IDA14

DEVELOPMENT POLICY OPERATIONS

A FRAMEWORK TO ASSESS COUNTRY READINESS FOR MAKING PRODUCTIVE USE OF DEVELOPMENT POLICY OPERATIONS

International Development Association
Operations Policy and Country Services

October 2006

ABBREVIATIONS AND ACRONYMS

CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CPAR	Country Procurement Assessment Report
CPIA	Country Policy and Institutional Assessment
DPO	Development policy operation
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IEG	Independent Evaluation Group
IMF	International Monetary Fund
OPCS	Operations Policy and Country Services
PEFA	Public Expenditure and Financial Accountability (Initiative)
PER	Public Expenditure Review
PFM	Public financial management
PRS	Poverty reduction strategy
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper

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EXECUTIVE SUMMARY

1. This report responds to a request by the IDA Deputies for a proposal for a framework to assess countries' readiness to make productive use of development policy operations (DPO). It draws on a review of recent experience, including the 2006 Development Policy Lending Retrospective,[1] and builds on over 20 years of experience with fast-disbursing lending. Although the term "Development Policy Lending" is widely used in Bank documents to refer to one of the two basic types of Bank lending instruments, this report uses the term "Development Policy Operations" to clarify that these operations are funded by both IDA credits and IDA grants, and to maintain consistency with the IDA14 Deputies' Report.

2. ***Objective of DPOs.*** DPOs encompass all Bank operations that provide rapidly disbursing policy-based financing to support a country's program of policy and institutional actions that promote growth and enhance the well-being and increase incomes of poor people. Building on the experiences accumulated during the 1980s and 1990s, a new comprehensive policy for development policy operations (known as Operational Policy 8.60) was adopted in August 2004. In replacing the previous guidelines, the Bank retired prescriptive passages on specific policy areas, such as privatization, financial sector reform, and public sector reform, because it had recognized that generalized prescriptions often fail and policies need to be country- and time-specific.

3. ***Readiness Considerations in Bank Lending.*** Current Bank policies and procedures imply assessment of readiness to make productive use of DPOs on two levels, the country assistance strategy (CAS) and the individual operation. The CAS allocates IDA resources across different instruments and sectors, and considerations about readiness for DPOs—including considerations regarding debt sustainability and absorptive capacity—feed into this strategic choice along with the country's financing requirements and its IDA allocation. According to the Bank's operational policy[2], DPO readiness is based on an assessment of the country's policy and institutional framework—including the country's economic situation, governance, environmental/natural resource management, and poverty and social aspects. The Bank also considers the strength of the program and the country's commitment to and ownership of the program against its track record. It assesses the country's institutional capacity and ability to implement effectively the program. Ultimately, the share and volume of DPOs in country programs reflect not only considerations of readiness to make productive use of DPOs (the main subject of this paper), but also (a) considerations about the complementarity of instruments in pursuing the same development objective, and (b) the potential productivity of alternative instruments in pursuing other development objectives.

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1 *Development Policy Lending Retrospective* (SecM2006-319), July 13, 2006.

2 OP/BP 8.60, Development Policy Lending, August 2004.

4. ***Corporate Oversight.*** To ensure broad corporate oversight of the strategic choices in CASs and DPOs, Bank processes require two corporate reviews of CASs and one corporate review of DPOs. These internal reviews—with a Bankwide distribution of documents—ensure input from all relevant Bank units for decisions on shares of financing instruments and performance benchmarks in CASs, and on authorizing appraisal of individual DPOs. CASs must be cleared by the responsible Managing Director (Operations) before they are distributed to the Board of Executive Directors.

5. ***DPO Shares***. During FY06, 26 percent of IDA commitments were for policy-based operations. DPO shares are projected to remain within a similar range during FY07. Distributional analysis using Country Policy and Institutional Assessment (CPIA) ratings suggests that under the existing framework the Bank has used DPOs selectively. For example, during FY98-06, less than 14 percent of IDA's commitments for policy-based operations have been made to the bottom 40 percent of the CPIA distribution.

6. ***Proposed Readiness Framework.*** Readiness to make effective use of DPOs reflects the likelihood that the borrower will implement the program as planned and that program actions will influence outcomes as expected. Policy research and reviews and retrospectives of policy-based lending suggest that readiness to make effective use of DPOs depends on three main factors: (a) the policy and institutional framework, (b) ownership, and (c) capacity (see below).

A Readiness Framework for DPOs

The proposed readiness framework builds on three pillars and a set of assessments that inform any summary readiness assessment. In particular, the following elements form key ingredients to make readiness assessments identified in the paper:

Policy and Institutional Framework

- Macroeconomic Policy Framework
- Budget Framework
- Public Financial Management and Fiduciary
- Governance Environment and Corruption
- Management of Distributional Effects
- Management of Environmental Effects
- Monitoring and Evaluation Framework
- Risk Management Framework

Ownership

- Track Record
- Participatory Processes and Consultation
- Political Economy

Capacity

- Program Design
- Program Implementation
- Program Monitoring and Evaluation

7. ***Assessing Readiness.*** The Bank has access to a variety of tools to assess readiness under this framework. Core elements of development policy operation preparation include assessments of the policy and institutional framework, in particular the macroeconomic policy framework;

the public financial management system; the management of distributional and environmental effects; the borrower's monitoring and evaluation framework, and the borrower's risk management framework. Regarding ownership, the Bank's assessment typically relies on the government's track record, indications of country ownership as expressed in participatory processes, and, at times, political economy analysis. The Bank and other donors frequently identify capacity constraints when designing, executing, and evaluating programs, and this analysis informs the design of the operation and triggers additional financial and technical support to address capacity bottlenecks.

8. ***Readiness Assessment and Country Circumstances.*** In practice, the Bank assesses a country's readiness to make productive use of DPOs in its CAS as well as at the level of the individual operation. In doing so, it weighs different readiness criteria against each other and, in deciding on a DPO engagement, weighs the resulting risks against the strength of the government program. Depending on country circumstances, different criteria may carry different levels of importance when reviewed against the potential benefits of engagement. For example:

- In *better-performing countries with recurrent DPOs*, the soundness of policy and institutions, including public financial management systems, would typically receive important weight in assessing readiness given the relevance of sound budgetary systems for achieving results. Strong ownership, evidenced by a good track record, and relatively strong capacity levels are also important considerations under such medium-term engagements.

- In medium-term engagements for *sectoral DPOs*, similar considerations apply, but considerations regarding ownership of the reform program may be more narrowly focused on the sectoral aspects of the program rather on the broad countrywide situation. In a *subnational DPO* setting, the policy and institutional framework of the subnational government, as well as its reform ownership and capacity, receive close attention.

- *DPOs in post-conflict countries and after rapid policy shifts* may offer important immediate benefits by restoring state functions or strengthening incipient reforms. Against such benefits, the Bank may be willing to take higher risks signaled by significant weaknesses in policy and institutions and capacity, as long as ownership of the program is strong.

- *Gradual improvers* may occasionally offer opportunities for engagement in policy areas where a consensus is emerging. Typically, in these cases there are still considerable weaknesses in the policy and institutional framework and in capacity, and a lack of universal ownership. However, anticipated benefits of deepening and enhancing policy reforms in select areas with a small financial engagement may at times outweigh such risks.

- *Crisis and external shocks* may require a reassessment of the appropriate volumes of DPO support for any given readiness level, provided that the government displays sufficient ownership and commitment to use the additional resources in a way that contravenes the crisis and shock and delivers the intended benefits.

- *Deteriorating governance and conflict situations* would typically not be conducive to making productive use of DPOs unless a significant shift in policy stance occurs.

9. ***Implementation of the Framework.*** The Bank has the capacity and tools to review different elements of the readiness framework during preparation of CASs and DPOs using widely available analytic work for IDA countries. As was recently emphasized in the Development Policy Lending Retrospective, the Bank's use of DPOs has been selective, and the overall policy framework is robust, although some elements of the framework—notably the tracking of progress in public financial management and the upstream use of poverty and social impact analysis—may require additional strengthening during implementation. The framework will continue to rely on strong corporate oversight, including mandatory corporate review for DPO and CASs, senior management clearance of CASs, and Board discussion of CASs and DPOs, except follow-on operations in a programmatic series.

10. ***Readiness Framework and DPO Shares.*** Many elements of the readiness framework rely on country knowledge and do not lend themselves to the establishment of a summary numerical indicator that could be linked to an "appropriate" share of DPOs. Taken together, these factors suggest that the appropriate share of DPOs will remain tied to a qualitative assessment within a framework of tight corporate oversight. Past experience suggests that within such a framework, IDA's DPO commitments have been predominantly geared toward better performers, with selective engagements in weaker environments.

11. ***Monitoring Shares and Effectiveness of DPOs.*** The Bank monitors the effectiveness of DPOs, using its own work and independent or external evaluations of budget support instruments. A new DPO retrospective is planned for FY09, giving a second progress report on implementation of the new DPO policy adopted in August 2004. As in FY05 and FY06, the Board will receive annual updates on past and projected three-year rolling averages of the share of DPOs for the Bank, and will be alerted if IDA's share for any given year is projected to exceed 30 percent (excluding resources used to repay bridge financing to clear arrears in countries reengaging after prolonged periods of inactivity). The Board will have the opportunity to give guidance to Management on DPO volumes at the time of the annual discussion on the Medium-Term Strategy and Finance paper.

DEVELOPMENT POLICY OPERATIONS

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I. INTRODUCTION

1. At the Fourteenth Replenishment of IDA, Deputies noted that the commitment volume of development policy operations (DPOs) should remain below 30 percent of total IDA commitments for the IDA14 period.[1] As a basis for further discussion on IDA's development policy operations (DPO) volumes, Deputies requested that by the Mid-Term Review they receive a "proposal for a framework to assess the readiness of countries to make productive use of development policy operations, based on a systematic review of experience."[2] This paper sets out such a framework, drawing on a recent Development Policy Lending Retrospective and a wealth of other analytic work conducted over more than 20 years on adjustment lending and budget support by the Bank and by the donor community in general. Although the term "Development Policy Lending" is widely used in Bank documents to refer to one of the two basic types of Bank lending instruments, this report uses the term "Development Policy Operations" to clarify that these operations are funded by both IDA credits and IDA grants, and to maintain consistency with the IDA14 Deputies' Report.

2. ***Objective of Development Policy Operations.*** DPOs encompass all Bank operations that provide rapidly disbursing policy-based financing. As defined in the Bank's policy in place since August 2004, the overarching objective of DPOs is to support a country's economic and sectoral policies and institutions aimed at accelerated sustainable growth and efficient resource allocation to enhance the well-being and increase the incomes of poor people. To this end, DPOs typically support a program of policy and institutional actions and finance the borrower's overall budgetary expenditures, except for a limited number of items on a standard list of excluded expenditure (negative list).

3. ***History of Fast-Disbursing Lending.*** Although the Bank had granted fast-disbursing program loans to member countries since its inception under the special circumstances rationale,[3] a policy framework for structural adjustment lending was set out for the first time in May 1980.[4] Structural adjustment lending objectives were originally defined as assisting countries in "modifying the structure of an economy so that it can maintain both its growth rate and the viability of its balance-of-payments in the medium term."[5] The number of adjustment policy instruments was over time enhanced with the creation of sectoral adjustment lending to support sectoral reform processes and a variety of options, such as special adjustment lending for middle-

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1 Resources to repay bridge financing in arrears clearance cases would be excluded from this ceiling.

2 *Additions to IDA Resources: Fourteenth Replenishment – Working Together to Achieve the Millennium Development Goals* Report from the Executive Directors of the International Development Association to the Board of Governors, March 10, 2005.

3 Before 1980 Bank management assumed that program lending might amount to 7 to 10 percent of total lending commitments, see A Note on Program Lending (SecM80-150), February 29, 1980.

4 Structural Adjustment Lending (R80-122), May 9, 1980. All fast-disbursing lending has been and continues to be justified under the special circumstances provision of the Bank's Articles of Agreement.

5 Operational Manual, Statement No. 3.58, Annex II, November 1982.

income countries in crisis. Both the Bank's Independent Evaluation Group and policy departments have at regular intervals reviewed experiences with the lending instruments, leading to refinements of policies, broadening of objective, and evolution of its application over time.[6]

4. ***Evolution of Fast-Disbursing Lending Instruments.*** The Bank's lending instruments for fast-disbursing lending evolved during the1990s in response to lessons learned in the application of first-generation adjustment lending focused on short-term balance-of-payment support. The new paradigm involved greater focus on poverty reduction, sustained support for policy and social programs, and capacity and institution building. Also, in response to research findings and studies suggesting that programs without sufficient ownership are more likely to fail, the Bank began highlighting the importance of adapting its support to a country's development priorities and implementation capacity. Important milestones in reflecting these lessons were the introduction of programmatic adjustment lending in 1999 and the launch of poverty reduction support credits (PRSCs) in 2001 to support poverty reduction strategies (PRSs).[7]

5. ***Programmatic Approach.***[8] The programmatic approach involves a series of operations with a single tranche that are sequentially presented to the Bank's Board, with a medium-term framework specified at the outset—including completed prior actions, monitorable progress indicators, and expected prior actions (triggers) for subsequent operations.[9] This approach combines the discipline of a medium-term framework with triggers for subsequent operations that offer the flexibility to accommodate the unpredictability and uncertainty of complex policy reforms. Unlike traditional multitranche operations, which relied on promises for future actions to justify disbursements, each single-tranche loan under a programmatic approach is approved following actual performance—that is, on the basis of already completed actions—and thus contributes to systematic policy implementation.[10] Typically, programmatic lending is used to support complex medium-term institutional reforms. To the extent possible, programmatic approaches align disbursements with the borrowing country's financing needs during the annual budget cycle. In low-income countries, the PRSC is a programmatic development policy credit

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6 For example, *Structural Adjustment Lending: A First Review of Experience*, Operations Evaluations Department, Report No. 6409, September 9, 1986; *Report on Adjustment Lending II: Policies for the Recovery of Growth,* (IDA/R90-49), March 1990; *The Third Report on Adjustment Lending: Private and Public Resources for Growth* (IDA/R92-29), March 1992; *Structural and Sectoral Adjustment: World Bank Experience, 1980-92,* Report No. 14691, Operations Evaluations Departments, June 1995, and *Adjustment Lending Retrospective* (SecM2001-215), April 2, 2001.

7 PRSCs were designed as a separate adjustment lending instrument to support the implementation of PRSs in low-income countries through programmatic adjustment operations. Their objective was to (a) help operationalize and finance a medium-term program to implement the PRS, (b) improve resource predictability, and (c) provide a framework for donor harmonization. *Poverty Reduction Support Credits: A Stocktaking* (IDA/SecM2005-238.), April 29, 2005, reviews the Bank's experiences with this instrument.

8 World Bank, Programmatic Adjustment Lending Retrospective (Report 26315), OPCS, March 2004.

9 See OP8.60, Development Policy Lending, para.14.

10 Experience with the programmatic approach to date suggests that it has been robust and effective in a wide range of country circumstances, largely because of the design features that have provided sufficient flexibility to facilitate a stronger focus on results, participation, and harmonization; see World Bank, *Programmatic Adjustment Lending Retrospective* (Report 26315), OPCS, March 2004.

or grant designed to assist well-performing countries in implementing their poverty reduction strategy.[11]

6. ***From Adjustment Lending to Development Policy Lending.*** Building on the experiences accumulated during the 1980s and 1990s, a new comprehensive policy for development policy operations (known as Operational Policy 8.60) was adopted in August 2004. It replaced and unified all previous adjustment lending policies and instruments.[12] In replacing the previous guidelines, the Bank retired prescriptive passages on specific policy areas, such as privatization, financial sector reform, and public sector reform, because it had recognized that generalized prescriptions often fail and policies need to be country- and time-specific. Development policy operations explicitly aim at supporting a country's program of policy and institutional actions to promote growth and achieve sustainable reductions in poverty. These programs are expected to be based on country and sectorwide analytic work (carried out by the country itself, third parties, or the Bank); in addition, operations need to assess the country's fiduciary arrangements; the policy effects on its environment, including forests and other natural resources; and the likely poverty and social impacts of key policies supported by the operation. As regards conditionality, the new operational policy mandates that conditions should be confined to those actions that are critical for implementing the country's program to achieve the expected results. Programs supported under the new operational policy are expected to reflect consultation with stakeholders in the country, and to include a results framework that allows adequate monitoring and evaluation.

7. ***Readiness Considerations in Bank Lending.*** Current Bank policies and procedures imply assessment of readiness to make productive use of DPOs on two levels, the country assistance strategy (CAS) and the individual operation. The CAS allocates IDA resources across different instruments and sectors, and considerations about readiness for DPOs—including considerations regarding debt sustainability and absorptive capacity—feed into this strategic choice along with the country's financing requirements and its IDA allocation. According to the Bank's operational policy[13], DPO readiness is based on an assessment of the country's policy and institutional framework—including the country's economic situation, governance, environmental/natural resource management, and poverty and social aspects. The Bank also considers the strength of the program and the country's commitment to and ownership of the program against its track record. It assesses the country's institutional capacity and ability to implement effectively the program. However, whereas readiness considerations for DPOs can identify the risks associated with using the DPO instrument in a particular country setting, they do not necessarily suggest that other financing instruments are less risky or have a higher chance of succeeding in delivering sustainable development outcomes. Ultimately, the share and volume of DPOs in country programs therefore reflect not only considerations of readiness to make productive use of DPOs (the main subject of this paper), but also (a) considerations about the complementarity of instruments in pursuing the same development objective, and (b) the potential productivity of alternative instruments in pursuing other development objectives. Where current circumstances do not suggest that IDA resources can be fully used in a productive

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[11] World Bank, *Poverty Reduction Support Credits: A Stocktaking* (IDA/SecM2005-0238) OPCS, May 26, 2005.

[12] World Bank, *From Adjustment Lending to Development Policy Lending: Update of World Bank Policy* (R2004-0135), OPCS, July 15, 2004.

[13] OP/BP 8.60, Development Policy Lending, August 2004.

manner by any Bank instrument, the CAS can limit commitment volumes below the level of the IDA allocation and indicate through performance triggers the circumstances under which the Bank would consider increasing financing volumes within the level of the IDA allocations. Similarly, CAS performance indicators can be linked to particular DPO readiness concerns and may allow for increasing DPO shares within a CAS period as an integral part of the Bank's strategy.

8. ***Corporate Oversight.*** To ensure broad corporate oversight, the Bank's processes require two corporate reviews of CASs and one corporate review of DPOs. These internal reviews—with a Bankwide distribution of documents—ensure input from all relevant Bank units for decisions on shares of financing instruments and performance benchmarks in CASs, and on authorizing appraisal of individual DPOs. CASs must be cleared by the responsible Managing Director (Operations) before they are distributed to the Board of Executive Directors. It is expected that results and recommendations of the ongoing IDA control review will serve to further strengthen internal risk controls for IDA.

9. ***DPO Share in Bank Commitments.*** The share of policy-based financing commitments by IBRD and IDA has fluctuated over time (see Figure 1). IBRD's policy-based lending share spiked as a result of crisis lending during FY02, whereas IDA's share fell sharply in FY04 during a rapid acceleration of IDA financing for investment operations. During FY06, IBRD's share of policy-based lending was 34 percent, and IDA's share stood at 26 percent.[14] The operational policy change in 2004 removed the prior 25 percent ceiling for the Bankwide share of policy-based financing commitments.[15] However, Management committed to report annually in a separate paper to the Board, at the same time as the Medium-Term Strategy and Finance paper and Credit Risk and Loan Provisioning paper, on the anticipated share for policy-based commitments on a three-year rolling average, giving Executive Directors an opportunity to approve a guideline for the share of DPOs.[16] Management also monitors separately the anticipated share of DPO commitments by IDA and would seek guidance from IDA Executive Directors if the projected share of IDA DPO commitments exceeded 30 percent for any given year (excluding resources committed to countries reengaging with IDA for the purpose of repaying bridge financing used to clear arrears). It is currently not expected that IDA's DPO share will exceed 30 percent in FY07 or FY08.

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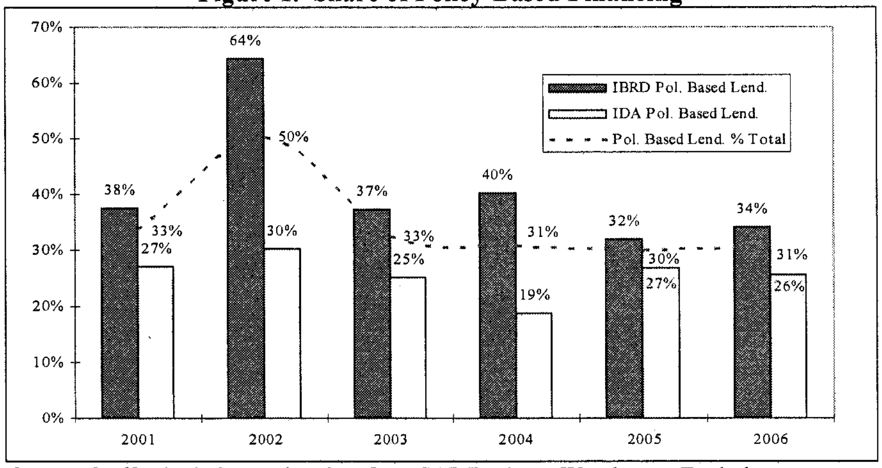
[14] IDA shares in Figure 1 include any resources to repay bridge financing for arrears clearances.

[15] The limit in the policy had been exceeded in actual lending for several years, and thus was deemed not practical. See World Bank, *From Adjustment Lending to Development Policy Lending: Update of World Bank Policy* (R2004-0135), OPCS, July 15, 2004 for a detailed explanation.

[16] *FY05-07 Outlook for the Bankwide Share of Development Policy Lending, First Annual Report* (SecM2005-128), March 17, 2005, and *FY06-08 Outlook for the Bankwide Share of Development Policy Lending, Annual Report* (SecM2006-140), April 5, 2006.

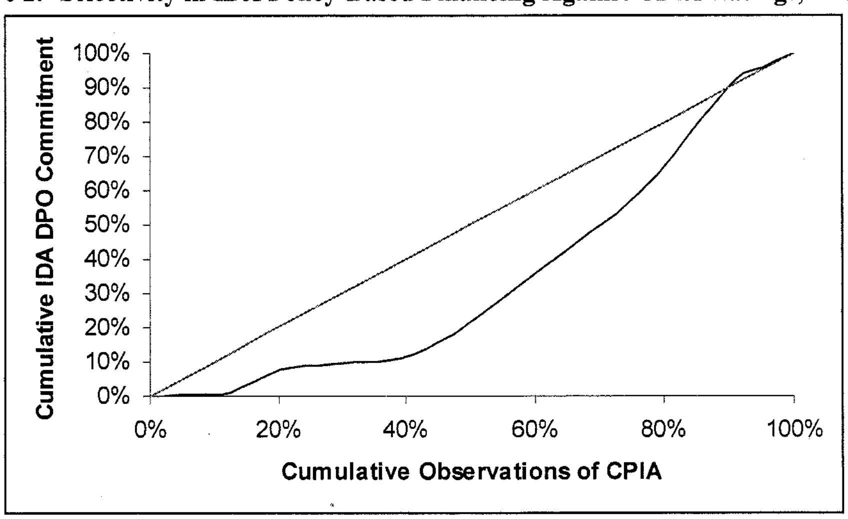
Figure 1. Share of Policy-Based Financing



Source: Staff calculations using data from SAP Business Warehouse. Excludes guarantees.

10. ***Selectivity of DPOs.*** Distributional analysis of Country Policy and Institutional Assessment (CPIA) ratings and commitments for policy-based operations suggest that the Bank is selective in its use of policy-based financing (see Figure 2). A significantly larger share of policy-based commitments is made to countries in the upper range of the distribution of CPIA ratings. Bankwide, less than 7 percent of commitments for policy-based operations have been made to the bottom 32 percent of the CPIA distribution during FY98-06, and less than 17 percent of commitments to the lowest 45 percent of the CPIA distribution. Selectivity considerations are even more evident for IDA countries, where less than 14 percent of IDA policy-based commitments during FY98-06 have been made to the bottom 40 percent of the CPIA distribution. At the same time, some fairly limited resources (9.6 percent of total policy-based IDA financing), including for cases to repay bridge financing used to clear arrears, have been committed to countries with a CPIA below 3.0, mostly to support countries emerging from conflict, experiencing rapid changes in policy environments or engaging in a new policy reform agenda.

Figure 2. Selectivity in IDA Policy-Based Financing Against CPIA Ratings, FY98-06



Source: Staff calculations.

11. ***Structure of the Report.*** This report is organized in five sections. Section II outlines a set of key considerations for development policy operations as a framework for assessing a country's readiness to make productive use of DPOs. Section III discusses operational aspects of these different considerations and different challenges in applying them, drawing on recent experiences and prior evaluations of adjustment operations. Section IV reviews challenges and examples in arriving at a summary judgment in determining the readiness for development policy operations in different types of country circumstances. The last section sets out conclusions.

II. A READINESS FRAMEWORK FOR DEVELOPMENT POLICY OPERATIONS

12. The effectiveness of any Bank financing instrument depends on the likelihood that the borrower[17] will implement activities as planned and that these activities will influence the outcomes as the borrower and the Bank anticipated at the outset.[18] Within this broad context, this section outlines key considerations that affect the likelihood that DPOs will achieve their intended objectives, as a framework for assessing a borrower's readiness for making productive use of DPOs.

13. ***DPO Approach.*** DPOs rely on the strength of a government's program and on government program implementation to achieve program objectives. DPOs support the implementation of policy and institutional actions as part of an overall government program—in IDA countries set out in a Poverty Reduction Strategy Paper (PRSP)—with the ultimate objective of sustainable reductions in poverty. By focusing on policy and institutional actions, DPOs can help address—in a sequential way—weaknesses in the country's systems that may hamper the achievement of government objectives. At the same time, by providing financing for the government's budget, DPOs can assist governments with delivering their services or implementing policies in support of the program targets.

14. ***Readiness Pillars.*** Because DPOs rely on the strength of the government's programs and policy implementation (including budget execution) for achieving the development objectives, the likelihood of their achieving their intended results, and the associated risks of the instrument, are closely linked to three areas: (a) the country's policy and institutional framework, including the effectiveness of the government in spending budgetary resources consistent with program objectives; (b) the country's ownership of the program; and (c) the government's capacity to take program actions as planned and monitor program implementation. These three pillars are closely intertwined, but nonetheless represent separate reflections of a country's strengths and weaknesses in implementing a program (see Figure 3 for a schematic representation). Over many years, academic research, Bank retrospective studies, and the work of the Bank's Independent Evaluation Group (IEG) have identified these three aspects as key factors in the success of policy-based operations (Box 1 offers an overview of some findings in some earlier studies).

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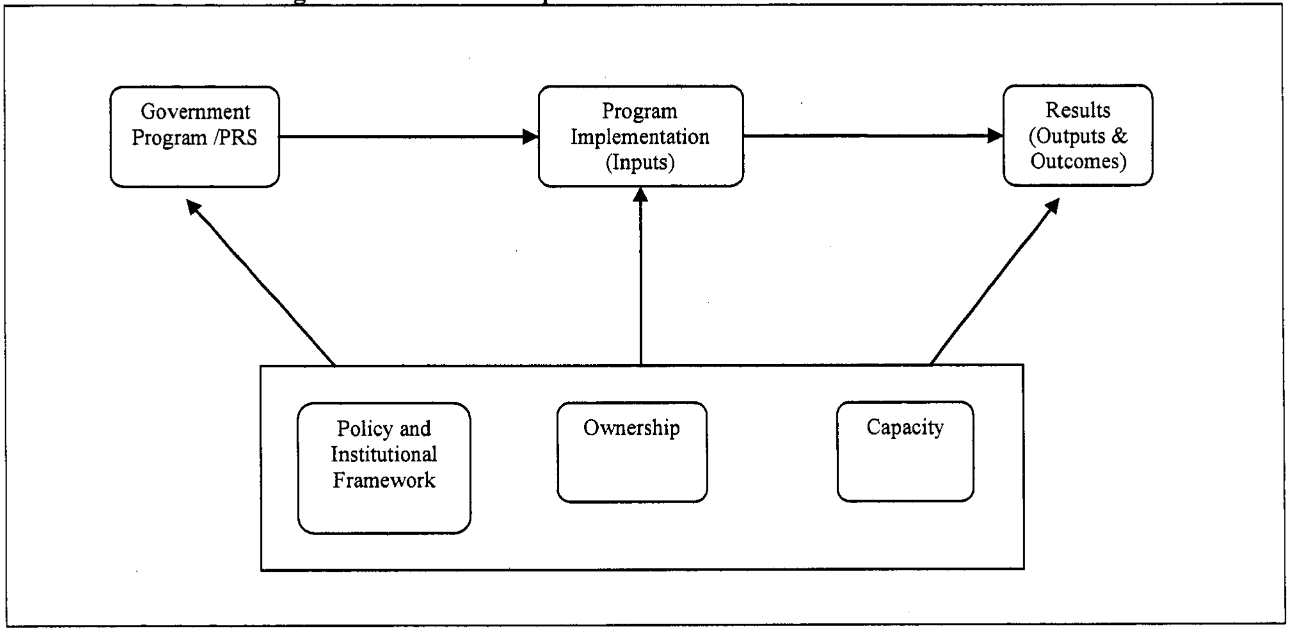
17 The term borrower here is understood to encompass recipients both of IDA credits and of IDA grants.

18 These and other dimensions are also reflected in the ratings of the Bank's Implementation Completion and Results (ICR) Reports.

Figure 3. Schematic Representation of the Readiness Framework



Box 1. Analytic Findings on Readiness Considerations for Policy-Based Lending 1986-1995

In 1986, the Bank's Operations Evaluation Department (now known as the Independent Evaluation Group) concluded that the "Bank needs to assess the commitment of the important agencies concerned and, to the extent possible, assist countries to forge a consensus on the reforms that are to be undertaken." The study also advised that country capacity was frequently not properly assessed and was overtaxed by the complexity and the wide-ranging conditionality of many of the first structural adjustment loans (*Structural Adjustment Lending: A First Review of Experience,* Operations Evaluations Department, Report No. 6409, September 9, 1986).

In 1988, a review of adjustment lending noted three prerequisites for adjustment lending: (a) the Bank and the government should reach an understanding on the diagnosis of the main impediments to growth and on the program, including short-term stabilization and longer-term development objectives; (b) the government must own the program, understand it, and fully accept it; and (c) the program must be realistic in being restrictive enough to reflect available financing but not so restrictive as to prove socially and politically unacceptable (*Adjustment Lending: An Evaluation of Ten Years of Experience*, Policy and Research Paper Series No. 8022, December 1988). Progress reports in 1990 and 1992 stressed the important prerequisite of macroeconomic stability and additional implementation issues regarding growth, poverty and distributional effects, and the importance of public sector spending allocations and public sector reforms (*Report on Adjustment Lending II: Policies for the Recovery of Growth,* (IDA/R90-49), March 1990; *The Third Report on Adjustment Lending: Private and Public Resources for Growth* (IDA/R92-29), March 1992).

A 1995 report by the Operations Evaluation Department stressed the importance of macroeconomic stability and ownership for program success. It highlighted that political stability, support of various constituencies, and, to a lesser extent, official attitudes toward certain reforms were predictors of ownership. The report suggested that important operational policy considerations were (a) the understanding of a country's political system; (b) attention to track record; (c) focus on policy areas with consensus; and (d) explicit consideration of institution building. The report highlighted that programs with favorable initial conditions, such as strong institutions, perform better. It also suggested that adjustment lending may be inappropriate for countries recovering from war and natural disasters, and for those with drastic changes in political systems. Finally, it concluded that types and balance of lending instruments should depend on country conditions, and decisions on them should be taken in Country Assistance Strategies. (*Structural and Sectoral Adjustment: World Bank Experience, 1980-92,* Report No. 14691, Operations Evaluations Departments, June 1995).

15. ***2001 Adjustment Lending Retrospective.*** A comprehensive discussion of readiness considerations in the 2001 Adjustment Lending Retrospective gave the following main findings:[19]

- Research findings of the late 1990s indicate a significant positive relationship between *country policy and institutional characteristics* and success rates of policy-based lending. Although lending itself may not initiate policy reform, it can help leverage the benefits of policy improvement once a reform process is under way and reforms are accelerating. The Bank took such links into account to the extent that commitments for policy-based lending during FY95-00 were geared predominantly toward better performers as measured against the CPIA ratings. (This selective use of policy-based lending was reconfirmed for the FY98-05 period in the 2006 Development Policy Lending Retrospective.[20]) Moreover, the 2000 Annual Review of Development Effectiveness found that all lending instruments—policy-based lending and investment lending alike—perform better in better policy environments, and that policy-based loans had consistently higher rates of satisfactory outcomes even in weaker policy environments.[21] This finding, which has been reconfirmed for operations exiting during FY00-05,[22] suggests that current choices of lending instruments within country lending envelopes are consistent with maintaining high quality at exit, and, although facing greater risks, policy-based lending may work even in weaker environments, as long as ownership of a program and commitment to its implementation are strong.

- *Ownership and commitment* are the most critical condition for ensuring the success of reforms supported by policy-based lending.

- It is essential to consider the government's *capacity* to carry out the reform program to be supported. Of particular importance are appropriate implementation arrangements, adaptation of the design to country capacity, and realism of policy actions and their timing and sequencing.

16. ***Recent Studies on Effectiveness of Budget Support.*** Recent studies indicate that assessing readiness in the three areas described above, with careful consideration of the strengths and weaknesses of programs, ownership, and capacity, combined with an approach to directly address weaknesses in government systems under the supported program, can make budget support an effective aid instrument.[23] Two recent studies indicate that PRSP processes may help focus government spending on priority areas and affect budget processes and allocations, and that budget support, when combined with nonfinancial inputs, has proven effective in assisting

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19 *Adjustment Lending Retrospective* (SecM2001-215), April 2, 2001.

20 *Development Policy Lending Retrospective* (SecM2006-319), July 13, 2006.

21 *2000 Annual Review of Development Effectiveness: From Strategy to Results, Independent Evaluation Group, Washington, D.C.: World Bank, 2005.*

22 *Development Policy Lending Retrospective (SecM2006-319), July 13, 2006.*

23 The term *budget support* in this context is typically understood to characterize recurrent policy-based financing of a government's general budget expenditure.

efforts to strengthen public financial management (PFM) systems and outcomes.[24] A recently concluded broad multiyear study on general budget support in seven countries notes that budget support can be an efficient, effective, and sustainable way of supporting national PRSs, and that it can strengthen ownership, have positive effects on allocative and operational efficiency of public expenditures, and increase the general quality of aid.[25] It also finds that benefits are less conclusive in a country with a weaker policy environment and one with more volatile conditions for policymaking. This finding echoes the 2003 Annual Review of Development Effectiveness on policy reform, which emphasized that the Bank was successful when linking its support with good or improving policy environments, but was less successful when it linked its support to policy reforms in countries with weak (or no) track records or with deteriorating policy environments.

A. Policy and Institutional Framework

17. Research has confirmed that country policies and institutions affect the quality of the program, program implementation, and the likelihood for DPO financing to have the intended results. The policy and institutional framework thus sets the stage for government efforts to change development outcomes as intended. Economic policies, the governance and PFM framework, the policy setting for managing any adverse effects of policies, the risk management framework, and the institutions for monitoring and evaluating the program are part of any consideration of the policy and institutional framework.

18. ***Economic Situation.*** A country's economic situation, in particular its macroeconomic policy framework and its need to finance its development program, affect its ability to achieve the objectives of any program supported by DPOs. Inappropriate macroeconomic policies—for example, policies leading to persistently high inflation and large fiscal deficits—make it much less likely that Bank financing will achieve the intended objectives. Similarly, programs with residual financial needs that cannot be met in a noninflationary way are not likely to achieve their objectives.

19. ***Governance.*** Governance in its different dimensions affects the likelihood that DPOs will have productive outcomes. The first and most direct governance area is the public sector, which plays a core role in the direct implementation of the program. Foremost among public sector governance considerations for DPOs is the PFM system, which determines how resources are allocated, spent, and accounted for. Weaknesses in this area—from inefficient spending and procurement to outright fraud and corruption—directly increase the risks for achieving program objectives. Other areas of public sector governance include the framework for managing the public administration, the relations between national and subnational governments, and more generally the country's legal and judicial framework. The potential productivity of DPOs would also be affected by the institutions and policies governing private sector activities, such as laws and regulations that can hamper the private sector response to incentives and thus reduce the

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24 Rosa Alonso, Lindsay Judge, and Jeni Klugman, "PRSPs and Budgets: A Synthesis of Five Case Studies" and Tim Williamson, "General Budget Support and Public Financial Management Reform: Emerging Lessons from Tanzania and Uganda," in *Budget Support as More Effective Aid? Recent Experiences and Emerging Lessons*, Stefan Koeberle, Zoran Stavreski, and Jan Walliser, Washington, D.C.: World Bank, April 2006.

25 *Evaluation of General Budget Support: Synthesis Report*, International Development Department, University of Birmingham, and Associates, May 2006.

likelihood that government interventions (such as expenditure on infrastructure or government services) will have the intended effect on growth, output, and incomes.

20. ***Managing Adverse Program Effects.*** Adverse distributional effects or adverse effects on the environment and natural resources can reduce the likelihood of meeting development objectives. If growth-enhancing policies have adverse distributional implications, this may reduce their poverty-reducing impact. Similarly, a negative effect on natural resources could undermine the sustainability of government policies aiming at growth and poverty reduction.

21. ***Monitoring and Evaluation.*** Institutional arrangements to monitor progress under the program and adjust implementation on the basis of evidence are an essential element for successful program implementation. Without regular monitoring and evaluation, lessons of experience cannot be incorporated, and targets may be missed because necessary adjustments to the program have not been identified and made.

22. ***Managing Risks.*** Government policy implementation is subject to a variety of risks, including external shocks such as natural disasters, conflict, or fluctuations in export prices. The institutions and policies in place typically affect how successfully a government can manage these risks and keep program objectives in reach even in face of adverse conditions.

B. Ownership

23. Experience shows that ownership is a key ingredient for the success of supported programs. Ownership is a concept that denotes the likelihood that a government will implement a program as planned, even if there is opposition. It also influences the likelihood that actions will not be undermined or reversed in the future, and thus increases the chance that targeted outcomes will not only be achieved but also be sustained. Long-term experience also shows that conditionality cannot replace ownership and that reforms cannot be "bought."[26]

C. Capacity

24. Even where the policy and institutional framework is sound and government ownership strong, a program may not achieve its results if the government lacks capacity to design, execute, monitor, and evaluate the program. Government capacity influences the quality of program implementation and is a key element in translating sound policies and institutions into activities and in successfully extracting lessons from experience. Program design, and the level and form of external support, therefore must take into consideration any capacity constraints of the government.

III. EVALUATING READINESS

25. In gauging a country's readiness for DPOs, Bank and country staff need to candidly assess each of the different pillars to arrive at an overall judgment. This section reviews some dimensions along which these elements are typically evaluated and refers to recent experiences in making these assessments.

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[26] *Review of World Bank Conditionality* (SecM2005-361), June 20, 2005, and Development Committee Communiqué, September 25, 2005.

A. Assessing the Policy and Institutional Framework

26. In assessing the key elements of the policy and institutional framework, the Bank draws on its own analysis and analysis by government and third parties. In joint budget support settings, assessments with other donors, such as joint fiduciary documents and the Public Expenditure and Financial Accountability (PEFA) program are increasingly common analytic underpinnings, allowing a common view on key readiness aspects.

27. ***Macroeconomic Policy Framework.*** In the DPO context, good practice suggests that the assessment should review the sustainability of external and fiscal balances, and the contribution of the supported reform program and Bank financing to sound macroeconomic policies and growth.[27] Such an assessment by the Bank takes into account the Bank's own projections and the IMF's views but is not necessarily tied to the existence of an IMF program. When the macroeconomic policy framework is not appropriate (for example, there are policies that perpetuate a highly inflationary environment), DPO financing is unlikely to achieve its objectives and is therefore not appropriate.[28] Recent experience suggests that the Bank routinely and systematically assesses macroeconomic policy frameworks in all its DPOs, drawing on debt sustainability projections under the debt sustainability framework with the IMF and systematically reporting on IMF views on macroeconomic policies.[29] Moreover, as part of its assessment of the macroeconomic policy framework, the Bank ascertains that the program is fully financed with the Bank's contribution, assuring the realism of the proposed program.

28. ***Budget Framework.*** The Bank regularly reviews countries' budgetary frameworks to ascertain that the overall resource allocations proposed in the budget are consistent not only with sound macroeconomic policies but also are likely to support the government's poverty reduction objectives. In many IDA countries, therefore, as part of the preparation of DPOs the Bank discusses the contents of the government budget and medium-term expenditure framework as well as budget outturns. Moreover, in most countries with DPO involvement the Bank, with government and other donors, undertakes regular public expenditure reviews (PERs) to assess the efficiency of expenditure allocations. A decision for DPO financing would generally rely on congruence between the strategic objectives of the program and the resources allocated for achieving these objectives.

29. ***Public Financial Management and Fiduciary Considerations.*** For DPOs the Bank and the borrower agree on a standard and limited set of items for which the resources may not be used (negative list), but otherwise Bank resources are normally made available for financing a country's budgetary expenditure. Hence, any assessment of fiduciary arrangements for DPOs and of the attendant risks of the borrower's capacity to receive and manage the resources must take a holistic view of a country's entire PFM system and environment.[30] As highlighted in the

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27 "Designing Development Policy Operations," in *Good Practice Note for Development Policy Lending,* Operations Policy and Country Services, World Bank, October 2004.

28 Adherence to a sound macroeconomic policy framework has been considered essential for achieving the results of policy-based lending since the inception of the adjustment lending instrument.

29 Development Policy Lending Retrospective (SecM2006-319), July 13, 2006.

30 A similar vision applies to resources made available under the multilateral debt relief initiative, which are also allocated through country's own budget management systems. Moreover, for subnational DPOs, the PFM environment of the subnational government must be considered.

good practice note for financial management in DPOs,[31] the Bank therefore reviews country PFM systems as part of DPO preparation. This review draws on (a) the analysis of existing systems for budgetary and foreign exchange management; (b) an assessment of the strength of the government's program to address identified PFM weaknesses and progress in implementing it; and (c) a judgment on the government's commitment to implement any such program. A number of standard analytic tools—including the Country Financial Accountability Assessment (CFAA) and the Country Procurement Assessment Report (CPAR)—are available for almost all IDA countries where DPOs are being considered and are the main sources of country knowledge on PFM systems. The Bank is now also moving to integrated assessments with other donors under the Public Expenditure and Financial Accountability (PEFA) program, which relies on a set of 28 indicators. As regards foreign exchange management, in most IDA countries the Bank can draw on the IMF's safeguard assessments of the central bank. The Bank does not use the level of any single indicator or rating of the PFM environment to come to a conclusion on the country's readiness but instead weighs the risks of engagement against the potential benefits of addressing weaknesses directly under the program as long as credible progress is made in a timely manner. Recent experience indicates that such an approach, which is similar to the approaches of other development partners such as the European Commission, has resulted in (a) systematic evaluation of PFM systems under Bank operations in IDA countries; (b) integration of reform programs for PFM systems in virtually all DPOs in IDA countries; and (c) reporting on program implementation in subsequent operations. The Development Policy Lending Retrospective suggests that the Bank can further strengthen this approach by (a) more systematically referring to the Bank's assessment of the strength of PFM programs and their timely implementation; (b) better tracking of progress over time, including with PEFA indicators; and (c) ensuring a fuller discussion of residual fiduciary risks.[32]

30. ***Broader Governance Considerations.*** The Bank regularly evaluates the broader governance environment for DPO implementation—such as public administration and civil service, the legal and judiciary framework, and the regulatory framework for private sector activities[33]—all of which affect the potential impact of DPO financing. An increasing number of analytic tools and indicators are available for IDA countries on the private sector regulatory environment and incentives, such as investment climate assessments (ICA), Doing Business indicators. Drawing on these indicators, the Bank assesses the likelihood that the country will successfully implement the program and use financing productively to enhance growth and reduce poverty. Typically, weaknesses in this broader governance area would be covered under the policy dialogue, and time-bound actions to address weaknesses in the governance framework would be reflected in the program.

31. ***Managing Distributional Effects and Effects on Vulnerable Groups.*** Some government policies, although contributing to economic efficiency and growth, may at the same time harm certain groups of the population and worsen income differences. As part of assessing the country's readiness to make productive use of DPOs, it is Bank policy to review the likelihood

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31 "Financial Management Issues in Development Policy Lending," in *Good Practice Note for Development Policy Lending,* Operations Policy and Country Services, World Bank, October 2004.

32 *Development Policy Lending Retrospective* (SecM2006-319), July 13, 2006.

33 For a broader discussion of governance and anticorruption issues and the Bank's approach, see Strengthening the Bank Group Work in Governance and Anticorruption (R2006-155), July 31, 2006.

that policies supported under the program have distributional effects or affect vulnerable groups. In case such effects are significant and likely, the Bank assesses the potential borrower's policy and institutional framework for reducing negative effects and enhancing positive effects under the program and identifies any knowledge gaps.[34] The readiness to make productive use of DPOs would depend on the inclusion of measures in the program to reduce any likely and significant negative distributional effects (and enhance positive effects), and to address analytic gaps in a timely manner. Most recent operations discuss distributional impacts and, where warranted, include a discussion of how the program can address them. However, the quality and disclosure of analytic work could be significantly strengthened by more strategic upstream consideration, and analytic findings could still be better linked to conclusions about the potential impact of the program.[35]

32. ***Managing Environmental Aspects.*** Government policies may affect the environment, natural resources, and forests and may not be sustainable without additional policy actions. As part of assessing the country's readiness to make productive use of DPOs, the Bank reviews the likelihood that policies supported under the program will have significant environmental effects or will significantly affect forests and other natural resources. If such likely and significant effects are identified, the Bank assesses the potential borrower's policy and institutional framework for reducing negative effects and enhancing positive effects under the program and identifies any knowledge gaps.[36] The readiness to make productive use of DPOs would depend on the inclusion of measures in the program to reduce any likely and significant negative environmental effects (and enhance positive effects), and address analytic gaps in a timely manner. The Bank is reviewing operations systematically for any likely significant effects; however, better upstream integration of analysis and progress in preparing country environmental analysis and, where applicable, strategic environmental assessments would improve the quality of Bank assessments.[37]

33. ***Monitoring and Evaluation.*** The Bank assesses the adequacy of the borrower's monitoring and evaluation framework as part of the preparation of DPOs; and as part of supervision, Bank staff review progress in implementation and validate monitoring and evaluation findings. There is no minimum level of quality for an institutional framework for monitoring and evaluation that the Bank uses to determine appropriateness of DPOs. However, borrowers are expected to address weaknesses during program implementation so that they can fulfill their responsibility to monitor and evaluate the program. Although the Bank has made much progress in defining results frameworks for DPOs for Bank monitoring purposes, most DPOs could be used more strategically to address weaknesses in monitoring and evaluation systems. Moreover, a more systematic setting of benchmarks for monitoring indicators is needed to render the frameworks fully operational.[38]

34. ***Risk Management.*** In assessing readiness for the use of DPOs, the Bank reviews the government's framework for managing and mitigating risks to program implementation. A weak

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[34] *Using Poverty and Social Impact Analysis to Support Development Policy Operations*, October 2005.

[35] *Development Policy Lending Retrospective* (SecM2006-319), July 13, 2006.

[36] Environmental and Natural Resource Aspects of Development Policy Lending, October 2005.

[37] Development Policy Lending Retrospective (SecM2006-319), July 13, 2006.

[38] Development Policy Lending Retrospective (SecM2006-319), July 13, 2006.

government risk management framework would likely exacerbate risks to DPO implementation and reduce the likelihood of achieving targeted development objectives. Risk management considerations in the context of DPO readiness include exposure to external shocks and such issues as whether rapid and unforeseen deteriorations in governance may expose a country with high aid dependency to large declines in resource flows if DPOs provide a significant share of recurrent budgetary spending.[39]

B. Assessing Ownership

35. Although ownership has long been recognized as a key ingredient for the success of reform programs, in practice the degree of ownership of a program is not easy to assess. As the 2005 conditionality review recognized, careful review of the country's political economy and of stakeholders' concerns is required to identify the scope for a sustainable reform program.[40] Given the complexity of country situations, such an assessment goes beyond a notion of ownership that presupposes a uniform government position or a full consensus. Moreover, not all countries are functioning democracies, can successfully avoid elite capture, and respond to the interests of the majority of the population. A realistic assessment of ownership relies on the government's track record of reform and a review of its participation in program formulation. It also acknowledges the political economy reality that reforms may be owned by some constituencies and opposed by others who stand to lose from them.[41] All three dimensions—track record, participation, and political economy—can be explored, as needed, in determining readiness to make productive use of DPOs. Where analysis reveals insufficient ownership—including lack of ownership in tackling key constraints under the program—the Bank would not engage in DPO and would not attempt to use conditionality to induce policy and institutional reforms that the country is not ready to undertake. External donor support, if well designed and targeted, can help strengthen the analytic base of policy making and support internal domestic processes to strengthen policymaking and consensus-building.

36. ***Track Record***. The track record remains the most easily measurable proximate indicator of ownership and commitment. Typically, past performance and the prior implementation record give a good indication of the likelihood that a future program will succeed.[42] For example, most IDA countries that receive recurrent DPO support from the Bank—frequently as a PRSC—have established a track record of reform. Although the track record is a good predictor, it cannot identify cases of rapid performance changes (e.g., emergence of a country from internal conflict), in which Bank engagement, including with DPOs, may add great value but possibly at higher than usual risk of failure. In these cases the Bank will need to make an informed judgment on benefits and risks, drawing on its knowledge of the country's historical and political background.

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39 Such considerations would naturally take into account the flows already committed under the Multilateral Debt Relief Initiative, which could cover recurrent budgetary costs without any uncertainty.

40 *Review of World Bank Conditionality* (SecM2005-361), June 20, 2005.

41 For a discussion of conceptual frameworks for assessing ownership, see Adjustment Lending Retrospective, (SecM2001-215), April 2001, p. 73; see also J. Johnson and S. Wasty, Borrower Ownership of Adjustment Programs and the Political Economy of Reform, World Bank Discussion Paper No. 199, Washington D.C., World Bank, 1986; and World Bank, An Operational Approach to Assessing Country Ownership of Poverty Reduction Strategies, February 2005.

42 Adjustment Lending Retrospective (SecM2001-215), April 2, 2001.

37. ***Participation.*** Broader country ownership of a program beyond the government can be gauged at least in part through an assessment of the participatory and consultative processes that underpin government processes in designing the program. Involvement of stakeholders and civil society in preparing, implementing, and monitoring government programs can help broaden the acceptance of reform measures and also help identify possible adverse affects. As part of any DPO preparation, the World Bank advises countries to consult with and engage the participation of key stakeholders in designing the program. The Bank also reviews the participatory processes a government may have used to design its program, and uses this information in any consideration of broader program ownership. (In addition, the Bank discloses its own analytic work to allow it to feed into any participatory processes or consultations.)

38. ***Political Economy Analysis.*** Political economy analysis, which can give additional insights into the likelihood of a program's success, could be employed at both the CAS level and the level of the individual operation. Political economy analysis can also inform a realistic sequencing of reforms, give indications for an appropriate mix of instruments, and help provide the necessary space for country processes to be fully completed.[43] The Bank conducts some political economy analysis as part of poverty and social impact analysis for certain reforms and, at times, in preparing for CASs.

C. Assessing Capacity

39. Capacity levels affect the government's ability to apply policies and use institutions in line with government objectives. Weak capacity can hamper the effectiveness of programs supported by DPOs at program design, implementation, and monitoring. Capacity constraints are often assessed concurrently with policy and institutional frameworks. Usually, analytic work by the Bank, government, or third parties simultaneously identifies weaknesses in policy and institutions and shortfalls in capacity, and makes suggestions for capacity reinforcement. In assessing a country's readiness to make productive use of DPOs, this information cannot only be used to determine the likelihood of success but typically also plays a central role in the design of any operation and would trigger additional financial and technical support to address capacity bottlenecks.

40. ***Capacity to Design Programs.*** Capacity to translate a country's objectives into concrete and time-bound actions is a key element of operationalizing country PRSs and policy priorities. Weak capacity in this area frequently hinders the Bank from drawing directly on country documents to design Bank-financed operations. Although external assistance for program design can help overcome weaknesses, it also risks undermining the government's ownership. For the Bank, operationalizing the PRS has meant that DPOs in IDA countries include increasingly large policy matrices that set out the broader government program; these matrices have been criticized as overly intrusive and complex.[44] Therefore, addressing weak capacity during the design phase

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43 Shantayanan Devarajan, David Dollar, and Torgny Homgren, *Aid and Reform in Africa, Lessons from Ten Case Studies,* World Bank, 2001 discusses the stages of reform processes based on different country cases and argues that the donor community used aid instruments too indiscriminately in different reform stages in the past. It also underscores the relation between crisis and reforms, and the importance of institutions in political economy analysis. The volume notes that conditionality cannot entice reforms governments are not willing to undertake.

44 *Review of World Bank Conditionality* (SecM2005-361), June 20, 2005.

through external support requires a considerable degree of sensitivity that allows government and internal country processes to play the predominant role.

41. ***Capacity to Implement Programs.*** Capacity to implement DPOs centrally relies on the strength of the civil service and, in particular, the government's financial management capacity in executing and controlling the budget. The Bank's assessment also places particular emphasis on the government's capacity to address potentially adverse distributional effects or effects on the environment, as both reflect important aspects of readiness. Capacity gaps in these areas, which would be normally identified in the Bank's analytic underpinnings, are addressed through program design, including through targeted technical assistance. The supported program would usually serve as a platform for consideration of broader capacity-building support with other financial partners.

42. ***Capacity to Monitor and Evaluate Programs.*** The Bank assesses the capacity to collect and process the information required to monitor and evaluate the program. This assessment is generally part of the Bank's validation of the country's monitoring and evaluation findings in the context of progress reviews. As the recent Development Policy Lending Retrospective noted, Bank operations should more fully incorporate capacity weaknesses into the supported program and more directly address weaknesses in statistical, data collection, and evaluation capacity.[45]

IV. SUMMARY READINESS ASSESSMENTS

43. Assessing a country's readiness to make productive use of DPOs requires an overall consideration of the policy and institutional framework, ownership, and capacity. Such an integrated judgment—with the appropriate weighing of strengths or weaknesses under each of the pillars—would contribute to assessing the risk of engaging with DPOs under the particular country circumstances. In ultimately deciding on the use of DPOs, these risks would need to be weighed against the strength of the program, potential benefits of engagement, and availability of alternative instruments to achieve the country's development objectives. This section offers an overview of considerations in developing an overall judgment and discusses a variety of typical cases and examples to illustrate experiences in making these assessments in DPOs.

A. General Considerations

44. Within the Bank's operational architecture, reviews of countries' readiness to make productive use of DPOs take place on two levels—the level of the CAS and that of the individual operation. Generally the CAS is the appropriate level at which to make the strategic decisions on how best to use available IDA resources, taking into account the different elements of the readiness framework. The readiness considerations feed into the CAS determination of whether a DPO may deliver the results a CAS is targeting, which risks are associated with using DPOs to deliver these results, and whether alternative instruments may be more efficient to support the same or other development objectives. DPOs would typically be well-suited to help strengthen a country's systems (including public financial management), provide general support to development programs, and signal reform willingness. Investment operations typically support specific sectoral or subsectoral activities, particularly when close collaboration on implementation is essential for success. Considering readiness for DPOs at the CAS level may

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45 *Development Policy Lending Retrospective* (SecM2006-319), July 13, 2006.

also give valuable information for deciding on financing of economic and sector work (ESW) under the CAS to support any emerging policy agenda or fill analytic gaps. Further readiness assessments have to take place at the level of individual operations, in particular in areas where considerations at the CAS level necessarily have to remain incomplete or are too generic to judge the potential benefits of the supported program against the weaknesses identified, and because readiness may become more apparent once the proposed program contents are clear.

45. ***Weighing and Balancing Readiness Considerations.*** Different elements of the readiness framework would need to be weighed against each other to judge the likelihood that a country could use DPOs productively. For example, a country with weaker capacity and weaker institutions but strong commitment may be more likely to implement a program successfully than one with stronger institutions but much weaker commitment. Thus, there is no minimum level of any one element of the framework—except the need for appropriate macroeconomic policies—that would render DPOs unproductive. Instead, the likelihood for making productive use of DPOs would vary depending on the totality of elements of the readiness framework, after a careful balancing of strengths and weaknesses.

46. ***Assessing Readiness Aspects against the Strength of the Program.*** An important element in considering readiness is whether the program itself may enhance the likelihood of success. For example, a program may address weaknesses in the policy and institutional framework and capacity (e.g., fiduciary and governance concerns) and thus already incorporate elements that enhance the likelihood of success. The program may also receive additional, and complementary, support from other donors, which may help support readiness by offering additional confidence that program design and implementation capacity bottlenecks are being addressed. In other cases, the program may not be able to address weaknesses right away, but may carry large benefits. In these cases, the productive use of DPOs may be less likely at the outset, but a successful DPO could address important shortcomings and bring important benefits that would otherwise be out of reach. Those instances may be particularly relevant in post-conflict situations and rapidly shifting policy environments. The overall assessment of risks and benefits of any DPO engagement resulting from weighing readiness concerns and program strength would also inform strategic decisions on the financial volume of any possible DPO engagement.

B. Assessing Readiness in Different Country Circumstances

47. The Bank has used DPOs in a variety of country settings, responding to different country circumstances, and giving different weights to different readiness criteria. The CAS provides the overall rationale for the use of DPOs and sets out their share in the lending program, taking into account an assessment of readiness criteria and a broad weighing of the benefits and risks of the instrument against those of other available instruments. In addition, the individual operation is tailored to the strategic context through design options such as tranching (single or multiple tranches) and the possible choice of a longer-term programmatic engagement through a series of single-tranche operations. The Bank has also used sectoral DPOs and DPO options, such as subnational lending and supplemental financing, in IDA countries. Below, a number of such engagements are characterized and discussed against readiness criteria.

48. ***Better-Performing Countries with Recurrent Support.*** Since 2001, the Bank has supported several better-performing IDA countries on a regular and recurrent basis through

PRSCs. PRSCs, typically annual single-tranche operations spanning several key areas of the PRS, are intended to offer predictable support over the medium term provided that the government implements its program in a satisfactory manner over time (see Box 2).[46] PRSCs also frequently take up a substantial part of the IDA envelope. They allow addressing policy and institutional reforms in a medium-term setting and offer scope for scaling up financing of essential services through predictable resource transfers. They frequently incorporate Bank support for the social sectors, at times replacing investment operations in these areas. PRSCs also typically support wide-ranging reforms in the area of public administration and public financial management. Readiness considerations for DPOs on the policy and institutional side in these cases build on (a) a poverty reduction strategy formulated by government; (b) a track record of sound macroeconomic management; (c) established budget planning processes that allow translating programs into activities—often twinned with additional activities planned under the program to further improve medium-term planning, monitoring, and evaluation; (d) solid public financial management systems, with a strong program for further upgrading; and, frequently, (e) established sector programs, especially in health and education. Not surprisingly, most countries with such characteristics also tend to have above-average CPIA ratings.[47] In addition, in most cases ownership assessments build on a track record of policy implementation that established a degree of mutual trust in the policy dialogue between the government and the donor community. These countries also tend to have core capacity to conceive, execute, and evaluate the government program, in the context of both sector program reviews and annual reviews of the PRS. Overall, for medium-term repeated engagements, the readiness assessment therefore gives fairly equal weights to the strength of the policy and institutional environment (including the level of fiduciary controls), ownership, and capacity. There is broad agreement on policy priorities; and addressing remaining weaknesses in policies and institutions and in capacity is high on the government's agenda and integral part of the supported program. Thus, in these environments the risk that DPO resources would not be used productively is generally low, and DPOs over time may take a rising share of the IDA envelope in these countries as domestic systems improve. Indeed, in the relatively few cases when PRSC series were interrupted, the interruption generally resulted from political instability that interfered with program implementation.

49. ***Sectoral and Subnational DPOs.*** In some cases, country circumstances may call for support of sectoral or subnational reform processes rather than multisectoral or nationwide policies and reforms. In such cases, the Bank also has frequently engaged in series of single-tranche operations under a programmatic series (see Box 3). Readiness considerations for sectoral operations rely on the policy and institutional framework for the country as a whole (rather than for the sector only), since DPO resources flow to the general budget. However, the assessment of commitment and ownership of the reform program, and capacity to implement it, may be more narrowly focused on the sectoral aspects of the reform program rather on the broad countrywide situation. In a subnational setting, typically the policy and institutional framework of the subnational government, as well as its reform ownership and capacity, would be most relevant. National issues may be confined to macroeconomic stability and the review of financial relations between the national and subnational government. Typically, both sectoral and subnational operations rely on a selective engagement in better policy environments with strong

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[46] For further information, see *Poverty Reduction Support Credits: A Stocktaking*, April 29, 2005.

[47] The Africa Regional strategy explicitly reserves the use of PRSCs for better performers.

government commitment and good core capacity, giving strong weight to all three readiness pillars for what is frequently a longer-term engagement. The risks for medium-term DPO engagement tend to be low. The choice for subnational and sectoral engagements is normally driven by country and portfolio size rather than intrinsic differences in the composition of readiness aspects.

Box 2. Supporting PRS Implementation in Burkina Faso

Burkina Faso has been the recipient of six annual PRSCs and grants since 2001. (IEG rated the first series of three operations as well as the fourth PRSC as having satisfactory outcomes.) Burkina Faso had already upgraded some of its systems and established a track record by 2001, supporting a decision for longer-term engagement. What particularly distinguished the country as a candidate for PRSCs was the combination of determined leadership by government, commitment to a reform process driven by the PRSP, and the trust established with donors as a result of sustained policy implementation. These qualities allowed advancing step-by-step with further reforms under the PRSC-supported program, addressing remaining weaknesses and challenges.

During 2001-06, PRSCs have accompanied core reforms in public financial management and in social and productive sectors. Two programmatic series of three operations each have seen solid economic growth rates of about 6 percent, a successful opening and restructuring of the cotton sector attracting important levels of foreign investment, and first steps in reorganizing the electricity sector. A solid framework for managing and accounting for government resources—including the regular and timely production of accounts and budget execution laws, as well as creation of a supreme audit institution—was put in place. In the social sectors, PRSC financing helped overcome disbursement delays in basic education projects to increase coverage, supporting a 14.5 percentage point increase (to over 60 percent) in gross primary enrollment during 2001-05. Vaccination campaigns helped raise diphtheria and tetanus vaccination rates from 64 percent to 96 percent over the same period.

50. ***Post-Conflict Countries and Rapid Policy Shifts.*** In cases of political transitions—rapid shifts in policy stance—the Bank may be well placed to provide quick support to help stabilize the situation and support emerging reform processes (see Box 4). In such cases, governments—especially those emerging from a post-conflict situation with significant destruction of physical and human capital—often must meet high expectations of their populaces. Fast-disbursing DPO resources in situations of weak domestic revenue can help stabilize the macroeconomy and quickly reestablish some, even if rudimentary, state function (for example, by beginning to make salary payments on time and clear arrears), and thus can support rebuilding trust in government institutions. DPOs also carry the internal benefit of focusing programs on institutions and capacity building and enhancing the integrative feature of interventions. Experience shows that transitions are often fragile, and thus DPOs in these environments face multiple risks from possible collapse of a transition; insufficient information on social, economic, and political conditions; and weak fiduciary environments. Transitions take time, and stabilization can rarely be achieved with a "one-off" engagement, so waning donor enthusiasm after four to five years of a transition is one of the dangers for sustaining progress. Thus, often a programmatic series of single-tranche operations can help balance the need for ensuring sufficient progress with some flexibility in adapting triggers to newly emerging priorities in a fluctuating environment as long as the program stays broadly on track.[48] In other circumstances, a single-tranche stand-alone operation may be appropriate to support early steps in a reform program, especially if the transition agenda is still emerging and the program is not yet fleshed out. Readiness considerations in these environments have to recognize weaknesses in the policy and institutional framework—including serious weaknesses in public financial management and ability to manage

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[48] *Development Policy Operations and Program Conditionality in Fragile States: Good Practice Note in Development Policy Lending,* Operations Policy and Country Services, World Bank, June 2005.

potential adverse program effects and risks—and severe capacity constraints. Thus, an ultimately favorable bottom-line assessment for the use of DPOs would need to rely on the government's commitment and ownership in combination with the strength of the program to address weaknesses in the institutional environment and capacity gaps. The risks for a productive use of DPOs and failure of the reform process, which in most cases are high, would need to be weighed against the anticipated benefits of the reform program, be acknowledged frankly, and taken into consideration in the volume of support.

Box 3. Support for Institution-Building in Afghanistan

The Bank has supported Afghanistan's recovery with two policy-based operations since 2004 as part of a programmatic series of three operations. (IEG evaluated the first operation in the series as having satisfactory outcomes, with a fuller evaluation to take place once the series has concluded.) Bank support was part of a multidonor effort relying on a coordinated policy matrix. The Bank's operations focused on restoring key functions of the state, raising fiduciary standards, enhancing human development, and strengthening the general environment for private sector activity. The programmatic structure was chosen (over single- or multiple-tranche designs) to support a medium-term process of institution building while retaining flexibility to adjust the program to emerging priorities. Given the relatively high risks of engagement, the size of the financial envelope allocated to DPOs in Afghanistan remained limited, with a substantially larger share of the IDA commitments going to investment operations. The Bank's assessment of the country's readiness to use DPOs productively rested largely on the government's ownership and commitment as laid out in a multidonor program, the important benefits from increasing government discretionary resources in a low-revenue environment, and the assessment that small advances in reestablishing a functioning state would yield benefits that outweighed the considerable risks.

51. ***Gradual Improvers.*** In some circumstances, an opportunity arises to support a relatively narrow reform agenda that does not yet benefit from a vast change in the surrounding policy environment. In these cases, the Bank may consider one-off DPO support through a single- or multiple-tranche operation—if the reform process is a relatively closed set of activities—or a series of programmatic operations with limited financial volume and a clear understanding that support is based on sustained improvements in performance (see Box 5). Typically, in these cases, there are still considerable weaknesses in the country policy and institutional framework, capacity gaps remain, and ownership may not be universal. However, in contrast to countries with deteriorating governance or countries in crisis and conflict, "gradual improvers" can offer opportunities for engagement in policy areas where a consensus is emerging. Drawing frequently on a longstanding policy dialogue, these emerging reform areas—for example on key public sector governance aspects—may offer a window of opportunity for building momentum and establishing a track record that could eventually lead to larger volumes of commitments (for example, by tackling policy and institutional weaknesses constraining IDA's performance-based resource envelope). The readiness assessment would usually identify important weaknesses under all three pillars, reflecting that risks of failure and reversal are particularly high, and would need to be counterbalanced by an assessment of the benefits as well as a careful scaling of the size of DPO engagements in the country program.

Box 4. Focusing on Select Policy Areas in Tajikistan

Tajikistan's economic management and policy reform efforts slowed and policy implementation was uneven in the middle to late 1990s in the wake of a civil conflict. Two policy-based operations were approved in 1999 and 2001 after the end of the civil conflict and reestablishment of macroeconomic stability. However, progress under the second structural adjustment credit, a multitranche operation, was slow, and disbursement of the second tranche was delayed. (IEG rated the second operation as having marginally satisfactory outcomes.) The PRS framework in Tajikistan also remained fairly weak, in terms of both content and the underlying processes. In these circumstances, the Bank committed no further policy-based financing during 2002-2005. In 2006, a first programmatic development policy grant was approved as part of a new programmatic series that focuses more narrowly on key governance-related reform measures in private sector, productive areas, public administration, and service delivery. The re-engagement with policy-based operations builds on emerging government consensus for reform in these areas, which could lead to an improved track record and CPIA over time. Recognizing the important remaining weaknesses in policy and institutions, and the need for establishment of a policy track record, the engagement with DPOs in the current CAS remains limited to $20 million (out of $120 million).

52. ***Crisis and External Shocks.*** Fast-disbursing operations offer the possibility of supporting countries that are in crisis or suffering from external shocks (e.g, oil price increases). In these cases, the benefits of quick stabilization and relief may call for expanding the use of DPOs, even if readiness criteria may otherwise suggest a lower level of financial engagement with DPOs (see Box 6). As a result, changing external circumstances may require a reassessment of the appropriate volumes of DPO support for any given set of policy and institutions and capacity, provided the government displays sufficient ownership and commitment to use the additional resources in a way that contravenes the crisis and shock and delivers the intended benefits (i.e., maintenance of a sound macroeconomic policy framework and deployment of resources to alleviate the impact of shocks). In these cases the readiness criteria that receive strong attention for medium-term DPO engagements—such as the institutional environment for public financial management—could be outweighed by the immediate benefits of stabilization.

Box 5. Responding to the Earthquake in Pakistan

The Bank may provide supplemental financing to a program under implementation if the program continues to be implemented as agreed and the borrower cannot obtain additional financing from other sources in time or at reasonable costs. Supplemental financing offers, for countries that are already implementing a DPO-supported program, the possibility of obtaining fast access to additional resources in case of shocks. A powerful and destructive earthquake hit Pakistan on October 8, 2005. The national government and its North-West Frontier province were implementing programs supported by fast-disbursing financing from the Bank. As part of the Bank's response package, two supplemental financing proposals were prepared for a total of $200 million and approved on an accelerated basis by the Board on October 25, 2005, supporting the government in addressing the most immediate needs after the earthquake. These engagements increased the DPO share beyond the originally planned levels based on the judgment that they could support quick economic recovery most efficiently compared to other forms of Bank engagement and thus warranted increasing the share of fast-disbursing resources.

53. ***Deteriorating Governance and Conflict.*** Where weaknesses in country policy and institutions and capacity are not counterbalanced by commitment and ownership of a sufficiently strong policy reform agenda, DPOs are not likely to be productive. Deteriorating governance situations or outright political crisis and conflict are therefore generally not conducive to using

DPOs effectively in support of development goals, and DPOs would typically be inappropriate unless a significant shift in policy and/or strong commitment to policy reforms occurs.[49]

C. Implications of Readiness Considerations for IDA's DPO Share

54. The broad framework set out above, and the discussion of its application, suggest that the evaluation of readiness can result in different levels of DPO support, depending on an overall judgment that weighs country policy and institutions and capacity against commitment and ownership and the inherent strength of the supported program. Many elements of the readiness framework rely on country knowledge and do not lend themselves to the establishment of a summary numerical indicator that could be linked to an "appropriate" share of DPOs. For example, some weaknesses related to country institutions and policies in making effective use of DPOs may carry over to weak outcomes for investment operations, and summary numerical indicators such as CPIA scores may therefore not carry enough information on the relative effectiveness of DPO and investment financing instruments. Ownership, a concept not readily accessible to numeric scoring, may be more important than any weaknesses in country institutions in assessing the likelihood of success of policy-based support. In addition, the program itself may tackle the weaknesses identified in the readiness framework, and thus, in spite of higher risk, may be worth supporting, if there is sufficient ownership. Finally, external factors such as commodity price shocks and natural disasters may shift the appropriate level of DPO support for any given level of readiness. Taken together, these factors suggest that the appropriate share of DPOs will remain tied to a qualitative assessment, within a framework of strong corporate oversight. Past experience suggests that within such a framework, IDA's DPO commitments have been predominantly geared toward better performers, with selective engagements in weaker environments.

V. CONCLUSIONS

55. This report which is based on 20 years of experience with policy-based lending, lays out a broad framework for assessing a country's readiness to make productive use of DPOs. It suggests that such an assessment rests on a careful review of (a) the country's institutional and policy framework; (b) ownership; and (c) capacity.

56. ***Implementation of the Framework.*** The Bank has the capacity and tools to review different elements of the readiness framework during preparation of CASs and DPOs using widely available analytic work for IDA countries. As was recently emphasized in the Development Policy Lending Retrospective, the Bank's use of DPOs has been selective, and the overall policy framework is robust, although some elements of the framework—notably the tracking of progress in public financial management and the upstream use of poverty and social impact analysis—may require additional strengthening during implementation. The framework will continue to rely on strong corporate oversight, including mandatory corporate review for DPO and CASs, senior management clearance of CASs, and Board discussion of CASs and DPOs, except follow-on operations in a programmatic series.

57. ***Monitoring the Aggregate Share of DPOs.*** The share of DPOs resulting from these readiness considerations will vary with country circumstances, and will respond to shocks and

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[49] See *Strengthening Bank Group Work in Governance and Anticorruption* (R2006-0155), July 28, 2006.

fluctuating economic conditions. In setting a country's DPO share, the CAS would build on the readiness criteria and the strength of the program, and would take into consideration the country's financing requirements given the actions necessary to achieve the expected results of the program. As a result, general readiness criteria cannot be mapped to any single appropriate share of DPOs for IDA. However, within the framework outlined above, it is not expected that the overall DPO share will deviate drastically from past experience, and evidence presented in this paper suggests that DPOs in the past has been selectively directed toward better performers. Moreover, as part of the annual monitoring of DPO commitments, Management will continue to inform the Board of Executive Directors at the time of the annual review of the Medium Term Strategy and Finance paper of the past DPO share for IBRD and IDA and the outlook for future years based on a three-year rolling average. If the projected share[50] of DPO commitments by IDA exceeds 30 percent for any future year, Management will seek additional guidance from IDA Executive Directors.

58. ***Monitoring Effectiveness of DPOs.*** The effectiveness of DPOs will continue to be subject to regular monitoring, drawing on the Bank's work and independent or external evaluations of budget support instruments. A new DPO retrospective, planned for FY09, will provide a second progress report on implementation of the new DPO policy adopted in August 2004. With growing experience with implementation of DPOs, subsequent retrospectives would be expected to give additional information on the effectiveness of the instrument in different circumstances to foster policy reform, strengthen governance and institutions, and support progress toward the Millennium Development Goals.

[50] Excluding resources committed to countries reengaging with IDA after a prolonged period of inactivity and used by recipients for the purpose of repaying bridge financing used to clear arrears.