

Adjusting Conditionality: Prescriptions for Policy-Based Lending

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There is growing acceptance of three key ideas about the World Bank's policy-based lending: conditionality should be consensual, not coercive; selectivity is the alternative to coercive loan conditionality; and institutionally and politically complex reforms present difficult challenges for the utility and design of conditionality. Although less often discussed, it is also true that many of the reforms now associated with policy-based lending have no net fiscal cost. Within this context, the potential non-financial benefits and costs of policy-based lending depend on the circumstances surrounding each loan, and careful attention to these circumstances is important to ensure that a policy-based loan does more good than harm. The Bank has begun to revise its approach to policy-based lending in ways that reflect these ideas, and there are further steps that can be taken to increase the likelihood that policy-based lending will generate net benefits.

1. There seems to be growing acceptance of three key ideas related to World Bank policy-based lending (also called adjustment lending)¹. First, country ownership is a *sine qua non* for successful, sustainable reforms, and therefore conditionality associated with policy-based lending should be, in Tony Killick's words, "pro forma," consensual conditionality rather than "hard core," coercive conditionality. Second, in place of coercive loan conditionality, the Bank should exercise country selectivity, providing policy-based lending only if and when a country has already taken adequate ownership of the reforms that the Bank believes are essential for accelerating growth and poverty reduction. Third, as recognized for over a decade, policy-based lending is now used mostly to support second or third generation reforms rather than macroeconomic adjustment programs. These second and third generation reforms are institutionally and politically complex, and for these sorts of reforms the utility of conditionality is especially uncertain and its design is problematic.
2. The Bank has begun to come to grips with the implications of these ideas for its policy-based lending operations. Its recent efforts to write new guidelines and define good practice for policy-based lending reflect these ideas in some important ways. But in its common practice the Bank still needs to accept their implications more fully in order to increase the likelihood that policy-based lending will generate net benefits. In addition, the Bank needs to address directly

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¹ Though this paper, I use the term "policy-based lending" rather than "adjustment lending" for two reasons. First, "adjustment" is a misnomer for the sorts of reforms now commonly associated with quick-disbursing loans conditional on specified policy and institutional reforms, as discussed in the paper. Second, the World Bank, following its recent review of its lending instruments, has retained policy-based lending using the name "development policy lending" and has dropped the name "adjustment lending." "Policy-based loans" (PBL) is used in this paper to refer to both IBRD loans and IDA credits or grants, and "loan" refers to both IBRD loans and IDA credits and grants

the question of under what circumstances, if any, policy-based lending is appropriate in supporting reforms that have no net fiscal cost. More generally, it needs to revisit the broad question of what policy-based loans (PBLs) are in fact financing and to develop clearer guidelines on the appropriate amounts of each PBL and on how those amounts should be adjusted in response to delays or deviations in implementation of the associated reform program.

3. This paper explores several remaining conceptual problems of World Bank policy-based lending when such lending is used to support second and third-generation reforms rather than to assist countries in responding to macroeconomic or financial crisis.² It begins with an elaboration of the points noted above. This leads to a discussion of the potential non-financial benefits and costs of policy-based lending in terms of their contribution to the design and implementation of good reforms. Finally, the paper makes recommendations for the guidelines and good practices for Bank policy-based lending.
4. This paper make assertions about common patterns of Bank policy-based lending in recent years based on a thorough review of IBRD PBLs during FY00-02, a more limited review of IDA PBLs during that period, on selected Country Assistance Strategies (CASs) from that period, and on my own experience as a former Bank staff member. However, the validity of the analysis and recommendation should be further examined using a larger and more recent sample of policy-based lending, including especially IDA credits, and more recent CASs.

Current Doctrine and Reality about the Bank's Policy-Based Lending

Country ownership and conditionality

5. It is now widely held that it is wrong and futile to use lending conditionality to compel a government to do that which it is not convinced it should do. In the case of many creditworthy, especially middle-income, countries, this reflects a simple reality. These countries have reasonable access to international capital markets, and IBRD lending typically provides only modest financial advantages. Therefore, the Bank does not have any significant financial leverage over these countries' policymaking (except possibly during periods of financial crisis when access to alternative financing is severely constrained). In the case of non-creditworthy, mostly low-income, countries that remain dependent on continuing flows of IDA credits and other ODA, the Bank might be able to exercise considerable leverage. But it is now official doctrine that conditionality should not be compulsive. Paul Collier and Tony Killick laid the basis for this new doctrine in their early critiques of conditionality, and the new doctrine is now widely

² The arguments and recommendations put forward here relate to policy-based lending by the World Bank not related to macroeconomic or financial crisis. Furthermore, they do not necessarily apply to conditional lending by the IMF. The IMF normally provides financing under different circumstances and deals with a very different set of policy and institutional issues than the Bank.

expressed in World Bank documents, if not yet fully reflected in Bank practice. The Bank's well-known study on *Assessing Aid* stated: "In its own internal reviews the World Bank has come to the same conclusion—'ownership,' or strong domestic support of reforms, is essential for adjustment lending to succeed."³ The Bank's recent, draft Good Practice note on designing policy-based lending—which uses the term "development policy operation" as the new name for policy-based lending—states: "Conditionality should complement ownership, not substitute for it. Conditions for development policy operations need to be agreeable to the government and the Bank. When conditional lending is used to induce a government to undertake reforms that it does not wish to do, it is unlikely that these reforms will be fully implemented and sustained. Furthermore, the prospects for improving governance and the accountability of a government to its own citizens will likely be undermined."⁴

6. It is still true that PBLs involve "money-for-policy." The Bank's proclaimed justification for each of these loans is that it "supports" the government's reform program. The disbursements of the loans are explicitly conditional upon the government's implementation of agreed measures within those reform programs. But under the new doctrine these conditions are, in the vocabulary of Tony Killick, "pro forma" rather than "hard-core" conditions:

Pro forma conditionality [is] described as policy commitments written into aid agreements for the convenience of both parties. These are consensual, included in order to set out systematically and clearly a mutually-agreed package of measures, codifying what should be done and in what sequence; serving as a kind of institutionalized memory against the possibility of changes among key ministers, officials, perhaps even the government itself; providing a vehicle through which agencies can undertake their program lending, and for persuading the management and/or Boards of aid agencies of the adequacy of the policy program. Hard core conditionality, by contrast, [is] seen as coercive: actions, or promises of actions, made only at the insistence of the lender or giver, measures that would not otherwise be undertaken, promised involuntarily by governments in urgent need of money.⁵

7. In his 1999 study, Killick advocated the use of pro forma conditionality and went on to say: "The question may well be asked: why...bother with the modalities of conditionality at all? The answer is that, for the reasons just suggested, these may make life easier for both parties, may smooth the path for policy reform, make it more orderly, more assured."⁶ Although the Bank has not adopted the term "pro

³ World Bank 1998, p. 52.

⁴ World Bank 2004, p. 3. This draft note, which is now posted on the Bank's external website for comment, is entitled "Good Practices in Designing Development Policy Operations." Development Policy Operations is the Bank's new name for policy-based lending.

⁵ Killick 1998, p. 188.

⁶ Killick 1998, p. 188.

forma” conditionality, it has in principle adopted the concept. The draft Good Practice Note for policy-based lending answers Killick’s question in this way:

A development policy operation [the new term for a PBL] can complement ownership in several ways. The process of preparing the Program Matrix of relevant actions and outcomes generates a dialogue among various parts of the government—and often with nongovernmental stakeholders—that can improve the design of the reform program and help build broader support for the reforms. Bank staff can play a useful role during the design phase by providing analysis and advice, drawing on experience in other countries, and by facilitating communications among stakeholders within the country. Once agreement within the government and between the government and the Bank has been reached, the formal conditionality associated with development policy operations can complement country ownership:

- The Program Matrix can help keep the program on track during its implementation, in particular by creating a timetable and incentives for completing actions.
- The formal agreement to the conditions and triggers that are part of the Program Matrix signal to the broader government and to the public that the government is committed to carrying through the reform program, generating momentum in the reform process and strengthening expectations that the reform will be sustained. This is often important in inducing a positive private sector response to a policy change.
- The agreement between the government and the Bank on conditions and triggers also provides assurance to Bank Management and shareholders that the reform program will be sustained and will generate benefits that justify the loan, credit, or grant.

8. If the reforms associated with Bank PBLs are consensual rather than coercive, this does not mean that the Bank has no influence at all on the content of the policy

reforms. During the course of dialogue associated with the preparation and negotiation of a PBL, including related Economic and Sector Work (ESW), the Bank staff may very well persuade the government about what reforms are needed and may significantly influence the details of the reform program. And the government might equally persuade the Bank to change its initial ideas and positions. In any particular instance it would be difficult to determine which party has exercised more influence over the other in deciding on the details of policy reforms. But, to the extent that the Bank follows its new doctrine, it is appropriate to say that conditionality is not coercive even if the Bank has been very influential in designing the reform program associated with a PBL.

Selectivity as a Substitute for Hard Core Conditionality

9. The doctrine that the Bank should use policy-based lending only to support reforms that enjoy country ownership does not imply that the Bank should be willing to finance any sort of reform or to finance a country-owned program that involves no substantial effort to address the country's remaining policy and institutional impediments to development. Instead, the prevailing wisdom is that the Bank should provide PBLs selectively to those countries that have already taken ownership of a set of reforms that the Bank agrees are useful for its further development. The draft Good Practice Note (GPN) states the principle in this way: "Ownership is a necessary but insufficient condition for Bank support. The Bank should finance development policy operations to support reform programs that have adequate ownership and, in the Bank's judgment, contribute to the country's development goals. Collaborative analytic work and policy dialogue help define the set of reforms that meet these dual criteria." The draft goes on to say:

Designing a development policy operation is a two-stage process. First, the Bank's Country Assistance Strategy (CAS) sets the strategic context with which all of the Bank's individual lending operations should be consistent. It also defines the country outcomes, which the Bank expects to positively influence and to which the individual lending operations should contribute. In the CAS the Bank exercises judgments about *country selectivity* in the allocation of Bank resources and about the broad conditions in which a development policy operation would be appropriate. Through the CAS and its updates, the Bank makes clear the general direction of the reform program to which the government should be committed prior to active preparation of each possible development policy operation.

- Inclusion of a development policy operation in a CAS's base-case lending scenario reflects a judgment that such an operation is justified by the country's current

level of policy and institutional development, its needs for Bank financing, its creditworthiness, and its general commitment to move forward in appropriate reform areas.

- In some cases, a development policy operation may be included only in a high-case lending scenario—that is, after an improvement in specific dimensions of the country’s policy and institutional framework or a demonstrable increase in the government’s commitment to move forward with a reform program in specific areas.

When a government has achieved the relevant thresholds indicated in the CAS, including a sufficient indication of ownership of the associated reform program *in broad terms*, the country and Bank begin to design and negotiate the details of that operation. The amount and the timing of the operation may be adjusted relative to that envisioned by the CAS in response to (a) the quality and cost of the policy and institutional changes that the government decides to pursue, and (b) any significant changes in the country’s economic environment (such as terms of trade shocks that affect the fiscal balance).

10. In one important respect, such selectivity is similar to hard core conditionality: access to the financial resources of a PBL depends on the government’s acceptance of a set of reforms that the Bank considers useful for the country’s development. Nonetheless, there are important differences between this concept of selectivity and the traditional application of hard-core conditionality. First, and most importantly, from the government’s perspective, the primary challenge is no longer reaching agreement with the Bank on a set of reform measures but building sufficient support for the reforms within the country. Second, with respect to timing, selectivity implies that at least a reasonable level of ownership for a particular set of reforms has been achieved before the Bank begins to work with a country on the detailed definition of a reform program and the conditionality for an associated PBL. Such prior ownership implies a much higher likelihood that the reforms will be implemented and sustained. And, third, following the selectivity approach, the nature of the Bank’s dialogue and engagement with the country is likely to be different than in the case of traditional policy-based lending based on hard core conditionality. In some cases, the Bank may be absent from the internal dialogue through which a government develops ownership for a reform program. This is more likely to be the case in a country in which the Bank has not earned a reputation as an objective, constructive partner. In other countries, the Bank may have actively engaged in both analytical work and policy dialogue about these reforms and have been an agent in building country ownership. In this latter circumstance, the dialogue is likely to be a non-coercive give-and-take in which the Bank can function as a partner in policy analysis and formulation rather than as a dictator of policy reforms. Through such dialogue, the

Bank can learn about the country's circumstances and the government's point of view so that the details of the reforms are more "home-grown" and less driven by ideas from Washington.

11. There are, however, two problems in applying this vision of selectivity. First, for non-creditworthy countries that desperately need Bank policy-based lending to cover fiscal needs, there is strong pressure to accept—or at least pretend to accept—the reforms that the Bank has indicated are necessary if the country is to be selected as eligible for additional policy-based lending. Critics of the Poverty Reduction Strategy Paper (PRSP) process have noted this problem frequently. They argue that governments put into their PRSPs those policy reforms that they assume the Bank and the IMF prefer. It might be the case that the Bank could detect such "fake ownership." This would require a rather careful assessment of the domestic politics surrounding a potential reform program, and the Bank may not be well situated or even motivated to undertake such an assessment.

12. Second, applying a selectivity approach in lieu of hard-core conditionality for policy-based lending requires that the Bank provides clear and timely information to a country on what reforms are considered necessary to merit Bank financial support. Doing so would require that the Bank's criteria for evaluating a country's policy and institutional environment and for allocating loan resources are fully understood by the governments concerned. This would need to be done at a Bank-wide level and, more importantly, for each individual country. Thus far, the Bank has partly embraced this idea. The substance of the Bank's Country Policy and Institutional Assessment (CPIA) and its related system of performance based allocation (PBA) of IDA lending resources have been made more transparent. Since 2000, for IDA countries, Bank staff have disclosed and discussed an IDA country's CPIA ratings and the PBA system with the government authorities, and the CPIA ratings for all IDA countries are posted in quintile format on the Bank's website. For IBRD countries, country creditworthiness rather than the CPIA plays a key role in the lending decisions, and the CPIA scores for IBRD countries are not disclosed. Improving transparency at a systematic level would need to be matched at the country level by clarity in the Country Assistance Strategy (CAS). Ideally, according to the draft GPN cited above, "Through the CAS and its updates, the Bank makes clear the general direction of the reform program to which the government should be committed prior to active preparation of each possible development policy operation." But, in practice, this is not always the case. CASs sometimes provide only vague indications about what a country would need to do to qualify for additional policy-based lending.

Institutionally and Politically Complex Reforms

13. The reforms that the Bank supports through recent PBLs are usually very different from the sorts of reforms associated with policy-based lending in the 1980s and

even in the early 1990s. They are usually second- or third-generation reforms that do not involve major macroeconomic policy changes designed to achieve stabilization or additional major shifts toward a more market-oriented and open economy.⁷ As summarized in the Bank's recent Adjustment Lending Retrospective, "The content of [PBLs] has evolved in line with the changing development context ... it focused in the 1980s on fiscal adjustment in response to external shocks and on removing obstacles to growth ... the Bank's adjustment operations in the 1990s changed along a number of dimensions, with increased attention to poverty reduction, institutions, and complex social and structural reforms.... As many countries have removed economic distortions, [policy-based lending] is now increasingly supporting reform agendas associated with medium-term institution building."⁸

14. Often the reforms now associated with policy-based lending involve efforts to improve the provision of basic public services within a sustainable fiscal framework and to improve core government functions, such as the regulation of banking. Here are two examples of the type of reforms on which PBLs are often conditional:
- The Colombian Social Sector PBL supported, among many other things, "the expansion of the subsidized health insurance coverage of the poor, issuance of regulations to implement the new methodology for allocating health transfers to territorial entities, strengthening the Health Superintendency, ... establishment of performance and monitoring agreements between the national and selected governments/Education Secretariats...."
 - The Second Economic Restructuring Loan to the state of Karnataka in India required administrative reforms focused on "civil service reform, freedom of information, service agency reforms, measures to reduce corruption, decentralization, and e-governance, with the objectives of improving the efficiency and transparency by which government transacts its business and delivers services."
15. Such reforms are very different from the sort of "stroke of the pen" measures often associated with early structural adjustment programs—decreasing tariffs, increasing a tax rate, or eliminating a subsidy for electric power. For the most part, they involve changes in the behaviors of government institutions that are intended to improve the efficacy and efficiency of public services.⁹ Such reforms

⁷ For one of the earliest discussions of the evolving nature of reform programs in middle-income countries, see Naim 1995. This shift in the reform agenda over time is well described in Nelson 1996.

⁸ World Bank 2001, p. xi and xiv.

⁹ There are exceptions in which recent adjustment loans support first generation reforms. For example, Brazil's Programmatic Financial Sector PBLs involved privatization of state-owned public banks and the

may seem unambiguously good and hence uncontroversial. That may be true for the broad intentions. But, in fact, such reforms are institutionally and politically complex. The core interests of many groups are often at stake, and the devil is truly in the details. In many ways, these second- and third-generation reform programs are more difficult to adopt, and once formally adopted, harder to implement than earlier reforms.

16. Such reforms are institutionally and politically complex because they involve four sets of obstacles, as described by Nelson 1999 in her analysis of education and health sector reforms:

- Multiple vested interests and stakeholders. Many groups within and usually outside government must cooperate to implement these sorts of reforms. As Nelson says, "...simply overriding their objections may be unwise even where reformers have sufficient power."
- A long timetable. Changing institutional arrangements and behaviors of large government bureaucracies and large groups such as tax administrators or teachers takes time. According to Nelson, "this means that political battles do not stop after reforms are approved but are re-cast and re-fought at both national and local levels, often diluting or derailing the reforms."
- No blueprint for reform. Although there may have been a "Washington consensus" among international financial institutions and many borrowing governments about first-generation, structural adjustment programs, there are no technical models for public administration reforms or for reforming the education and health sectors that command wide consensus. What can be made to work in one setting is not likely to work elsewhere in just the same way. Bureaucratic cultures differ, and that matters a lot in institutionally complex reforms. As Dani Rodrik puts it, "institutional innovations do not travel well."¹⁰
- Little apparent urgency. Poorly run, even corrupt, public services are a well-recognized problem. But, unlike hyperinflation or other macroeconomic crises, they can be tolerated for a long time by societies and their political elites. In the face of opposition from vested interests (who face concentrated, often immediate losses), politicians often find it easiest to postpone reforms that have widely diffused, incremental, and long-term benefits.

17. Collier and Nelson predicted that this shift in the reform agenda in many countries would substantially complicate and perhaps reduce the use of policy-based lending. In writing about whether or not policy conditionality might be redesigned to avoid past failures in promoting reforms, Collier 2000 based his negative conclusion partly on the observation that "...the reform agenda has

Energy Sector Reform Loan required power tariff adjustments. The Tunisia Third Economic Competitive PBL included further privatization of state enterprises.

¹⁰ Rodrik 2002, p. 3.

largely moved on from macroeconomic policies to sectoral policies, such as civil service reform and privatization. These policies are intrinsically more complex, both politically and administratively, and so less suited to timetabled conditions than the earlier generation of reforms.”¹¹ Nelson 1996 also stressed the shift in the reform agenda of borrowing countries and, because of this and other factors, predicted (wrongly, or at least prematurely) that “the outlook is for further shrinkage in the relative and absolute levels of policy-based loans.”¹²

18. More specifically, the characteristics of the types of reforms now most commonly associated with Bank policy-based lending have these important implications:

- These reform processes cannot be well designed primarily by an external agency. Because good design requires intimate knowledge of the local setting and institutions and because implementation requires some degree of consent from the many stakeholders, such reforms must truly be “home-grown.” Imported designs will not carry much credibility.
- The process of designing reforms becomes much more complicated, involving not only the executive ministries but often also the national parliament, autonomous implementing agencies, sub-national governments, and non-governmental actors.
- Implementation of these reform programs usually involve some trial and error to discover what works best, and some give and take to maintain support from the various interest groups as implementation unfolds. This makes it hard, if not counterproductive, to specify and commit to the detailed steps of the reform program for two or three years in advance.
- These sorts of reforms almost never depend on a few key measures but require a host of small steps and behavioral changes. It is true that design and approval of a new law or major regulation is often important. But *implementation* of that law or regulation is the key and often more difficult challenge.¹³ Outlining a program of implementation involves a lot of detail.
- A related implication is that the process of reform has, in the words of Paul Collier, “fairly low observability—their operation depends upon behavior at the local level, or within the bowels of various ministries, over a long period of time.”¹⁴ This means that monitoring implementation of behaviors that matter and enforcing meaningful conditions by an external party is difficult, if not impossible.

¹¹ Collier 2000, p. 305.

¹² Nelson 1996, p. 1552.

¹³ In February 1999, Kim Dae-Jung, President of South Korea remarked: “Looking back on the past year of reform, I can draw one important conclusion. It is that introducing new laws and institutions alone is not enough. Reform can succeed only when these institutional changes are accompanied by changes in people’s minds. This is the real test.” Quoted in Santiso 2002.

¹⁴ Collier 2002, p. 8.

No net fiscal costs for the reforms

19. In many cases, the reforms programs associated with policy-based lending in recent years do not involve a net fiscal cost to the government—even in the short-run. Furthermore, the reforms are not undertaken in order to adjust to some exogenous shock to the country’s fiscal or external balance.

20. This distinguishes many recent PBLs from most of the early policy-based lending. In the early 1980s, especially in Latin America, the intention of policy-based lending was to provide financial resources during a transitional period in which the government took policy measures so that the country’s economy could adapt to the sudden increase in oil prices and interest rates during that era. Often these adjustment policies would involve short-term costs, but hopefully long-term benefits, to the government’s treasury and to the economy. The money from PBLs was intended to help bridge the gap. For example, reducing import tariffs would in theory help the economy to improve its international competitive and eventually its growth rate and external balance. In the short run, however, lower tariffs meant lower government revenues and higher imports. A PBL would at least partly compensate for the shortfalls in fiscal revenue and net foreign exchange earnings. In these circumstances, the money provided by the loan had an important role in cushioning the impacts of adjustment.

21. Beyond the early 1980s, policy-based lending was increasingly used to “support” reform packages that were designed to improve the government’s fiscal position from day one: the reforms involved no short-term net costs either to the treasury or the economy as a whole.¹⁵ In these cases, the formal justification for the Bank loan was that the country as a whole had an external financing need, not that the reforms themselves had any short-term costs. Until the early 1990s, the Bank economists needed only to establish that the country faced a current account deficit and therefore a need for capital inflows. In 1992 the Bank formally relaxed its macroeconomic criteria for PBLs, requiring only that a country had an “actual or anticipated external financing gap with balance of payments or fiscal origins.” This placed the focus primarily on the government’s need for financing for its overall fiscal program, including its debt service, rather than on the costs of the associated reform program.¹⁶

22. Among recent PBLs, many are associated with reform programs that do not increase the government’s overall expenditures, decrease its revenue stream, or increase its financing requirements. According to the Bank’s Adjustment Lending Retrospective, only about 60 percent of the FY98-00 adjustment operations even estimated the cost of reforms, implying that in at least 40 percent of the cases financing the near-term cost of the reform was not a rationale for the loan and indicating that the reforms probably had no significant fiscal costs. Many

¹⁵ On this point, see Gilbert and Vines 2000, pp. 21-23.

¹⁶ On these issues, see especially World Bank 2001, p. 68.

of the policy changes are designed to improve efficiency rather than expand programs—and therefore save money. Many others require changes in the behaviors or rules of existing government agencies, and the costs of such changes in terms of incremental expenditures for consultants or new staff are very small relative to the amounts of the loans. Here are two examples of reforms that involve little or no net fiscal costs:

- The Decentralization PBL to Mexico in 1999 had four main objectives: (a) imposing hard budget constraints on federal resources provided to states and municipalities; (b) reducing moral hazard in sub-national borrowing; (c) increasing the transparency and public accountability of sub-national fiscal and financial management ...; and (d) setting up pilot mechanisms to enhance efficiency in decentralized expenditures in the environment and health sectors.
- The reforms supported by Tunisia’s Third Economic Competitiveness PBL involved: (a) enhancing the private investment climate by improving the business environment and corporate governance and developing private sector participation in infrastructure ...; (b) strengthening banking regulation, accelerating development of the capital markets, and reforming the insurance sector; and (c) improving international communications technology (ICT) regulations.

23. Among recent PBLs, there are important exceptions to the observation that many reform programs have no short-term cost to the government.¹⁷ Recent loans for financial sector restructuring in Mexico and Brazil explicitly provide financing for the government to, in effect, buy bad loans from banks as part of a program to restore solvency to the banking system and reactivate commercial lending.¹⁸ In a few cases, the reform program may increase costs to the central government but induce savings among sub-national governments. For example, in the case of the Russian Fiscal Federalism and Regional Fiscal Reform loan, part of the loan was used to finance a facility that gives grants to provincial governments that are successfully implementing programs of fiscal reform. Also, pension reform programs often involve high front-end costs.

24. For those reform programs that do not need incremental financing, the logical question: what is the money from the PBL actually used for? The common jargon of Bank policy-based lending obscures this question. The operative word, as cited frequently above, is that the loan “supports” the reform program. The fuller formulation is equally vague: “[PBLs] provide quick-disbursing financing to

¹⁷ On the other hand, some PBLs are associated with policy reforms that actually bring windfall gains to the government. For example, the Information Infrastructure Sector Development Loan to Morocco for US\$65 m. was associated with privatization of the main telecommunications operator, which provided huge privatization revenues to the government.

¹⁸ For example, the PID for the Mexico Second Bank Restructuring Facility Loan says that “Bank funds would help finance part of the IPAB’s debt-servicing needs arising from the implementation of its bank resolution transactions, complementing other sources of funds available to IPAB....”

- member countries with external financing needs in developing and implementing policy measures and institutional reforms.”¹⁹ Although this might be mistakenly interpreted to mean that the PBL actually finances the incremental costs of a reform program, this is often not the case.
25. In some cases, the Bank loan does not expand the financial resources available to the government but simply substitutes for some other source of financing. A few loan documents are explicit about this. The Program Information Document (PID) for the Brazil Energy Sector Reform Loan explains: “The proposed loan does not increase the resources available for public sector spending. Under Brazil’s fiscal regime, a PBL from the Bank substitutes for financing from alternative, more expensive debt sources and substitutes foreign for domestic lending.” The PID for the Mexico Programmatic Environment Structural PBL is equally explicit: after repeating the exact wording quoted above from the Brazil loan, it adds “[The loan] does not increase aggregate fiscal resources available to environment and other sectoral agencies since the fiscal envelope is defined by the binding fiscal surplus targets.”
 26. Even if the availability of Bank financing would allow the government to expand its borrowing and expenditure programs at the margin but the associated reform program has no net fiscal costs, then, of course, the Bank typically has no influence over or perhaps even no knowledge about how these incremental resources are used. Even in the case in which the reform program has a net fiscal cost, it is not at all certain that the activities of the reform program itself would be in fact the marginal activity. If the reform program is part of the core of the government’s program, as expected if the program is truly owned by the government, then the incremental financing from the loan money actually goes to some other, unidentifiable activity. In the case of policy-based lending and in contrast to project lending, this fungibility of money is tacitly recognized by the absence of any pretense of linking the Bank’s disbursements to any particular set of expenditures.
 27. The fact that the funds from a PBL often cannot be linked directly to any set of expenditures—incremental or otherwise—begs the question of how the size of a PBL is determined. There are no clear guidelines within the Bank about how to set the amount of a PBL. The current Bank operational directive for policy-based lending states “there is no simple rule for determining the size of an individual [PBL].” It suggests that the costs of the reforms to be supported may be a helpful indicator of the appropriate size of the loan, but adds that “such costs are hard to measure with precision.... Generally speaking, the appropriate size of an adjustment operation is a matter of judgment based on a number of factors, including the actual or expected external financing gap, the scope for burden sharing with other donors and lenders, and the size of the overall lending

¹⁹ World Bank 2002, p. 2.

program. Decisions on loan size are also influenced by the country's creditworthiness (for IBRD countries)...²⁰

28. In traditional Bank practice, explicit consideration has usually been given to three factors—the amount of total financing that the country needed from the Bank to close its external “financing gap,” the importance and political difficulty of the associated reforms themselves, and informal norms about the size of loans relative to the size of the country's economy. The “financing gap” is notionally the amount of borrowing that the government needs from the Bank to complete its borrowing requirements—which may be defined by the overall balance of payments needs of the country or by the public sector borrowing requirement. However, in the case of most IBRD borrowers, when the government has access to private capital markets, the notion of a “financing gap” becomes meaningless. How much the government should borrow from IBRD rather than other creditors is indeterminate, and the concept of a financing gap provides no real guidance about the appropriate size of an IBRD loan. Even for most IDA countries that do not have many other financing options, the gap is subject to large estimation errors. Hence, in discussions within the Bank, considerable weight is often given to the equally ambiguous concept of the importance or difficulty of the associated reforms. Because the mindset of “buying reforms” has often dominated within the Bank, the key question has often been whether or not the Bank is—in a very subjective sense—“getting its money's worth”. Finally, there are some rough norms or rules-of-thumb within the Bank. Almost any PBL for a large economy like Brazil or Mexico is set in the range of \$400-600 m. PBLs for small economies like Bulgaria, Jamaica, or Tunisia would typically be set in the range of \$50-150 m.
29. However, at least implicitly within the Bank and probably explicitly in the minds of the government officials concerned, the size of PBLs has often been set keeping in mind a desired level of net disbursements from the Bank to the government and hence the desired direction and pace of change in the government's Total Debt Outstanding (TDO) to the Bank in the context of its overall debt management strategy. The case of Mexico illustrates the point: from 1990 through 2002, Mexico's TDO was held within a rather narrow range of \$10.9 to \$12.1 billion. A recent Country Assistance Strategy (CAS) argued that the TDO should be kept at around \$12 b. This stability was maintained primarily by adjusting the amounts of the steady stream of PBLs. In the case of Brazil, a recent CAS suggested that over the latter half of the 1990s there was an understanding that, subject to reasonable policy directions, the Bank would increase its TDO to Brazil, and the sizes of PBLs were set accordingly. For Morocco, a recent CAS noted that the government was gradually reducing its external indebtedness, taking advantage of large concessional inflows (largely from the EU) and privatization receipts, and that the Bank's TDO would continue to decline. Given this debt management objective, the next PBL was set at \$65 m. and sectoral PBLs in the pipeline were anticipated to be less than \$50 m.

²⁰ World Bank 2001, p. 70.

Implications for the Potential Non-Financial Benefits and Costs of Policy-based lending

30. Taking into account these dominant characteristics of many recent policy-based loans—consensual conditionality associated with institutionally and politically complex reforms, which often involve little or no net fiscal costs, what can be said about the potential non-financial benefits and costs of the Bank’s policy-based lending? In this discussion, non-financial benefits and costs are assessed in terms of the likely impact of the PBL on the design and implementation of a good reform program.²¹ The government concerned intends to implement the reforms anyway. The reforms by their nature need to be designed and implemented by the domestic stakeholders based largely on intimate knowledge of local circumstances. And, if the government does not need extra money to implement them, why should the Bank provide a loan to “support” such reforms? What are the pros and cons of the Bank’s involvement?
31. The non-financial potential benefits and costs of Bank policy-based lending fall into four categories: analytical contributions by Bank staff to policy formulation; value added to the bureaucratic decision-making process; value added to the political decision-making process; and value of the Bank loan as a signaling or commitment device.²² Consider each in turn.

Analytical Contributions by Bank staff

32. The Bank and its sympathetic observers claim that the design of the policy reforms associated with policy-based lending is improved through the analytical contribution of Bank staff. During the dialogue leading up to the loan, the staff may bring to bear their own analysis of the problems and policy options facing the country. Such analysis may be usefully informed by the experiences of other countries with similar reform programs, of which the Bank staff are more likely to be aware than their counterparts within the borrowing government.

²¹ In the vast literature on adjustment lending, there has been much attention to the “social costs of adjustment,” meaning the likely negative impact of adjustment policies on the welfare of various groups. In this paper, “cost” means only a negative impact on the likelihood that a reform program will be well designed and successfully implemented.

²² Other possible non-financial benefits have been suggested by some but, in my judgment, do not deserve serious consideration. One argument in favor of policy-based lending is that it provides reformers within the government with the opportunity to blame the Bank for necessary reforms. Although this has probably often been true, it should not be encouraged because it undermines longer-term country ownership of reforms. Indeed, it probably should be regarded as a non-financial cost, not a benefit. On this point, see Collier 1997. Another possible argument is that PBLs provide a positive signal to global capital markets that the country’s macroeconomic environment is judged stable by the Bank and that this might help induce capital inflows. However, given the number of occasions in which the Bank has provided PBLs in circumstances in which the macroeconomic situation turned out to be unsustainable, it is probably a more common view that the Bank gives PBLs primarily to countries in trouble.

33. Indeed there seem to be many compelling examples of the value added of the Bank's analytical work. In the case of the Programmatic Financial Sector Loan to Brazil, the PID claimed that "[The Bank] has maintained an active and fruitful dialogue on financial sector matters with the Brazilian authorities over the past years, including importantly through technical assistance lending to the Central Bank of Brazil (approved in 1997) and extensive analytical financial sector work carried out mainly in 2000." The Colombia Social Sector PBL also reportedly drew heavily on prior analytical work. According to the President's Report, the loan "represents the culmination of the Bank's program of social sector strengthening activities initiated with the [Government of Colombia] three years ago. This program consists primarily of three lending operations and two sector studies...."
34. There may be, however, two reasons to question the value of the analytical contributions of Bank staff to the design of policy reforms supported by PBLs. First, when the reforms are institutionally and politically complex as discussed above and there is no blueprint for successful reform, the knowledge and analytical skills brought to bear by Bank staff may be less relevant and, in the worst case, may crowd out more relevant local knowledge.²³ David Scott, in his book *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed*, discusses the differences between what he calls *metis*—local, practical knowledge—and *techne*—generic, theoretical knowledge. He argues compellingly that "true development" depends more on *metis* than *techne*. The same proposition may well be true for the sorts of reform processes now most commonly supported by Bank policy-based lending. In such circumstances, unless handled with great sensitivity, the involvement of outside "experts" from the Bank can easily do more harm than good by giving too much weight to the opinions of outsiders. As expressed on the Global Development Network website: "New insights from social theory or new findings from cross-country studies can only be applied in a specific country with a detailed understanding of local context. Without sound local knowledge, imported policy knowledge may be irrelevant or, worse, backfire."²⁴ The likelihood of doing more harm than good will depend in part on the substance of the reforms themselves. For example, what works best in the realm of banking sector regulation is likely to be more universal than in the realm of education services or public administration. But it is clear that the Bank's PBLs are increasingly focused on domains in which the importance of local knowledge grows and the relevance of other countries' experiences diminishes. This means that the potential benefit of the Bank's analytical contribution will be much harder to realize and may involve greater risk that the Bank's analysis and advice will be wrong and damaging.

²³ A similar argument is that, in their analytical work, the Bank staff are too "purist", pushing for technically appropriate solutions that give insufficient weight to the country's political and institutional constraints.

²⁴ See <http://www.gdnet.org/subpages/aboutgdnet.html>.

35. A second reason to wonder about the value of the analytical contributions of Bank staff is that, as their pool of human capital deepens, the technical quality of government staff and national researchers in most of the borrowing countries has probably improved substantially over the last couple decades and continues to improve. In these countries, nationals increasingly improve their capacities to learn about the reform experiences in other countries, and to interpret that experience without the intermediation of the Bank staff. Even if the Bank can do an excellent job at recruiting talented, highly trained, and experienced staff, their value added will necessarily decline relative to the value added to policy analysis, design and implementation from nationals both inside and outside of government.
36. The Bank has certainly recognized both of these challenges. There is much that it has done and can do to ensure that its analytical contributions do have value added to borrowing governments. In particular, expanding the use of national staff in country resident offices and undertaking analytical work collaboratively with nationals have been pursued as means to ensure the relevance of the Bank's analytical work.
37. But the key question remains this: why not put the quality of the Bank's analytical contributions to a "market test" by unbundling it from lending? Bank staff has long recognized that the offer of a large loan serves to "buy a seat at the table" and differentiates the Bank from most other sources of advice. It ensures that government officials will at least listen to their advice about policy design, even if they do not finally accept that advice. Hence, the Bank argues that "Advice is often more acceptable and credible when linked to resource transfer."²⁵ But the question should not be: is the Bank's advice accepted and credible? Instead, is it right? If, as suggested above, it is increasing difficult for the Bank to provide quality advice and there is even a growing risk that its advice will be wrong, shouldn't the Bank have to *earn* a seat at the table based on the quality of its analytical work? If so, then the potential analytical contribution of the Bank cannot be regarded as a benefit of policy-based lending *per se* but as a potential benefit of the Bank in its role as a "knowledge bank". In fact, the bundling of advice with lending probably increases the risk that the Bank will not have sufficient incentive to ensure the quality of its advice and that some governments will take bad advice just to get the money.
38. From the Bank's perspective, a substantial impediment to "unbundling" analytical work and policy advice from lending is that a loan is the primary means by which the Bank can recover at least part of the cost of staff and consultants involved in the analytical and advisory work. As expressed in an internal memo, "Clients have no way to engage the Bank on a sustained basis outside promising to borrow large amounts." Offering analytical and advisory services on a fee-based basis would not only put the quality of the Bank's work to a market test but also remove the distortions of incentives involved in linking policy advice to large loans.

²⁵ World Bank 2002a, p. xxii.

Value Added of the Bank to Bureaucratic Decision-Making

39. Focusing on the potential analytical contributions of Bank staff is in part motivated by the premise that designing and implementing policy reforms is primarily an intellectual task facing a government—as if the government were a rational, unitary decision maker. Of course, that it not the case. Policy is almost always made through a complicated bureaucratic and political game involving several parts of the central government administration, if not also parliament, sub-national governments and other stakeholders, on the basis of imperfect information and analysis. The process is usually burdened by bureaucratic and personal rivalries. Attention to the reform issues may be crowded out by the deluge of daily demands on senior players in the government. And there are often no deadlines for decision or action. Even putting political competition and interests aside, making policy is usually a messy, drawn-out process, and especially so for the sort of reforms described above.²⁶
40. In such a milieu, it is possible that the Bank can play a catalytic role simply by virtue of its conveying power, its access to actors at all levels within the government and among civil society, its incentives for pressing toward closure, and perhaps its reputation as a relatively neutral, objective party. From this perspective, the Bank’s involvement in the process of preparing and implementing the policy reforms associated with a PBL may facilitate the government’s decision-making process by stimulating dialogue, especially among parts of the government that otherwise would not communicate well, and by imposing a greater discipline and timetable on the process of internal dialogue and decision-making.
41. The documentation for recent PBLs occasionally, albeit vaguely, claims such a useful role for the Bank. In the documentation for the Colombia Social Sector PBL mentioned above, it is claimed that the Bank’s sector studies have stimulated discussions of social sector reform issues within and outside of government circles. The PID for the Third Provincial Reform PBL in Argentina states: “Lessons from the ongoing experience suggests that the loan design for a direct relation between the Bank and the provinces is important in enabling the Bank to bring to bear its international experience and in providing a mediating influence between the federal and provincial stakeholders.”
42. Obtaining credible evidence of the value added of Bank staff in the decision-making process associated with policy-based lending is difficult. The claims by Bank staff about such matters are likely biased. Occasionally officials from borrowing countries comment directly on the matter. According to the

²⁶ See Grindle and Thomas 1991, Brinkerhoff 1996 and Crosby 1996 for excellent discussions of the processes of policy making and implementation in developing countries.

Commission on the Role of the MDBs in Emerging Markets, “Officials from countries such as Brazil, Mexico, Turkey, Hungary, Thailand, and Korea repeatedly cite the services that are ‘bundled’ with MDB financing as a key reason for seeking MDB loans. They value the detailed, project, and sectoral analysis of MDB staff and the dialogue on tough internal policy and budget choices that the lending process catalyzes.”²⁷

43. Even granting the plausible claim that the Bank’s involvement stimulates dialogue among various parts of the government and between the government and civil society, the question is again relevant whether or not this depends on the lending itself. Perhaps the Bank’s potential role as a process facilitator could be unbundled from the loan and linked only to its analytical work. Such unbundling seems especially feasible since, in most cases, the line agencies involved in implementation of many of the reform programs often do not receive incremental financing from the loan in any case. On the other hand, perhaps the offer of the loan is crucial in legitimizing and strengthening the role of the Bank staff within the contentious process of policy debate. In particular, the offer of a loan might provide a crucially important ingredient to any difficult policy making process—an incentive to come to closure and take decisions. The value of a deadline to the process of government decision-making can be quite high. The pressure from Bank staff working toward agreement on a PBL—usually in response to the internal pressures within the Bank to bring forward loan proposals sooner rather than later—may therefore be helpful to governments. This may be especially true in dealing with reforms for which the pressure to act is not urgent—one of the characteristics of many of the reforms supported by recent loans.
44. But pressure to come to closure can be a double-edged sword for the sort of institutionally and politically complex reforms under consideration. It can short-circuit healthy, albeit time-consuming, processes of discussion and consensus building among the various stakeholders. It is this concern that underlies Joan Nelson’s recommendation to “make haste slowly:”

The intrinsic requirements for sustainable reforms in education and health and the durable internal constraints in both [the World Bank and the IDB] counsel a basic strategy of making haste slowly. The quickest road to major sustainable change may not be the most direct and shortest route, but instead a patient and circuitous journey that builds comprehension and recruits support. In many countries, the World Bank and the IDB should emphasize laying the groundwork and creating preconditions for future reforms rather than trying to press ahead immediately with ambitious measures.²⁸

²⁷ Commission on the Role of the MDBs in Emerging Markets 2001, p. 4.

²⁸ Nelson 1999, p. xvii.

45. The risk that time-pressure associated with a Bank loan may short-circuit healthy processes of decision-making with respect to complex reforms may be increased when a government's ministry of finance wants the loan for the sake of its external borrowing program. Once the finance ministry has decided that it wants or needs the Bank loan, it may work aggressively with the Bank to complete agreement on the details of a reform program without sufficient regard to the quality of agreement among the other parties in the government. When the local knowledge of those other parties is needed for good design and their cooperation is needed for effective implementation, this can seriously threaten the eventual success of the reform.
46. The 1999 Mexico Decentralization Adjustment Loan (DAL) illustrates such risk. In early 1999, the Mexican Ministry of Finance and the Bank agreed in principle that a \$600 million loan would be approved by the end of that calendar year and hence six months ahead of a national election. This large loan was an important component within the Ministry's annual external borrowing program and its strategy for strengthening the country's macroeconomic position going into the election period. Beginning in the spring of that year, the Bank and the government entered into an intensive period of analytical work and dialogue on the complex policies governing the fiscal relationships between the central government and the state and municipal governments throughout Mexico. According to the Bank's Operations Evaluation Department's Mexico Country Assistance Evaluation, this was a productive dialogue, and the Bank's analytical contributions were well received. By the end of the year, the Ministry had come to closure on a set of regulations that could be promulgated under the authority of that ministry, without congressional approval, and the loan went ahead on that basis. The loan documentation recognized the risks involved: "Making decentralization more efficient and accountable to democratic control will require a substantial set of reforms... The proposed loan will not directly address the full set of required reforms ... and should thus be seen as a first but significant step... The DAL policy commitments do not require legislative action, with one exemption—the already-scheduled budget submission for year 2000.... Even if government and Congress reach the necessary consensus, there remains a possibility that some states or municipalities would refuse to adopt recommendations that they may perceive as federal imposition." In other words, the tight timetable set for the lending operation, together with other factors, led to a process that did not fully include either the congress or the sub-national governments. This may have increased the risk that the process would be undermined at later stages. It is quite possible that linking these Mexican decentralization reforms to the timetable for a large loan was the right thing to do under the circumstances. But this case illustrates a potential, generic problem: relying on large Bank PBLs to complete a government's external borrowing program puts the preparation and agreement on that loan on a timetable that may be incompatible with a process for healthy national debate and democratic approval. In that case, the Bank's involvement in the country's decision-making process may do more harm than good.

Value of the Bank to the Political Decision-Making Process

47. There is another possible way—long cited in the literature on the political economy of reform—in which the Bank’s support for policy reform via PBLs might be regarded as helpful: the offer of a large loan contingent on certain policy reforms may tip the balance of political support in favor of the pro-reformers within the government. This is a subtly different justification than those presented above. It does not suggest that the Bank imposes its will on a government that is unified in opposition to the Bank’s policies, that the intrinsic quality of the Bank’s analytical work wins crucial support on its merits, or that the Bank’s participation in the bureaucratic *process* facilitates decision-making. Instead it is based on the recognition that almost every policy change involves winners and losers—even when the country as a whole benefits—and that the distribution of political power between winners and losers may be quite finely balanced. In such a case, the contingent offer of the Bank loan itself might swing the balance in one of several ways. Possibly the endorsement of the Bank will persuade some parties that this is in fact good for the country. More likely, the availability of the (at least supposedly) incremental financing from the Bank might be sufficient inducement for those who were otherwise neutral to support the pro-reform elements. In some cases, that incremental financing might even make possible expenditures that would at least partially compensate losers.
48. The Bank itself has used this argument to support policy-based lending. The Bank’s Adjustment Lending Retrospective notes: “Several country studies have identified a positive role for conditionality: reformers welcomed the conditionality and used the associated external commitment as a tool to push through the reforms....”²⁹ But without detailed case studies by politically knowledgeable observers of the circumstances of each loan, it is impossible to say how many recent Bank PBLs played such a role in the politics surrounding the associated reforms. The question has been studied in the literature on the political economy of reforms. Killick 1998 summarizes the issue and the evidence:

A last-ditch defense of conditionality can be offered. This tacitly accepts the dominance of domestic politics but asserts that conditionality provides a means whereby donors can strengthen the position of reformers within government and can tip the balance in favor of change.... But how often are the knife-edge situations favorable to effective intervention most likely to arise? Our own country studies drew a blank on this. That we were able to find little or no evidence bearing upon this question itself suggests that they may be rather rare occurrences.... Overall, then, a defense of conditionality in terms of its ability to tip the political balance in favor of reforms bears limited weight.³⁰

²⁹ World Bank 2001, p. 67.

³⁰ Killick 1998, pp. 156-158.

49. This negative conclusion about the political utility of the Bank's conditional loans for policy reforms is buttressed theoretically by two other considerations. First, the notion itself is most applicable to one-time, stroke-of-the-pen, and largely irrevocable policy decisions. That is certainly not the nature of the reform programs supported by many recent PBLs. As Nelson 1999 pointed out, the reforms of social sectors are played out over many years, and there are numerous points along the way at which political struggles between pro- and anti-reformers are waged. The provision of a contingent Bank loan in the initial period of reform is therefore unlikely to be helpful to the political sustainability of that reform. On the other hand, it might be argued that there is often a "tipping phenomenon" at play in the sense that, once the broad directions of reform are set in motion, subsequent political battles may modify the details of its implementation but not block or reverse it altogether.
50. Second, in some countries and political circumstances, the overt association of the World Bank with a particular reform is likely to be politically detrimental. It may generate more opponents than it neutralizes. As Collier has pointed out, the Bank's involvement may create the perception, regardless of the reality, that the reforms are not truly owned by domestic stakeholders. The loan's formal conditionality may raise doubts in the minds of the public that the reform program is indeed good for the country. Such a backlash is more likely in a country in which the Bank does not enjoy a favorable public image. This was likely a consideration in the minds of the Mexican government during the early 1990s. Since the World Bank was associated with the "imperialist forces" of Washington in the minds of many Mexicans, the government choose to associate the Bank loans only with reforms on which they already had strong political support and to keep the Bank's name away from the most controversial issues such as telecommunications and power privatizations.³¹

Value of the Bank Loan as a Signaling or Commitment Device

51. Finally, there may be circumstances in which the government's agreement with the Bank for a well-defined reform program is useful as a means to convince non-governmental actors of the seriousness of the government's intentions and its resolve to implement the reforms. This may be particularly helpful if the effectiveness of the reforms depends on a change in the way the private sector views its incentives and opportunities. For example, domestic and international investors may consider that the government's commitment to maintaining fiscal discipline and reducing inflation is more credible if such commitments are conditions of Bank lending and therefore subject to Bank monitoring, and this may induce higher investment levels. Or it might be that reforms involve a new set of prices, and demand and supply will not adjust to those new prices unless private actors are persuaded that the pricing reforms will not be reversed. Also,

³¹ See World Bank Operations Evaluation Department 2001.

- the government's commitment to the Bank to implement the reform program might serve to weaken the resolve of domestic opponents of the reform.
52. The Bank itself often uses this “commitment device” argument in defense of conditionality. For example, a recent Bank document states: “By increasing the cost of backtracking on policies ... commitments to donors can enhance the government's credibility in sticking to policies that face opposition from special interests or that have short-term costs but long-term benefits.”³²
53. Although in theory conditionality could be valuable as a signaling or external commitment device, there are several reasons to doubt that this is important in most circumstances. First, as an empirical matter, in discussions about disclosure policy within the Bank's Board of Executive Directors, the representatives of borrowing governments have traditionally opposed any requirement for the public disclosure of the full documentation of PBLs. Prior to approval of a new disclosure policy in mid-2002, only the very general Public Information Documents had to be disclosed on the Bank's external website.³³ Under the new disclosure policy, after much lobbying by NGOs and some OECD governments for greater transparency in Bank operations, there is a “presumption in favor of disclosure” but the full Program Document for Bank PBLs is made publicly available only after the borrower concerned gives its consent.³⁴ (As an exception to this general rule, the new policy requires full disclosure of the documentation for IDA Poverty Reduction Support Credits (PRCSs), which are based on a PRSP.) In short, the traditional attitude of most borrowing governments against required disclosure of PBL documents suggests that they do not typically regard PBLs as a useful commitment device.³⁵
54. The utility of recent PBLs as signaling or commitment devices is also theoretically doubtful because the success of the sorts of reforms now commonly supported usually does not depend on the expectations and market-driven responses of non-governmental actors.³⁶ Furthermore, since most of the reform

³² See World Bank_2002c, p. 101. World Bank 1998, which strongly supports a shift from traditional conditionality to country selectivity, stated: “Conditionality still has a role—to allow governments to commit to reform and to signal the seriousness of reform....” (p. 19).

³³ Among the FY00-02 PBLs by IBRD, the full Program Documents are available on the Bank's website only for the Colombia Social Sector PBL and the Mexico Programmatic Environment Structural AL. In some cases, it is even hard to find the required Project Information Document (PID) about PBLs on the World Bank public website. For example, the PBLs for Brazil do not show up in the list of lending operations accessible from the Brazil country page but can only be discovered through a document search. Similarly, the loans to the Indian states of Karnataka and Andhra Pradesh cannot be found on the India country page but only through a search of the Bank's entire website.

³⁴ See World Bank 2002d, pp. 7-8.

³⁵ It might be argued that borrowing country governments have resisted public disclosure of Bank documents not because they want to avoid publicizing the Bank's support for the associated reform program but because those documents usually include a risk assessment that might be politically sensitive. If that were their primary motivation, however, it would have been logical to resist inclusion of such risk assessments in public documents rather than to suppress public release of the entire document.

programs now supported by PBLs are rather prolonged processes of change, conditionality is likely to be useful as a signaling or commitment device only for brief periods of time when the intentions of a government are unclear and its track record unproven.³⁷

55. Another argument against the utility of PBLs as a signaling or commitment device is that the Bank's record of enforcing conditionality is not very strong, as argued by Killick 1998 and Collier 2000. Given its mixed track record on enforcement of conditions, the Bank may have already "debased the currency" and greatly weakened the potential utility of loan conditionality as a commitment device. It would take some years of visibly tough enforcement of conditionality to reverse this legacy. This is particularly unlikely in light of the nature of the reforms now supported by policy-based lending. As noted above, such reforms typically involve a myriad of small steps rather than a few key measures, and failure to implement some of these small steps would not logically cause the Bank to withhold disbursements.

Summing up potential non-financial benefits and costs

56. The non-financial net benefits from Bank policy-based lending that is not associated with a macroeconomic or financial crisis depend on the circumstances surrounding the loan. Because they are typically subtle and hard to observe, assessing the net benefits in any particular case is likely to be difficult. For an individual loan, only one or two, if any, of the possible non-financial benefits cited above may be relevant. The Bank's analytical contributions to the design and implementation of reforms can often be helpful. But the fact that the Bank is buying rather than earning the attention of the government may also have negative effects in terms of crowding out local knowledge which is especially relevant to the institutionally and politically complex reforms that countries are now pursuing. Other potential benefits—facilitating the government's decision-making processes, tipping the political balance in favor of reformers, or providing a signaling or commitment device—might arise from time to time. But it cannot be assumed that these potential benefits will be routinely significant. Given the nature of the reform programs now often associated with PBLs, there may be an equal number of circumstances in which the Bank's involvement in the reform process through its PBL—especially if done without great care—has adverse effects on either the politics of reform or the decision-making process. In particular, the time-pressured processes and detailed advance blueprints traditionally associated with Bank PBLs may do harm to healthy national debate and consensus building and to learning-by-doing that must underpin these sorts of reforms. Drawing heavily on the advice of outsiders and specifying relatively short time horizons for their implementation may lead to wrong designs and overly hasty implementation. Especially in those cases in which the reforms

³⁷ This is an important conclusion of Devarajan, Dollar, and Holmgren, eds. 2001. See p. 34. Although this study used case studies of African countries, the point is likely to be valid among IBRD borrowers as well.

involve no incremental fiscal costs or the government has alternative access to financing, such harmful effects from the Bank's involvement might outweigh the financial benefits of the loan. When the PBL is needed to help meet overall financing requirements, these harmful effects might be overlooked or excessively discounted by the government and the Bank.

Recommendations for Non-Crisis PBLs

57. There are many steps that the Bank could take—and in many cases, seems to be taking—to increase the likelihood that PBLs will do more good than harm. In many ways, the draft Good Practice Note already cited is aimed in the right direction. The recommendations below apply to PBLs for second and third generation reforms that are not designed to help respond to a macroeconomic or financial crisis.
58. In designing its new guidelines for PBLs, the Bank should give more attention to the point that the potential non-financial benefits and costs of PBLs depend to a large extent on the nature of the reforms to be promoted and on the institutional and political circumstances surrounding the reforms. The guidelines should require staff to talk with the government about the potential non-financial benefits and costs, should encourage discussions about how to maximize potential net benefits, and should explicitly discourage use of PBLs when circumstances are unfavorable to providing net benefits. This more cautious approach might lead to more sparing use of PBLs than currently anticipated by the Bank.
59. The Bank needs to clearly and repeatedly articulate to broad audiences, including within borrowing countries, its current doctrine that conditionality is used only as a complement to, not a substitute for, country ownership. To make that persuasive, it needs help from the borrowing governments, which must make their ownership of the reforms associated with PBLs clear and credible. The Bank also needs to improve guidance to and training for its staff in assessing ownership and should cite evidence of ownership in its documentation of PBLs. The draft GPN takes a step in this direction.
60. The Bank also needs to further strengthen the capacities of its staff to contribute usefully as facilitators of a government's decision-making process. This non-financial benefit of PBLs can be important and useful in many circumstances, and the Bank needs to further legitimate this purpose of its work on PBLs and train staff explicitly for this role.
61. The Bank team working with a government on the design of policy reforms and the loan conditionality should aggressively seek to tap into local knowledge and should be seriously humble about the relevance of other country experience. This means forming partnerships with national think tanks and academics, using national consultants, and relying heavily on staff with deep country knowledge,

- including nationals of the country working in the resident mission. And it means a general tendency to defer to the judgments of government on issues of institutional design.
62. In recognition of the need for trial and error and for flexibility in the timing of reform programs, the Bank should in most cases use what it calls programmatic policy-based lending. Under this approach, a three-year program of expected reform measures is agreed in advance, usually with increasingly less detail for the second and third years. Loans are approved only on an annual basis. The exact preconditions for each loan are agreed only in the months before loan approval, and they may vary somewhat from the originally agreed measures. This is intended to encourage regular monitoring and evaluation of the reform program and its outcomes and to facilitate mutually agreed modifications to the reform program as implementation proceeds. These advantages of programmatic policy-based lending are increasingly recognized within the Bank. The draft Good Practice Note states: “A series of single-tranche loans, credits, or grants [i.e., a programmatic operation] is usually the best approach for supporting a well-specified medium-term program.” For IDA countries, the Poverty Reduction Support Credit (PRSC)—the new “gold standard” for IDA policy-based lending— is almost always a programmatic operation.
63. The Bank should recognize that most PBLs will need a rather substantial set of “mini-conditions” and should reinterpret its publicly stated intention to simplify and streamline the conditionality associated with its PBLs. The Bank itself and outside observers have routinely advocated such simplification and streamlining.³⁸ But, given the nature of typical reform programs, this intention will be consistently frustrated. If the Bank wants an agreement with the government about what will happen “on the ground” rather than merely on paper, there needs to be a rather elaborate set of “mini-conditions.” In this connection, it would be very helpful to create a clear vocabulary to distinguish between a few key measures, if any, that are regarded as essential to the reforms (for which failure to implement on schedule would likely trigger reductions in future loan amounts or withholding further disbursements of an on-going loan) and other measures that would be regarded more flexibly (for which failure to implement on schedule would not even need formal “waivers” from the Bank). The former category of measures should become formal conditions, and the others could be retained in the program documentation as “milestones” or “benchmarks.” The draft Good Practice Note on policy-based lending puts forward such a vocabulary and advocates the limited use of “conditions” but ample use of “milestones.”

³⁸ For example, the Bank’s 2001 Strategic Framework paper says (p. 10): “... we will streamline loan conditions—making them fewer, better targeted, and more realistic.” The issues paper prepared in anticipation of updating the Bank’s PBL guidelines (World Bank 2002) refers to the “Bank’s continuing efforts to make conditionality more focused and selective.” (p. 1) The Commission on the Role of the MDBs in Emerging Markets 2001 advocates that “To ensure that conditionality augments rather than undermines the effectiveness of MDB lending, the MDBs should simplify policy conditionality...” (p. 11).

64. A related point is that, at least with respect to non-crisis PBLs, the Bank should avoid tough rhetoric about its intentions to strictly enforce its conditionality and develop practices that favor modulating loan amounts rather than all-or-nothing disbursement decisions.³⁹ It should accept the fact that the typical reform programs are not amenable to “get tough” approaches to enforcing conditionality.⁴⁰ The progress of the reform program as a whole involves many small steps, which are usually inputs rather than outputs. Monitoring overall progress is hard. Probably not one of the detailed steps and the associated “mini-conditions” by itself can be used as a make-or-break conditionality. This, together with the need for flexibility noted above, usually makes it hard for the Bank to completely withhold disbursements or new commitments because the program is demonstrably off track. Instead, the Bank needs to develop a practice of modulating the amounts of lending within a programmatic framework in response to delays in or deviations from the agreed reform program.
65. The Bank ought to further amend its recent disclosure policy to require—not just encourage—that both the government concerned and the Bank publicly disclose the full documentation for PBLs, including the government’s Letter of Development Policy. Getting agreement on such an amendment would likely require an effort by Bank management to persuade borrowing governments that, as stated in the Good Practice Note, “the principle of country ownership of reform programs cannot be credible without such disclosure.”
66. To pursue its intention to use selectivity as an alternative to hard-core loan conditionality, the Bank needs to be clearer about its criteria for determining whether or not a country qualifies for policy-based lending. Beyond disclosing its CPIA and PBA systems for IDA countries, this means ensuring that CAS documents are always clear about which reforms are considered essential for the country’s development and would merit support through policy-based lending.
67. The Bank needs to keep the preparation of PBLs on very flexible timetables, resisting the internal pressures to get loans approved within a targeted fiscal year. This will avoid short-circuiting the necessary processes of designing a home-grown reform and building country ownership.
68. The Bank should seek to expand its offer of fee-based consulting services for the sorts of reforms that are now often associated with PBLs. This would provide governments the option of seeking the Bank’s analytical contributions and advice without having to take a loan, and it would allow Bank managers to offer such

³⁹ The Commission on the Role of the MDBs in Emerging Markets 2001 also proposed that “Once conditions are agreed upon the MDBs should be prepared to halt disbursements if governments fail to honor commitments.” (p. 11).

⁴⁰ Even if IBRD had leverage because of the government’s lack of alternative financing, Killick 1998 (p. 190) argues that hard-core conditionality might be applied effectively only for policy changes that are simple, easily monitored, and amenable to treatment as a precondition. That is seldom true with respect to the elements of institutionally complex reforms.

services without feeling that they must also push a loan in order to justify their use of staff time and budget.

69. Finally, the Bank needs to be clearer and more transparent—in its internal discussions and in public disclosures of its programs—about the factors determining the size of individual PBLs and the level of total PBL financing for each country. Unless there is greater clarity about the basis and rationale for PBL financing, there will be no basis for judging whether or not the financial benefits of the loan outweigh any potential non-financial costs. There are several possible approaches:

- One possibility is to require that policy-based lending is only used to finance reforms that have a near-term fiscal cost, and the size of each loan would be chosen to cover all or part of that cost over a certain period. This would have several important advantages. It would make clear that the Bank's involvement is warranted by the need to finance the costs of the reforms. It would lend credibility to a government's claim of country ownership of reforms because it eliminates the incentive for governments to adopt the Bank's recommendations on reforms for the sake of gaining uncommitted financial resources. In these ways, it would enhance the transparency and integrity to the instrument.
- A second approach would be to explicitly acknowledge and seek to legitimate the now-tacit objective of using PBLs to manage the level of a government's TDO to the Bank. In doing so, it would need to make the case within each CAS for the desired trend in the TDO—which implies making the case for the government's overall borrowing plans and the Bank's role within that plan—and also to discuss within the CAS to what extent the Bank might adjust the levels of PBLs to help the government cope with unexpected fluctuations in its demand for external financing. Furthermore, it would need to make clear within each CAS which areas of policy reform would be linked to possible PBLs, ensuring that the Bank is engaging on issues that are critically related to poverty reduction and sustainable development and not only on areas in which the government is already interested in reforms. To do otherwise would allow the lending objective to drive the policy dialogue rather than the other way around. If the Bank uses the offer of a PBL to buy a seat at the table, it should make sure that it is the right table.
- A third possibility, and probably the best approach, is to fully merge policy-based lending with budget support lending in the sense that loans would be linked both to an agreed set of policy and institutional reforms and a defined set of public expenditures within an agreed framework for overall public expenditures. In some respects, this is the direction in which the Bank has been heading in defining the approach to Poverty Reduction Support Credits (PRSCs).

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