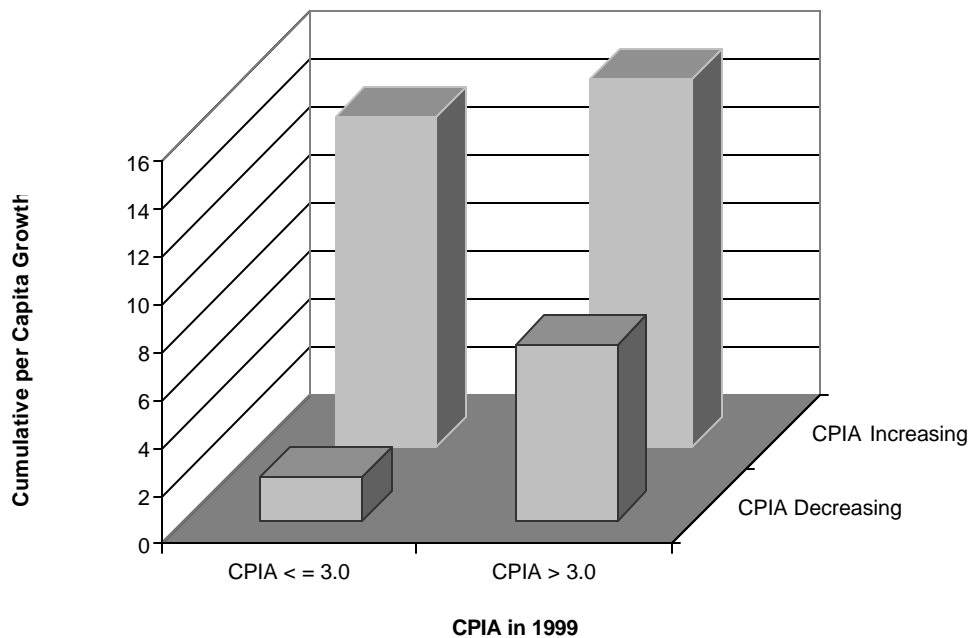
¹ A task force has recently reviewed this rating and has made some suggestions on its improvement.

Figure 3 Most Areas of Developing Country Policies Improved



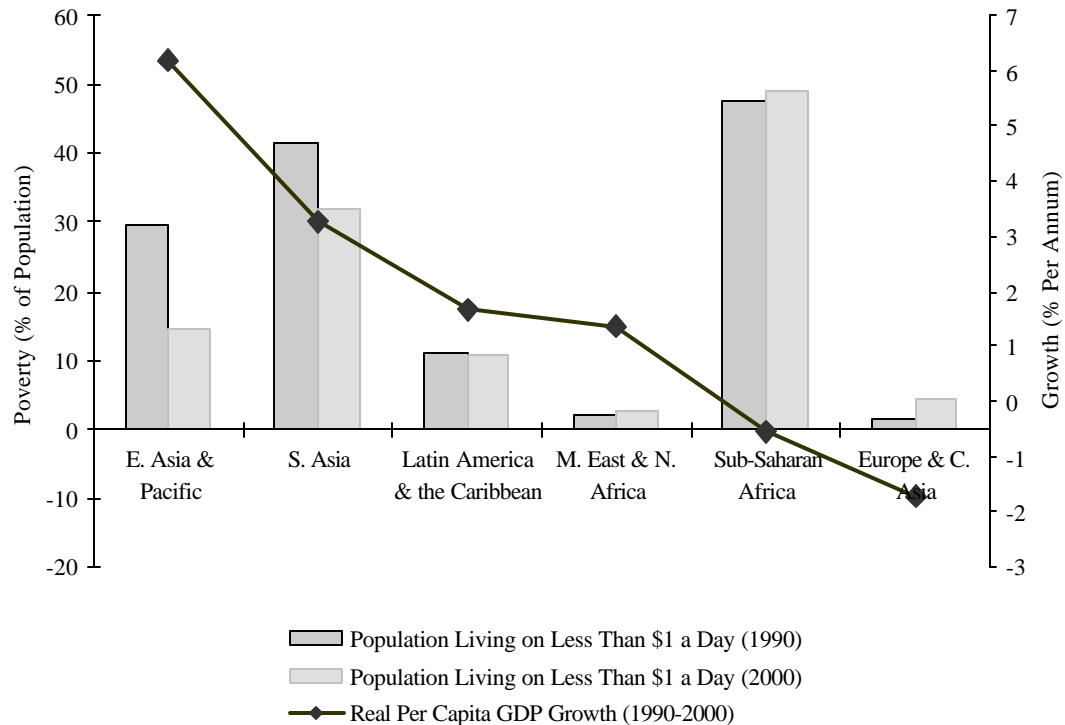
OED found that countries with better policies and/or improving policies grew more rapidly than did countries with weak policies and/or deteriorating policies (see Figure 4). There is a very close association between high CPIA rankings and improvements in CPIA rankings with growth outcomes. Cumulative per capita growth between 1998 and 2002 (the most recent period for which growth data are available that overlap with the period covered by the CPIA data) in countries whose policies were improving was over twice that in policy deteriorating countries.

Figure 4 Countries with Better/Improving Policies Grew Faster



We also find a very close correlation between economic growth and poverty reduction. As illustrated in Figure 5, the regions that achieved significant reductions in poverty during the 1990s were those where real per capita growth exceeded 3%.

Figure 5 Growth Is a Major Factor in Poverty Reduction



The World Bank's Role

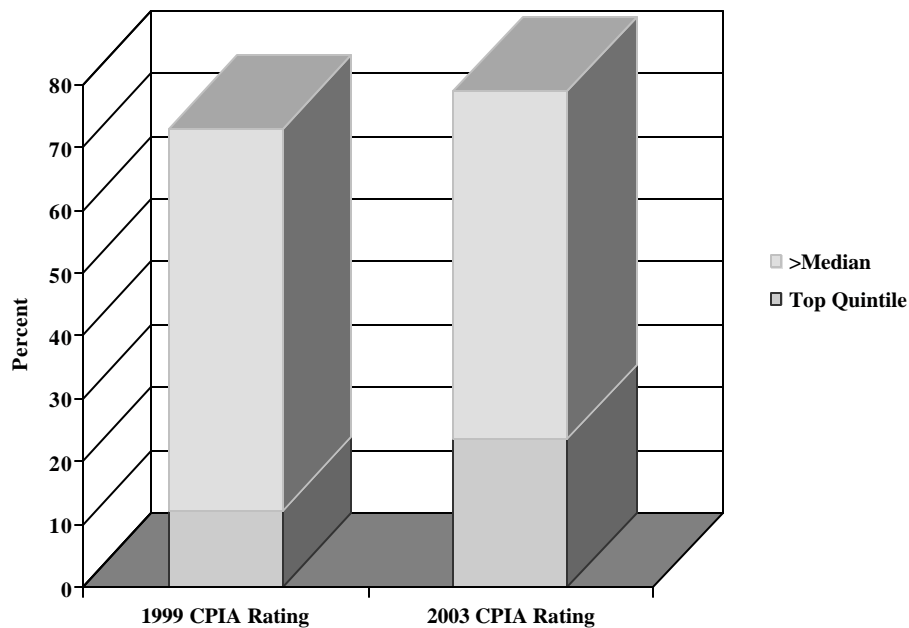
Given this broad picture of recent trends in developing countries' policies across the world, let's examine the role of the World Bank in support of policy reforms. Of course, it is difficult to precisely attribute favorable policy outcomes to the World Bank or other donor agencies and to what has been happening in the countries themselves.

The environment confronting many developing countries in the years immediately prior and during the period examined by the ARDE has been unusually favorable for reform. Most of the cases of strong reform were driven by necessity (e.g., transition and/or crisis) and/or opportunity (e.g., accession to the European Union). Development research suggests that these kinds of factors are frequently associated with episodes of policy reform. The environment for policy reform in the 1990s has been unique in some respects. A number of developing countries were in or coming out of crises (conflict, natural disaster, and/or financial) and twenty-six countries in Europe and Central Asia were in various stages of transition to a new economy. OED found that of the twelve countries that had the greatest improvements based on two or more of the four policy indicators examined, nine were transition countries (Azerbaijan, Brazil, Croatia, Estonia, Kazakhstan, Lithuania, Nicaragua, Romania, Russian Federation, Slovak Republic, Ukraine, Yemen). The group of countries that had the greatest deterioration based on similar criteria were

more diverse (Argentina, Egypt, Dominican Republic, Lebanon, Malawi, Panama, Trinidad and Tobago, Uruguay, Zambia, Zimbabwe). Financial crisis played a role in some, while several others had long vacillated on reform.

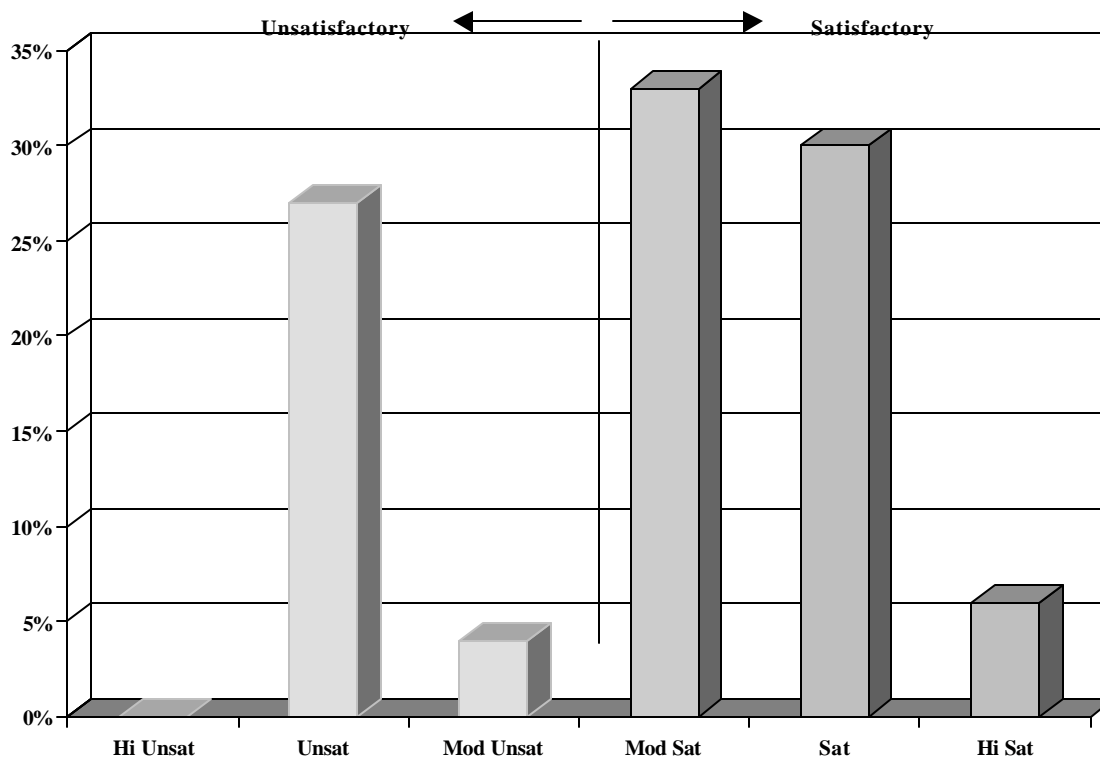
Figure 6 illustrates that the Bank's lending in general was more strongly associated with good policy environment in 2003 than in 1999. About 23% of total lending was going into countries that were in the top quintile of the 2003 CPIA ratings relative to about 12% for the 1999 CPIA ratings. The same trend is evident in countries ranked above the median.

Figure 6 Bank Lending is Concentrated in Countries with Improving Policy Environments



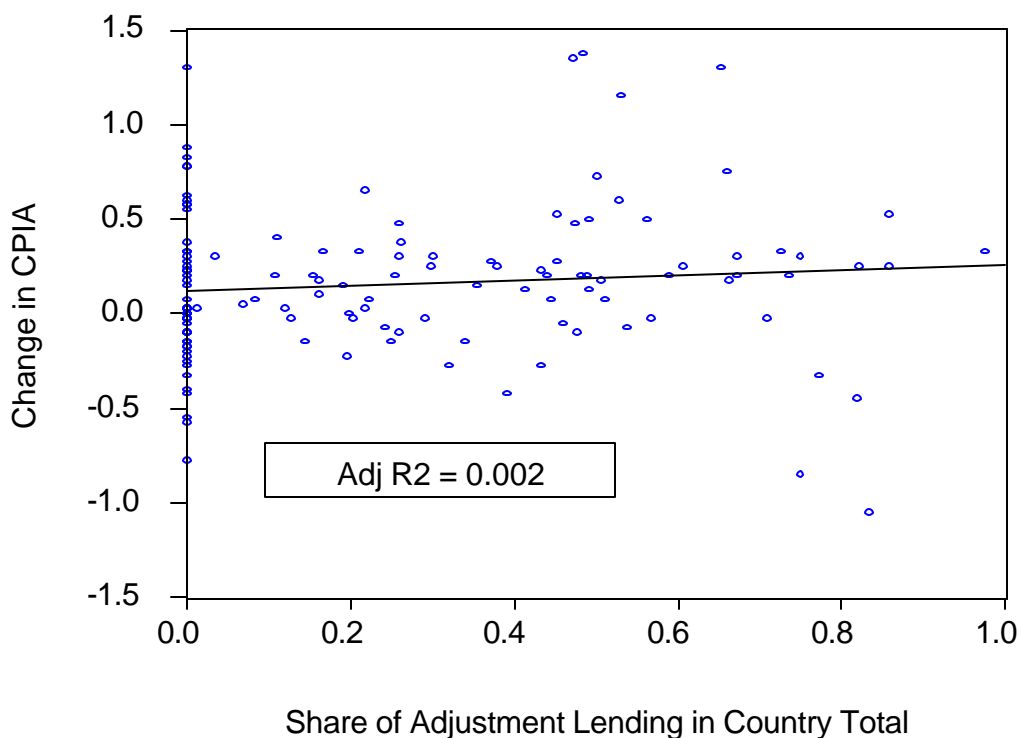
ARDE 2003 also examined the quality ratings that OED gives to different bank programs in different countries. OED's rating evaluates programs in terms of how successful they have been in helping countries reach certain outcomes. In the aggregate, OED's recent country assistance evaluations have rated outcomes of Bank assistance as moderately satisfactory or better about 70% of the time, while about 30% of the programs were rated moderately unsatisfactory or worse (see Figure 7)

Figure 7 World Bank Country Assistance Evaluations



Good results have been obtained with very different mixes of instruments and sectoral/thematic focuses. The key is finding a mix that fits the country situation. There is no evidence that policy-based lending per se is associated with improvements in policy indicators. As figure 8 illustrates, the share of adjustment lending has no correlation with improvements in policy outcomes. Bank programs have contributed to reforms in a number of countries without use of policy-based lending instruments. And the Bank has made heavy use of policy-based lending with little or no impact on policy as reflected in no changes or deteriorations in policy indicators. There is no single recipe for success. Program architecture has to be tailored to country policy-making styles and preferences and has to evolve over time. However, one characteristic that seems to cut across successful outcomes is a strong country and sectoral knowledge base provided by Bank ESW.

Figure 8 Share of Adjustment Lending and Policy Improvement



In examining the 30% of Bank programs that had unsatisfactory outcomes, ARDE 2003 found that knowledge was again an important factor that cut across countries. Insufficient knowledge before starting to engage with countries, very poor analytical base, and lending into ignorance without track record were factors that led to failures. Country-fit has been another very important failure factor – programs failed when the Bank’s advice was not custom-fit to local conditions and programs were disconnected from country owned strategies. For example, in Costa Rica, the World Bank’s program, which was conditional on certain legislation being passed, was rated unsatisfactory by OED because it was not well suited to what the Costa Ricans were demanding. A third failure factor is over-optimism regarding the potential for policy reform in some countries, especially in turnaround countries. This has led to false starts (e.g., Kenya of the past). The Bank has also been over-optimistic with regard to key determinants – particularly overall growth and export growth – of countries’ macro-economic environment leading to unsustainable debt.

Based on these analyses, OED recommends not lending in non-emergency/non-crisis situations without adequate prior ESW; phasing-in policy-based lending with track record; customizing World Bank strategies and products to local conditions; and strengthening debt sustainability analysis before ramping up lending.

Effectiveness of conditionality

The role of conditionality is to improve the development effectiveness of support for policy reform by linking aid flows to these reforms. The key effectiveness issues are: the effect of conditionality on adoption of reforms; the effect of conditionality on implementation of reforms; and the effect of conditionality on outcomes.

It seems that conducive internal factors and/or outside pulls have had a big impact on the overall improvement of policies during the period examined by the 2003 ARDE, e.g., necessity (crisis) and/or opportunity (EU accession of transition countries). The World Bank itself has not had a big impact on the adoption of reforms. There has been some impact on the implementation of reforms and on the speed with which they have or have not been implemented. However, it has had very little impact on the outcomes itself.

The design of conditionality and its effectiveness depend upon the circumstances in which it is applied. OED has analyzed four variables that determine the effectiveness of conditionality: shared objectives or ownership; means and policies; monitorability of outcomes; and the urgency of resource needs. Table 1 summarizes the results for different typologies. Ownership is critical to conditionality effectiveness. If the objectives sought to be achieved by conditions are not shared, then any conditionality is harmful. However, even if the objectives are shared, differences on means or policies depending on the monitorability of certain issues and urgency of resource needs can lead to very different implications of outcome-based and action-based conditionality.

Table 1 Working Hypotheses on the Effectiveness of Conditionality

Objectives	Means / Policies	Monitorability	Urgency of Resource Needs	Conditionality
Not Shared				Harmful
Shared	Shared	High	Low / Medium	Outcomes
Shared	Shared	Low	Low / Medium	Actions
Shared	Shared	High/Low	High	Actions
Shared	Not Shared	High	Low	Outcomes
Shared	Not Shared	Low	High	Actions - Possibly harmful
Shared	Not Shared	Low	Low	Outcomes – possibly ineffective

In conclusion, this analysis shows that there is an important role for outcome-based conditionality in certain situations, and OED recommends that the World Bank should encourage piloting and experimenting with outcomes based lending. One possibility would be to provide incentives to agreed outcomes. Another would be to introduce an outcomes element into the Bank's performance based allocation system. The basic idea is to find ways to better align incentives with bottom line results