



Ownership and Conditionality

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William Branson
Nagy Hanna



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Operations Evaluation Department
Partnerships & Knowledge Programs (OEDPK)
Email: ecampbellpage@worldbank.org
Email: eline@worldbank.org
Telephone: 202-473-4497
Facsimile: 202-522-3125

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Director-General, Operations Evaluation:	<i>Robert Picciotto</i>
Director, Operations Evaluation Department:	<i>Gregory Ingram</i>
Task Manager:	<i>Nagy Hanna</i>

Preface

Despite the potential benefits of globalization and technological change, world poverty has increased and growth prospects have dimmed for developing countries during the 1980s and 90s. The Comprehensive Development Framework (CDF) was launched by the World Bank in January 1999 in response to these difficult circumstances. It has evoked considerable interest throughout the development community as an approach that can address the increasingly intertwined challenges faced by development practitioners. Its basic elements are not new. What is new is their joint articulation as a framework to guide development assistance. The first point is that development constraints are structural and social, and cannot be overcome through economic stabilization and policy adjustment alone—they require a long-term and holistic vision of needs and solutions. Second, policy reform and institutional development cannot be imported or imposed; without domestic ownership, reforms and investments are not sustainable. Third, successful development requires partnership among government, local communities, the private sector, civil society, and development agencies. And fourth, development activities must be guided and judged by results.

In this context, the *1999 Annual Review of Development Effectiveness* (ARDE), authored by Nagy Hanna under the guidance of Robert Picciotto, set out to examine development experience through the lens of CDF principles. A number of papers were commissioned to support the ARDE by providing in-depth review of evaluation and research findings that assess the relevance of the CDF principles and constraints as well as promising approaches to their implementation.

Introduction

This chapter discusses the appropriate form and role for policy conditionality within the context of the Comprehensive Development Framework (CDF).¹ Traditionally, the World Bank has viewed conditionality as a blueprint package of policy conditions attached to tranche release of single loans. We propose a broader view of conditionality as an evolving process in support of a policy compact based on mutual commitment. The Bank and its partners would act as enabling agencies to support the country's motivation for reform, leaving significant room for the country to determine the means and timing of reform according to political economy considerations and genuine local learning.

Several factors present an opportunity to rethink and reshape conditionality as an instrument of policy reform: the end of the Cold War, international efforts to reduce indebtedness among poor developing countries, improvements of macroeconomic policies in many countries, recent research findings on aid effectiveness, and the growing concern about overall development effectiveness (Collier and others 1997).² Aside from changes in the global environment, there is growing consensus that the relationship between donors and aid recipients must become one of partnership, that country ownership is essential to sustainable policy improvement, and that traditional conditionality has often been misused and overused.

Conditionality should be understood as a credible indicator of commitment by the Bank and its partners to support a mutually agreed reform process, not an attempt to force externally designed policy changes on unwilling governments. It represents a transparent and explicit understanding of sustained external support for new and ongoing program, formulated by the country with wide participation by the private sector and the civil society and in cooperation with external partners. The program would be owned by the country, and conditionality would define the parameters of external support. Conditionality would take different forms as the reform process evolved and a track record was established. It could be geared to actions already taken—with further financial support predicated on the assumption that reform continues. Or it could support floating tranches, as in Higher Impact Adjustment Lending (HIAL), with the government choosing the sequence and timing of sector reforms as external support is calibrated to the quality of the program.

This chapter discusses conditionality as commitment technique and as part of an evolving process, rather than a one-off event attached to a single loan. It brings the discussion to bear on the relationship between conditionality and ownership, including the role of participation and the Bank's ability to assess and broaden ownership. The chapter lays out four conditionality scenarios, from ex post tranching for established reformers to floating tranching for credible reformers just establishing a track record, as in HIAL, to regular

tranching. Scenarios would also include an experimental single upfront tranche for new or less-credible reformers, and continued Bank engagement through advisory and technical assistance (without adjustment lending) for those not yet committed to reform. Adaptable conditionality would facilitate progress from the most demanding to the least demanding scenarios. Thus conditionality would be reshaped as an instrument of mutual commitment among partners and would be adapted to the different stages of a long-term reform process.

Conditionality as a Mutual Commitment Mechanism

Conditionality is widely viewed as a crude attempt to generate policy change in return for grants or loans. This view is illustrated by the following passage from Killick and others (1998, pp.10-11):

An alternative [to the “consensual” view—the view taken in this study—]starts with semantics. In its relevant sense, a condition, according to the *Oxford English Dictionary*, is “something demanded or required as a prerequisite to the granting or performing of something else: a stipulation.” This throws a quite different light [from the consensual view] on the matter, viewing conditionality as essentially coercive: the use of financial strength to promote donor objectives. A condition attached to a loan or grant sets out a requirement for action of some sort by the recipient government without which assistance will not be granted or continued....What is implied here is a distinction between ‘pro forma’ and ‘hard core’ conditionality....Hard core conditionality, by contrast, consists of actions, or promises of actions, made only at the insistence of the lender.

In effect, Killick and others define “hard core” conditionality as coercion. They contrast conditionality and borrower ownership by asking the question: “if the country owns the program, why is conditionality needed?” The answer advanced in this chapter is that conditionality would become the embodiment of external support for country-based reform programs. The rationale for this new concept of conditionality is outlined by Joseph Stiglitz (Prebisch Lecture, October 19, 1998, p.11):

This much seems clear: effective change cannot be imposed from outside. Rather than encouraging recipients to develop their analytical capacities, the process of imposing conditionalities undermines both the incentives to acquire those capacities and recipients’ confidence in their ability to use them.

Effective conditionality is an instrument of mutual accountability. Rather than imposing a position on the borrower, the Bank and its partners commit themselves to lend under certain jointly determined conditions. This view of conditionality is consistent with the concept of ownership by and partnership with borrowers. External assistance agencies commit themselves through conditionality, while the borrowing government commits itself through ownership of programs it has designed in consultation with internal and external partners. In this sense, conditionality can be seen as a policy compact or mutual accountability to poverty reduction and policy reform.

From this new perspective, conditionality takes several forms, well beyond the pro forma or hard core concepts that have lost credibility. It can be ex post, with continued lending based on continued and anticipated progress toward shared development objectives rather than tied to specific reform conditions. Reform-minded governments can proceed with reform with explicit assurances of continued external support. This form of ex post conditionality is consistent with the principles of reciprocity that underly trust in repeated games associated with reputation development under neoinstitutional models of cooperation.

In another form of conditionality the borrowing government receives an initial tranche, based on coherent selectivity criteria, and the Bank commits to further tranches as reforms continue, with timing determined at the discretion of the recipient government. Countries borrowing under this form of floating tranching, developed under the HIAL initiative in Sub-Saharan Africa, have performed relatively well compared with other IDA borrowers (OED 1999).

A third form of conditionality is an adaptable lending approach with multiple tranches for agreed policy reforms initiated by the government. It combines rigor with sustained Bank commitment to an ongoing reform process. This option is appropriate for a new government beginning a reform process. The Bank could commit to switching to one of the more flexible forms described earlier as the reform proceeds.

All three approaches respect borrower ownership while demonstrating Bank commitment in support of policy reforms aimed at *transforming* and *modernizing* society. Well managed, such conditionality is not coercive. The Bank can support an ongoing reform process based on actions already taken, on the assumption that the process will continue and with appropriate safeguards against potential policy reversal. This view of conditionality could form part of the shared responsibility for development outcomes underlying the CDF, symbolizing mutual accountability among all partners in a joint development enterprise. It would, in effect, contribute the “external” equivalent of borrower ownership.

Conditionality as a sign of commitment of external support would add to the credibility of domestic reform programs, particularly for the private sector and civil society. Externally, that would help shorten the foreign investment pauses often associated with reforms. Thus conditionality as commitment would be part of a virtuous circle in which Bank involvement would contribute to the success and credibility of sustained growth and poverty reduction.

Conditionality as a Process

Most studies treat conditionality as a one-off event—a set of specific conditions imposed by the Bank on a particular loan. This static view sees conditionality as tied to single loans rather than as part of a relationship, a view implicitly shared by the Killick and others (1998) and the Dollar and Svensson (1998), whose unit of account is the loan. Annex 1 reorganizes the Dollar and Svensson data to make the country the unit of account, thereby setting the relationship within a long-term horizon and acknowledging the information available from repeated lending.

The CDF gives a new meaning and modality to conditionality. It would form part of an ongoing process through which the Bank and the borrower develop and nurture mutual trust and commitment as the reform program proceeds. This could take the form of ex post

conditionality, as described earlier. This form would be successful as the country continues reforms and the Bank continues its support. Ex post conditionality might also be appropriate in other circumstances, such as in cases of urgent need and uncertain outcomes, where there are risks of the country abandoning the path of reform. In such cases, ex post conditionality would trigger a pause, or even a halt, in lending.

Policy reform is interpreted here as a dynamic concept—a path from past to future—not a one-time resetting of policy matrices or a fixed set of institutional changes. The Bank commits to support the reform process and the country commits to continuing along the path. In the ongoing dialogue between the Bank and the country, the path toward broad reform goals would be altered as new information about the effectiveness of reforms and the economic environment facing the country materializes. Allowances would also have to be made for changes in the country's preference for type and pace of reform—for example, to ensure social cohesion and broad-based ownership of the reform process by accommodating particular interest.

Conditionality as the Bank's commitment to support would also change over time. As the reform process deepens, conditions would become increasingly flexible. A model might be the relationship between a commercial bank and its customers. As long as the customer remains a credible performer, the credit line continues and perhaps increases. Thus conditionality is the Bank's side of a continuing relationship, while ownership is the country's side.

Conditionality, Ownership, and Participation

Conditionality provides the Bank's commitment to engage and lend. Borrower ownership represents the country's commitment to improved policies and institutions, with the aims of reducing poverty and promoting sustainable growth. The forms of conditionality and ownership evolve over time with the relationship between the Bank (and other external partners) and the country. From the standpoint of theory, this is akin to a "repeated game" that builds reputation and trust. As long as the country remains committed to the program through ownership, the Bank sustains its commitment to engage and lend. And as long as the country remains committed to the path of policy reform, it remains in the relationship.

This shows the complementarity between conditionality as a commitment instrument for the Bank, and ownership as a commitment indicator for the country. In a mutual relationship, commitment is needed on both sides. This win-win relationship contrasts with the win-lose model assumed in much of the recent literature; as long as the country owns the program there is no need for conditionality.³

Broad participation in the development of a program in cooperation between the Bank and the government should strengthen ownership on both sides. With broad support, the government can make its ownership more credible. With more credible country ownership, the Bank can more readily adopt flexible forms of conditionality. The Bank may be asked to help the government to develop participation through, for example, seminars for a wide range of participants, including members of parliament and the press. Equally, cooperation with local research organizations can help develop policy knowledge and contribute to ownership through participation of local researchers and officials. (See chapters on Participation and on Analytical and Advisory Services, in this volume).

Assessing country ownership can be difficult, but it is key to the design of flexible conditionality and of strategies to build ownership over time (PREMnote 25, 1999).⁴ Johnson and Wasty (1993) offer a methodology for assessing borrower ownership based on four factors: the locus of initiative in formulating the reform, intellectual conviction among key policymakers, political will as expressed by top leaders, and efforts to build consensus among constituencies. This method focuses on key political leaders. While such “political entrepreneurs” are needed to capture opportunities for change, this approach often underestimates the difficulties of securing adequate support from other actors. Most important changes also require sustained institutional effort to implement. Although relatively easy to conduct, leadership analysis is too narrow to meet the demands of the CDF and of adaptable conditionality.

Two other promising tools for ownership assessment are stakeholder analysis and reform readiness analysis. Stakeholder analysis is used to acquire an understanding of the influence and interests of stakeholders and to plan for how to involve each stakeholder group in subsequent stages of policy work. This tool also has its limitations: it often fails to assess the capacity and incentive of those affected by policy change to reorganize themselves as a political force. For radical policy reform the tool cannot reveal interest groups that are ready to push the reform forward, as the nature of the change and its likely outcome are beyond a society’s experience. Reform readiness analysis tries to look behind the positions of lenders at the underlying basis for those positions and to illuminate institutional arrangements that affect the ability of various actors to influence policy decisions or implementation. This tool demands detailed knowledge of a proposed reform and of the political situation surrounding it, knowledge often unavailable to outsiders.

Most promising is to use these tools to identify ways for the government and the Bank (and other partners) to help build broad ownership over time, not simply to make a “go” or “no go” decision. Analytical work can be carried out and disseminated to potential beneficiaries as a way of mobilizing their support. Sequencing of reforms could build support by achieving early gains. Participatory and other political processes could be put in place to help build ownership for subsequent reforms. The Bank can also strive to combine country knowledge with expertise about what has worked in other countries in reform areas that are of interest to the country. Monitoring of performance and policy impact can also contribute to policy learning, flexible conditionality, and broad ownership.

Finally, the reform process is likely to vary across sectors, and the Bank needs to develop a clearer sense of the dynamics and specificity of ownership and vested interests likely to govern each sector. (See Annex 3 on reforms in the social sectors.) In this context, it is important to note that, on average, sectoral adjustment lending has consistently outperformed structural adjustment.

The consultative and democratic aspects of the CDF process should give the policy reform targets increased legitimacy, as mutually agreed and nationally owned. Conditionality is seen as part of the dialogue between the Bank and countries, not an alternative to dialogue. Increased ownership would justify greater flexibility in conditionality design and phasing: if there is consensus about the broad objectives and directions, there is less need or justification for imposing a rigid view on means and detailed conditions (Hopkins and others 1999).⁵

It is important to extend the tools for assessing ownership by combining economic and management concepts. The economist's view of development emphasize the need for incentives to be correctly aligned and for measures to ameliorate imperfect markets (Hopkins and others 1999). It recognizes that there are conflicts of interest and principal-agent problems. The CDF, by contrast, is primarily a management tool to ensure that everyone is on board with respect to agreed development objectives. Combining the two views in complementary fashion would likely yield the best results.

Recent Empirical Evidence on Successful Adjustment Lending

Two sets of recent evidence support the view of conditionality as a commitment process and highlight the superior performance of flexible conditionality: the recent OED (1999) study *Higher Impact Adjustment Lending: Initial Evaluation*, and a reevaluation of the Dollar and Svensson (1998) data using the country as the unit of observation (see Annex 1). The HIAL study indicates the superior results from conditionality design that gives government increased freedom in the timing of reforms and focuses on fewer and selective conditions, thus allowing for greater ownership. This type of conditionality has been applied for the relatively credible reformers (Annex 2).

The reevaluation of the Dollar and Svensson data shows that past success is a significant predictor of present success. Thus there is information in past successes that Bank staff can use in the selection and design of current programs to increase the probability of success. But the Dollar and Svensson analysis was conducted for adjustment lending using the traditional form of conditionality. It might be that the information available from past performance and learning could be used even more effectively if conditionality were more flexible and tailored to the evolving reform process and the long term relationship between the Bank and the country.

The findings of this study are reinforced by a series of 10 country case studies (Devarajan, Dollar, and Holmgren 1999).⁶ Earlier analyses and recent literature have relied on cross-country studies, which suggest that policy formulation depends primarily on domestic political factors and that *on average* aid has had no effect on the quality of macroeconomic policies.⁷ But the average relationship has disguised the fact that aid supported policy reforms in some cases and poor policies in others.

The 10 country case studies reveal that aid can make a difference, provided that conditionality is compatible with or reinforces country ownership. Policy formation is driven primarily by domestic political economy issues and often induced by crises. In general, donors have not been selective among countries and have tended to provide the same reform package everywhere and at all phases of the reform process. Moreover, donors often failed to distinguish between first generation reforms, which may be undertaken by a small circle of reformers, and second generation reforms—such as improving civil service performance—which demand broader ownership and sustained support.

Perhaps the most important lessons come from the reformers—Ghana and Uganda in this case study series. First, institutions are important to the success of reforms, along with the way society organizes interest groups, technocrats, and leadership. Second, the timing and mix of financial and nonfinancial services are critical to different phases of the reform process. In a pre-reform phase, technical assistance and policy dialogue are

often useful, if demand driven and well adapted to local conditions. Policy learning has to take place at a country's own pace, and knowledge transfer should support local learning and capacity building. In this phase "pressure to lend" could have perverse incentive effects, if it leaves no space for learning and if financial aid lets countries defer reforms. In a rapid reform phase, conditional aid finance can support a deepening of reform commitments, increasing the benefits of reform, reducing the tendency for backsliding, and signaling the seriousness of reform to civil society and the private sector. But even during rapid reform, it is more important to build commitment for the broad directions while allowing for flexibility and adaptation in implementation. These findings are consistent with our view that conditionality is a process and that the instruments used should be compatible with autonomy and ownership.

A disturbing finding of the case studies is the tendency for aid to decline and donors to become *increasingly prescriptive and rigid* with reformers once good policies are in place. Donors like to think that their money is attached to policy change—not to a relationship of mutual commitment and policy compact. The Devarajan, Dollar, and Holmgren (1999) study thus speculates that conditional assistance should have quickly outlived its usefulness, as continued use of conditionality would undermine government credibility as a reformer and limit local participation in policymaking. But this should not be the case if conditionality is viewed as a mutual commitment process, with progressively flexible conditionality used for the credible reformers. By this stage, it should be clear that the reform process is locally managed and that donors are allocating aid selectively in support of long-term commitment to the reformers.

Conditionality Scenarios

The discussion and analysis presented here suggest at least four conditionality scenarios, ranging from most flexible to most restrictive.

The first would be continued lending to an ongoing reformer with a track record of success. Here the process of mutual commitment is fully under way. The country is making progress in reforms, and the Bank is lending under ex post conditions.

The second would be a HIAL structure of floating tranches for a country seen as a credible reformer with strong ownership, but no real track record. The government chooses the sequence and timing of the conditions and tranche release. In the HIAL study (OED 1999) the four countries with floating tranches outperformed the other HIAL countries (see table 1 in Annex 1).

The third would be a case of regular multiple tranches, which would be converted to floating tranches as ownership developed. This might be appropriate for a country that is just developing ownership but with a recent regime change or other change that improves credibility on reform. The country could also be a candidate for an experimental single tranche operation, such as the Chad Sector Adjustment Credit under HIAL in 1997, that provides a credit to a potential reformer with the understanding that additional lending will follow actual reform.

The fourth would be a country with a government not yet ready for reform. The Bank would maintain contact and policy dialogue, offer advice and technical assistance, and commit to support if the government can commit to reform.

All of these scenarios are consistent with adjustable conditionality and tranching. As countries progress, they could be expected to move up in the order of the scenarios. A country just beginning reform would move from scenario four to three, but with a commitment by the Bank to move toward scenarios two and then one as the process continues. This prospective sequencing should strengthen the movement toward mutual commitment.

Conclusion

This chapter proposes a new view of conditionality as a process of signaling and nurturing mutual commitment between the Bank and the borrowing country—a policy compact—in place of conditionality as coercion that attempts to induce borrowers to take actions against their will. Because other stakeholders are involved, the risks of coercion implicit in a secret negotiation between a hard-pressed borrower and a powerful lender are reduced. Equally, transparency and participation should minimize the risks of shirking or policy reversals. Under the CDF this design of conditionality is complementary to ownership. It is the Bank’s counterpart to ownership in a symmetrical relationship implying accountability for results.

Thus understood, conditionality must be flexible because it must also be combined with capacity building to achieve a level playing field in the relationship. Ongoing and credible reformers should have the option of ex post conditionality, in which the Bank lends on the basis of past actions, with the expectation that the reform process will continue. The country proceeds with reforms with the expectation that the Bank will continue to lend. In a successful relationship, both expectations are fulfilled. Credible new reformers might have floating tranche loans, as in the HIAL approach in Africa. Essentially the country decides the sequence of reform and sectoral tranche release. Conditionality would also be adjustable, as the country increases its ownership of the program. Where reform prospects are uncertain, adaptable conditionality may be the answer.

Annexes

Annex 1. Empirical Evidence in Support of Conditionality as a Process

Two sets of recent evidence support the view of conditionality as a commitment process and highlight the superior performance of flexible conditionality: the recent OED (1999) study *Higher Impact Adjustment Lending: Initial Evaluation*, and a reevaluation of the Dollar and Svensson (1998) data using the country as the unit of observation

Implications of Higher Impact Adjustment Lending

The HIAL study concluded that the HIAL group of countries performed better than other IDA countries in terms of policy outcomes and economic impacts because of greater selectivity in lending and more flexibility in disbursement. In particular, HIAL introduced floating tranching of conditions, in which the government could decide when to meet conditions that were generally sectoral and draw on the corresponding tranche. Several HIAL programs had an initial tranche based on selection criteria, generally based on macroeconomic stabilization, followed by floating tranches.⁸ Table 1 rearranges the data from the HIAL study to show the relationship between conditionality and tranching arrangements and outcomes. Countries are listed from fewest to greatest number of regular tranches.

If the change in real per capita GDP growth from the pre-HIAL period (fiscal 1993–95) to the HIAL period (fiscal 1996–97) is used as a summary of performance, countries in the group with one regular upfront tranche and one or more floating tranches had the largest average increase in growth (3.5 percentage points). Though the HIAL subsamples are small, this is an encouraging result for flexibility in conditionality and tranching. It provides fresh support for the idea of conditionality as a commitment process.

Reevaluation of the Dollar and Svensson Data

The 1998 Dollar and Svensson study indicated the importance of political economy variables in predicting success or failure (using OED ratings).⁹ “These results have clear implications for how to manage policy-based lending. They suggest that the role of adjustment lending is to identify reformers not to create them” (Dollar and Svensson 1998, p. 4).

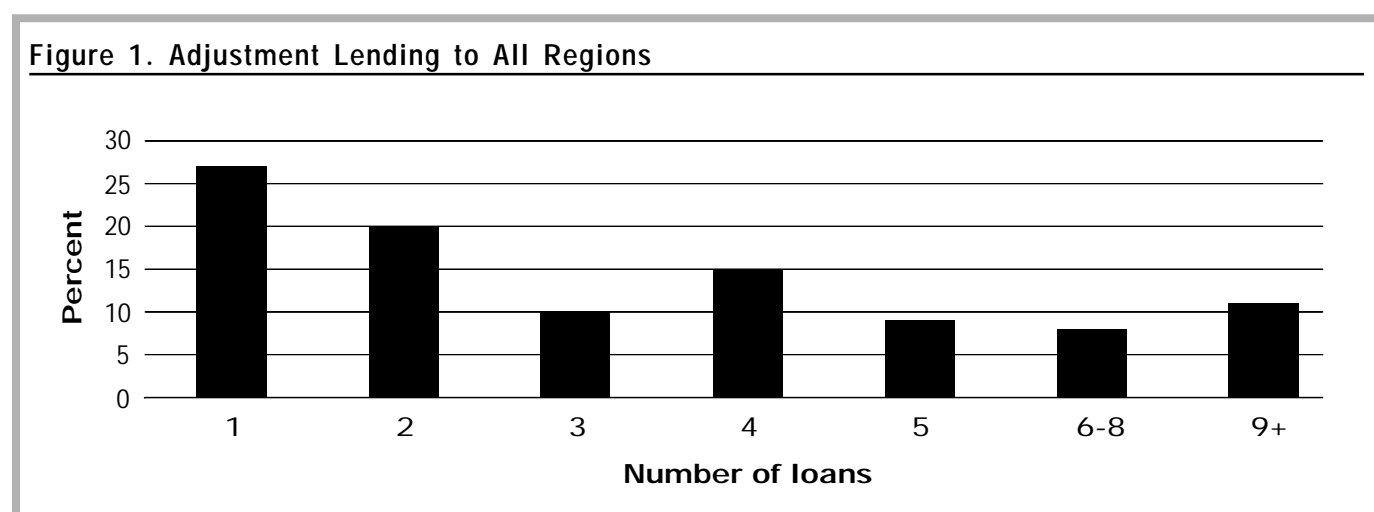
The results are based on probit regressions predicting the probability of success of an adjustment loan using political economy variables for the country receiving the loan, variables under control of the Bank, and dummy variables for geographic location. The unit of analysis is the loan, so no account could be taken of multiple loans to individual countries. The work reported here is based on the hypothesis that there is information in earlier success or failure to predict subsequent success that the Bank staff can use to select and design adjustment loans.

Table 1. Conditionality, Policy Outcomes and Impact under HIAL, Fiscal 1996-98

Country	Change from 1993-95 to 1996-98												
	Number of board effectiveness conditions	Number of post-effectiveness conditions	Total no. of conditions	Tranching mechanism	Average no. of post-effectiveness conditions	Primary Balance (percent of GDP)	Inflation	Real Effective Exchange Rate (1990=100)	Current Account Balance	Interest Rate Differential	Non-Gold Reserves	Gross Domestic Investment	Real Per Capita GDP Growth
Chad SAC I	13	N/A	13	1 regular	N/A								
Chad SAC II	23	N/A	23	1 regular	N/A	5.5	-7.4	-2.7	2.7	..	..	3.0	7.0
Madagascar	13	N/A	13	1 regular	N/A	1.7	-21.6	7.1	3.0	..	17.7	1.1	2.2
Niger	15	N/A	15	1 regular	N/A	2.7	-11.6	-3.4	0.2	6.8	-9.9	4.2	0.4
Malawi	1	3	4	1 regular + 1 floating	3	8.8	-26.0	12.0	5.3	-2.7	4.7	-0.5	2.8
Cameroon SAC II	10	15	25	1 regular + 2 floating	7.5	5.2	-9.0	-5.3	2.0	..	..	1.4	5.8
Tanzania	8	19	27	1 regular + 4 floating	4.75	4.0	-10.7	32.4	9.6	-18.7	11.2	-1.9	2.6
Côte d'Ivoire Pri. Sect. Adj. Cr.	6	11	17	1 regular + 5 floating	2.2	2.9	-10.4	-5.2	1.8	8.1	5.8	3.9	3.3
Kenya	4	11	15	2 regular	11	-0.3	-15.5	12.8	-1.5	13.4	1.0	-0.7	1.0
Mozambique	32	5	37	2 regular	5	5.2	-33.4	9.2	18.0	..	..	-5.6	1.8
Zambia	2	11	24	2 regular	11	0.8	-64.0	9.1	1.8	44.2	-5.6	2.3	6.9
Uganda/SAC III	6	13	19	2 regular + 2 floating	4.33	2.0	-6.5	4.6	2.3	3.1	3.3	0.7	-1.9
Cameroon SAC III	11	25	36	2 regular + 4 floating	5	5.2	-9.0	-5.3	2.0	..	..	1.4	5.8
Uganda/Edu. Sect. Adj.	14	31	45	3 regular	15.5	2.0	-6.5	4.6	2.3	3.1	3.3	0.7	-1.9
Mali	1	17	18	3 regular + 2 floating	4.25	2.4	-9.4	-6.3	3.9	2.4	5.1	1.1	2.8
Mauritania	3	11	14	3 regular + 2 floating	2.75	5.4	-3.6	-4.5	8.5	..	..	-3.3	0.1
Côte d'Ivoire Transp. Sect. Adj. Cr.	6	31	37	4 regular + 1 floating	7.75	2.9	-10.4	-5.2	1.8	8.1	5.8	3.9	3.3
Ghana	9	N/A	9	1 regular	N/A	1.1	-5.5	12.8	2.3	5.8	-	1.8	0.2
Cape Verde	9	5	14	2 regular	5	13.5	0.0	1.4	4.8	..	..	1.1	-0.7
Guinea	17	8	25	2 regular	8	-8.5	-2.7	-2.7	1.8	1.4	-	-0.8	0.4
Senegal	13	6	19	2 regular	6	2.8	-11	-8	2.6	7.2	7.8	2.7	3.4
Average	9.77	14.50	24.00		7.13								
Standard Deviation	8.28	9.51	11.24		3.71								
Mode	6	11	37		5								

Earlier OED cross-country evaluations on adjustment lending (Jayarajah and Branson 1995 and Jayarajah, Branson, and Sen 1996) have reported on many cases of multiple adjustment loans. A frequency distribution of all adjustment loans evaluated for the period 1979–98 by number of loans per country shows that 27 percent of countries had just one adjustment loan and 27 percent had five or more (figure 1). Thus, for a high proportion of countries there was prior information on success or failure in adjustment lending.

The patterns of success or failure on OED ratings for countries with five or more adjustment loans are shown in figure 2, with the upper entries showing satisfactory evaluations and the lower entries, unsatisfactory evaluations. (This is the sample for the regression results shown in table 2.)



The general visual impression from the country panels is one of strings of successes, occasionally preceded or followed by a failure. A plausible interpretation of a failure followed by a string of successes, as in the Philippines or Uganda, is that a change in regime gave reform credibility and an ongoing program developed. A failure following a string of successes, with at least a pause in lending, as in Madagascar or Tanzania, indicates that a country has abandoned the program for a time. These strings of evaluations are consistent with the interpretation of conditionality as commitment instrument and process.

To summarize these relations econometrically, additional probit regressions were estimated, adding a variable to the Dollar and Svensson data set, capturing—for each adjustment program—the performance of any previous adjustment loans (table 2). The number (and percentage) of satisfactory projects in the previous three years was added to the set of political economy regressors used by Dollar and Svensson (regression 1 of their table 3) with a view to explaining the performance (satisfactory or unsatisfactory rating) of adjustment programs. In particular, we focused on the three previous years for each loan, trying to minimize the tradeoffs between shorter time periods, which limit the number of observations, and longer time periods, in which older programs might confound or dilute the effects on more recent programs.

The coefficients of the variables capturing the effect of previous adjustment loans on the current one have the expected positive sign and are highly significant. Both regressions have good explanatory power, over and above a constant-probability specification. The

Figure 2. Outcome Patterns of Adjustment Lending by Country, 1980- 98

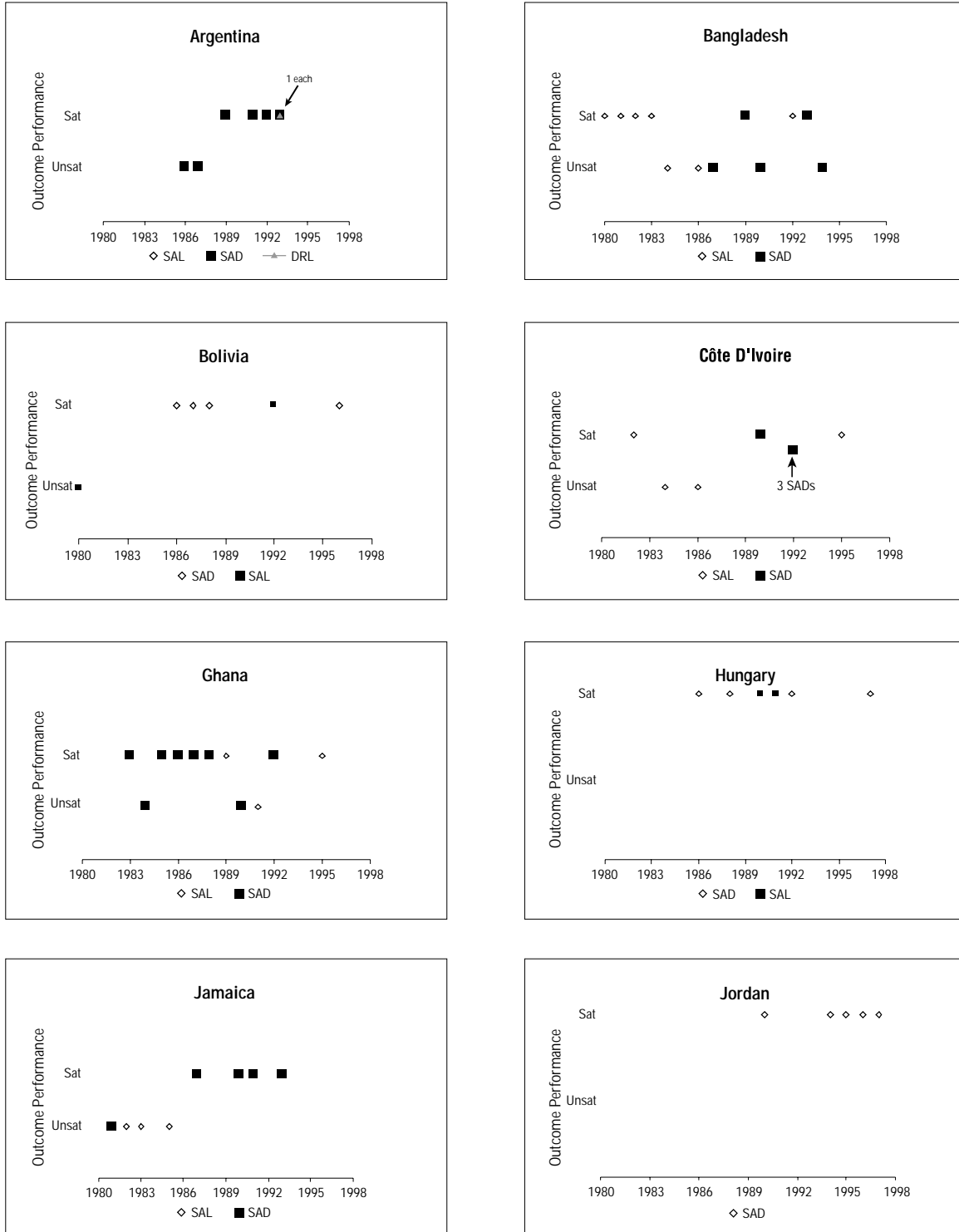


Figure 2. Outcome Patterns of Adjustment Lending by Country, 1980- 98 (continued)

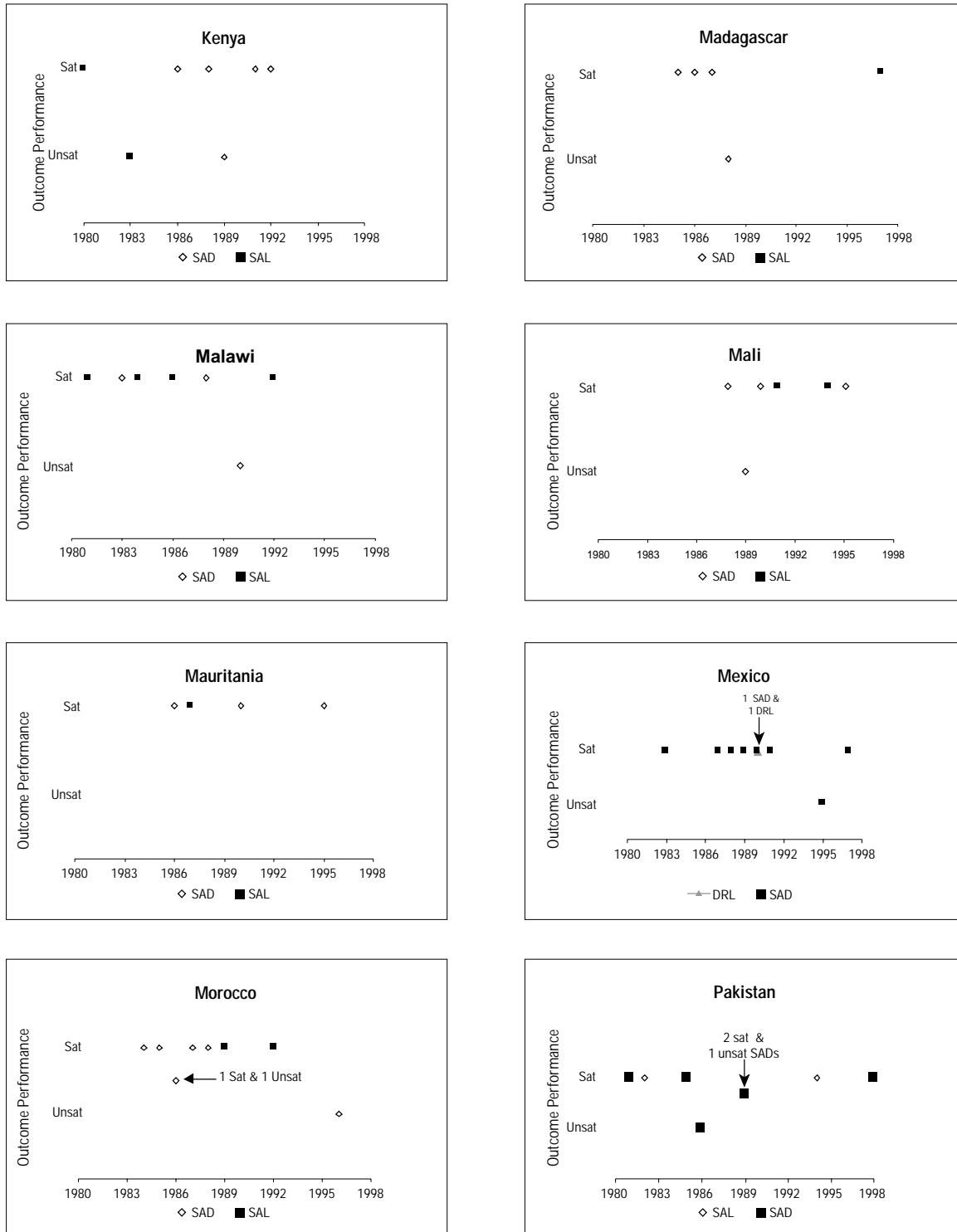


Figure 2. Outcome Patterns of Adjustment Lending by Country, 1980-98 (continued)

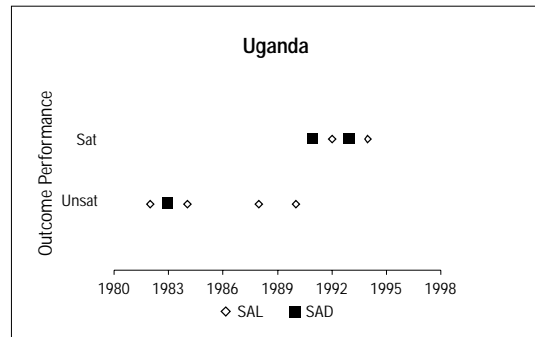
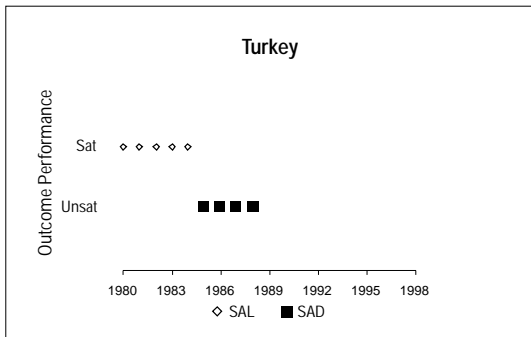
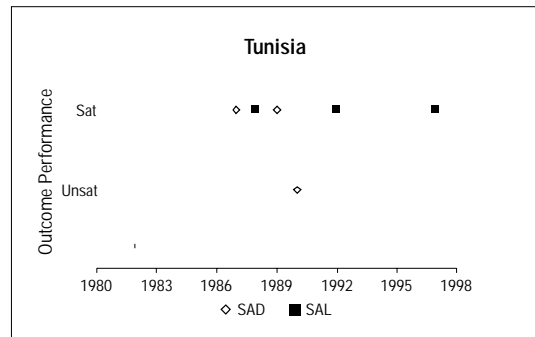
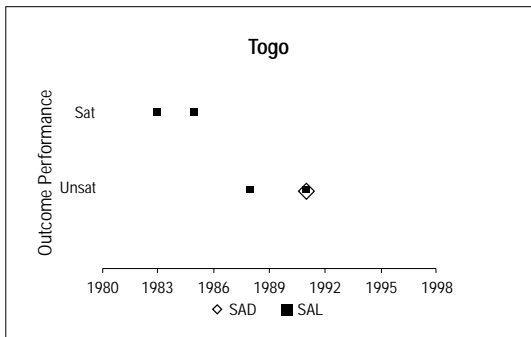
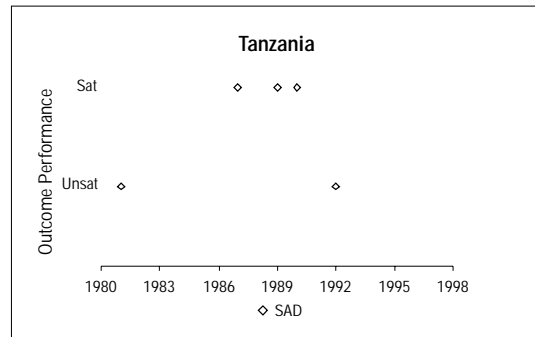
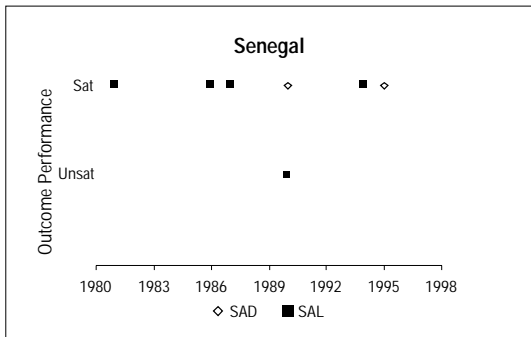
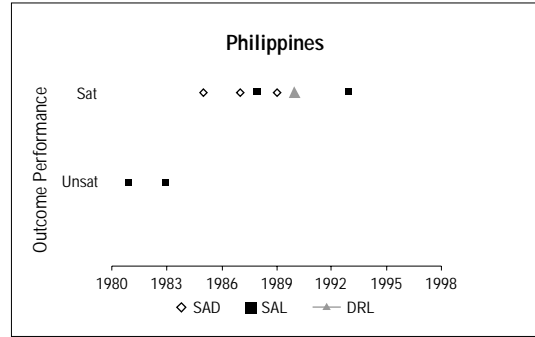
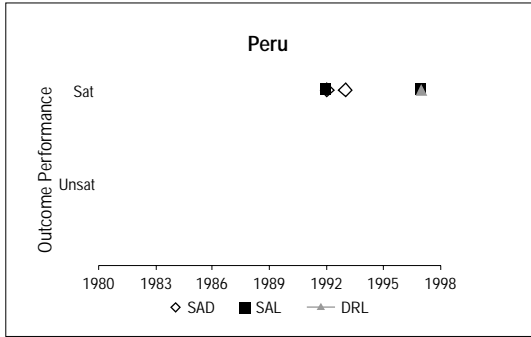


Figure 2. Outcome Patterns of Adjustment Lending by Country, 1980-98 (continued)

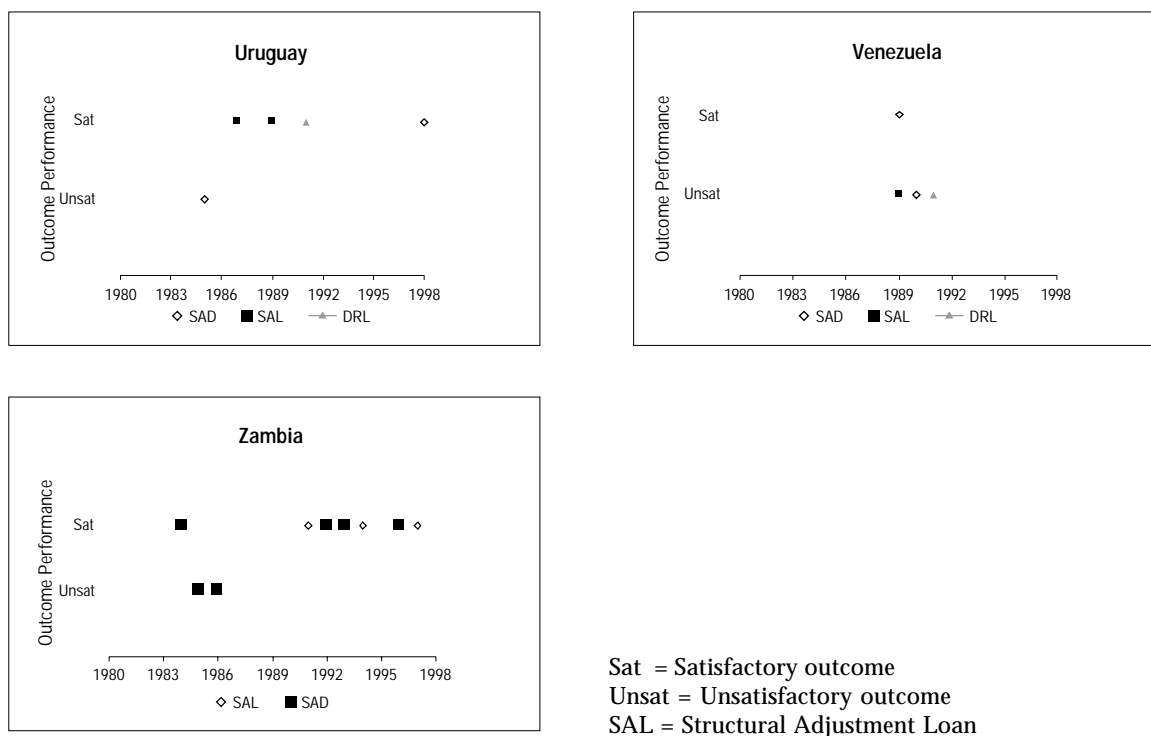


Table 2. Adjustment Loans Performance Probit Regressions

	Equation 1	Equation 2
Constant	-0.450 (0.380)	-0.489 (0.388)
Ethnic fractionalization	4.383*** (1.616)	4.439*** (1.614)
Ethnic fractionalization ²	-4.148** (1.663)	-4.289*** (1.653)
Average number of government crises	-1.047*** (0.371)	-1.056*** (0.372)
Democratically elected	0.752*** (0.266)	0.708*** (2.653)
Years in power	-0.068 (0.042)	-0.071* (0.042)
Years in power ²	0.002* (0.001)	0.002* (0.001)
Number of satisfactory adjustment loans in three previous years (if any)	0.353*** (0.117)	—
Percentage of satisfactory adjustment loans in three previous years (if any)	(0.256)	0.751*** (0.256)
Change in correct prediction from constant probability specification (percent)	6.8	6.7

results imply that past success, as measured by OED ratings, is a better predictor of current success than any of the other variables. A project's likelihood of success is 10 percent higher when preceded by at least one satisfactory adjustment loan (equation 1) and 21.5 percent higher when preceded by a series of all successful projects (equation 2). As for the political economy variables, the change in the likelihood of success associated with an improvement of one standard deviation is roughly the same across equations: average government crises, 9 percent; democratically elected, 10 percent; time in power (decrease) 1 percent; ethnic fractionalization (decrease), -2 percent. These findings suggest that there is information in past success that the Bank staff could use to forecast current outcomes.

These results are hardly definitive. The OED ratings summarize a wide range of information about past loans that is difficult to quantify for regression analysis. But they do support the concept of conditionality as a commitment device. A string of successful ratings, and the information that underlies them, could support increasing the flexibility of conditionality. The successes indicate increasing ownership of the program by the country so that the Bank can move toward ex post conditionality. In addition to political economy variables, past success may be a good indicator of current ownership.

Annex 2. Implications of the OED Higher Impact Adjustment Lending Study for Conditionality

This annex reviews the findings of OED's 1999 study, *Higher Impact Adjustment Lending* and derives lessons for the CDF.¹⁰

Client Ownership and the Bank's Role

Bank adjustment lending was introduced in 1979 to provide quick-disbursing loans to countries experiencing severe macroeconomic imbalances as the result of industrial country recession and suddenly rising world real interest rates. The rationale for lending was that borrowers needed to adjust the structure of their economies to the new international conditions. Thus adjustment lending was conditional on clients' changing policies in order to improve their structures.

After nearly two decades of experience with adjustment lending in Africa, a consensus had emerged in the Bank that it had not achieved high rates of economic growth nor reduced poverty (OED 1997, 1993; DEC 1996; Elbadawi 1992).¹¹ For instance, OED's (1997) study of adjustment lending to Sub-Saharan Africa during fiscal 1980–96 concluded that even in the best performing countries improvements in GDP growth have not been large enough to reduce poverty. According to a 1996 review of adjustment lending during 1980–92 (DEC 1996), the three strongest determinants of failure of adjustment lending were poor macroeconomic management, domestic political shocks, and an excessive number of loan conditions. While the first two are not under the control of the Bank, appropriate use of tranching and conditionality was thought to be a key to a successful operation.

In response to these findings, the Sub-Saharan Africa Region formed a working group in 1995 to develop recommendations for improving adjustment lending results. The working group identified poor compliance with conditionality and weakness in the design of adjustment lending as key issues. Their recommendations to enhance the results of adjustment lending by applying greater country selectivity and improving the design of adjustment

lending were launched as the Higher Impact Adjustment Lending (HIAL) initiative. During fiscal 1997, HIAL lending to Sub-Saharan Africa exceeded \$1.5 billion, through 14 operations in 13 countries.

The effectiveness of the concept of conditionality has recently been under attack because of the donors' unwillingness or inability to withhold aid from governments that renege on policy promise (Killick and others 1998). While good policies are essential for development and for effective financial assistance, donors cannot dictate policies (the failure of conditionality): in countries without strong ownership of reform, conditional support from donors has not led to significant improvements in policies or impact.¹²

The scope for increasing effectiveness by adopting more stringent methods is limited in adjustment lending because donors have little control over the use of funds (aid is fungible) or the extent to which reforms are sustained once the credit is disbursed. The most important factor for the effectiveness of adjustment lending may be increased country selectivity, which is a major HIAL instrument. According to the HIAL working group, six factors go into an assessment of country commitment and stakeholder participation and should be incorporated systematically into decisions on adjustment lending:

- An assessment of the country's track record and implementation of its reforms.
- Willingness of the government to draft its own Letter of Development Policy and adjustment program.
- Quality of national support for reforms.
- Fit between the country's official statements and the context of the proposed reforms.
- Fit between government tax and spending policy and the content of the proposed reforms.
- Extent of desirable "lock-in" actions to be completed before negotiation of an adjustment lending.

Whether the Bank has in fact been selective in approving HIAL operations is determined on the basis of four selectivity criteria: compliance track record with agreed-on policy conditionality (OED 1997), the Bank's Country Performance Ratings, OED's (1995) measurement of program ownership, and debt sustainability. The HIAL countries' performance at the time of selection was not significantly different from that of other Sub-Saharan Africa countries except on prior Country Performance Ratings, where it was marginally better.¹³

A primary indication of borrower ownership is willingness to draft its own Letter of Development Policy, which states government policy in specific areas supported by adjustment lending. HIAL results show that Letters of Development Policy were drafted by the government in seven cases, jointly by government and the Bank in two cases, and by the Bank alone in five cases. International Monetary Fund (IMF) guidelines are similar, ". . . to ensure ownership of the policy framework paper, the authorities should be encouraged to initiate its drafting" (IMF, 1998). Results also show that all 13 HIAL countries were implementing an IMF program at the time the HIAL operation was approved. Five had written the first version of their policy framework papers; in two cases, however, the drafts were considered inadequate and were subsequently redone by IMF and World Bank staff.¹⁴

Partnership with Government, Civil Society, Nongovernmental Organizations, and the Private Sector

The quality and nature of national support for the economic reform program and measures to mitigate its adverse effects are crucial indicators of ownership and partnership. In 9 of the 13 countries in the HIAL study the business community and the private sector were both seen as powerful proponents of reform. However, in some HIAL countries, such as Chad, lack of a strong private sector meant that support for reform came predominantly from the government. Nongovernmental organizations (NGOs) can be another strong constituency and can collaborate with government on reforms. NGOs were found to be particularly supportive in one HIAL country (Tanzania), but suspicious in another (Zambia).

Governments are more likely to buy into adjustment lending conditions for operations that promote a participatory process and increased ownership of reform programs. For example, to increase support for HIAL, operations were prepared in consultation with a broad range of civil society, the rationale for reforms was explained to a wide audience, and government was encouraged to present reform plans to the public. The HIAL study results show that governments consulted stakeholders in 9 of the 13 HIAL countries. This approach fostered transparency and ownership of the reform and reduced some of the negative sentiment about adjustment. The success of the HIAL programs could be partly attributed to these factors. This participatory process and promotion of country ownership of strategy and programs is one of the pillars of the CDF. Engaging civil society in projects and programs leads to better design and implementation results and usually greater effectiveness, including more local ownership.

Improvements in Adjustment Lending Design

HIAL was meant to improve adjustment lending program design by matching transfers to needs and providing smoother resource flows through flexible disbursement, floating tranches, and fewer, but more definite, conditions.

In the early years of adjustment lending conditionality was based on overoptimistic assumptions about the impact of reforms within the projected time period, resulting in program shortfalls. Operations with a large number of conditions had a very high probability of failure. In some cases the high number of conditions reflected doubts about government commitment and countries' lack of preparedness to undertake the operations.

The HIAL initiative recommended fewer and better focused conditions. HIAL operations averaged about half the number of conditions on adjustment lending to Sub-Saharan Africa during 1980–93. The HIAL study also found fewer conditions for fiscal 1997 adjustment loans to countries outside Sub-Saharan Africa than in the earlier period.

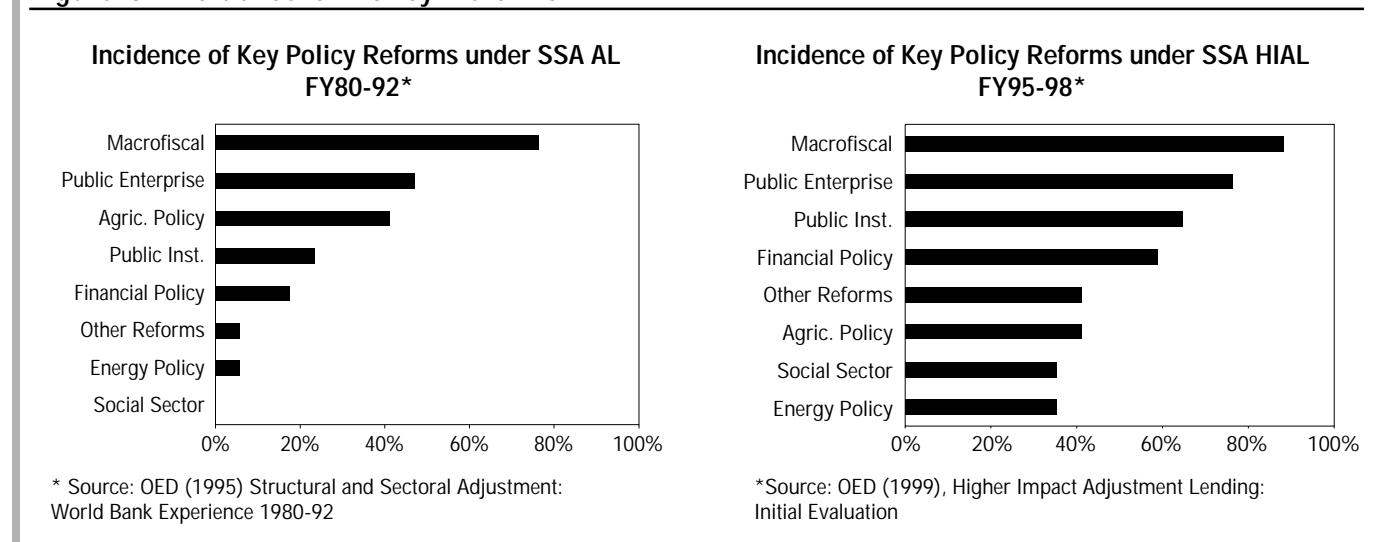
Prior to the inception of HIAL, two-tranche adjustment loans were the rule, three-tranche operations were less frequent, and single-tranche operations were rare. HIAL introduced floating tranche mechanisms and promoted single-tranche operations as an alternative in particular circumstances.¹⁵ Of the 21 HIAL operations in fiscal 1996–98, 9 had floating tranches (varying from one to five floating tranches each) and 5 were single-tranche operations. Thus about two-thirds of the operations have adopted tranching innovations. The new tranching arrangements increased ownership by giving governments increased freedom in the timing of reforms. The larger number and smaller size of tranches, together with more flexible timing, reduced pressure on the Bank to disburse even though conditions

were not fully met.¹⁶ Single-tranche operations were also common in adjustment lending in fiscal 1996-98 to countries outside Sub-Saharan Africa. The increased use of single-tranche operations is in line with the HIAL recommendations for greater ex post conditionality.

Balancing Structural and Social Concerns with Macroeconomic and Financial Adjustment

Initially, adjustment lending had different objectives from investment lending, and therefore there were differences in the emphasis of policy conditionality. While conditionality was already being used in Bank sector investment operations, macroeconomic policy reform conditions were introduced with adjustment lending. Conditions under fiscal 1980-92 adjustment lending to Sub-Saharan Africa covered a wide range of issues—macroeconomic balance, international competitiveness, improved public sector management, and in some countries agricultural sector policies. There was no explicit conditionality for social sector programs (figure 3).

Figure 3. Incidence of Policy Reforms



While HIAL operations support macroeconomic and sectoral policies that promote growth and efficient resource allocation, both of which are essential for poverty reduction, they also address social concerns in a more direct manner. The majority of HIAL operations aim to reorient public spending toward infrastructure and basic services for the poor or to eliminate distortions that disadvantage the poor. According to World Bank Poverty Board criteria, 11 of the 14 fiscal 1996-97 HIAL operations were “poverty focused.” While there were virtually no specific social sector conditions in adjustment lending to Sub-Saharan Africa during 1980-92, specific social sector conditionality was included in a significant number of HIAL operations. For example, the Tanzania Structural Adjustment Credit I had a floating social sector tranche that accounted for about 20 percent of the loan amount. Conditionality includes budgetary actions as well as specific social sector planning and programming activities.

Association of HIAL Initiative and Positive Policy Outcomes and Impact

The recommendations of the HIAL Working Group emphasizing ownership, partnership, and social concerns are being followed. Adoption of HIAL was associated with positive policy outcomes and impact. HIAL countries performed better than comparators (IDA countries in Sub-Saharan Africa and elsewhere) in fiscal adjustment, exchange and interest rate policy, and structural reforms. Better results were also achieved in economic growth, inflation, current account balance, foreign exchange reserves, and debt sustainability. The HIAL share of poverty-focused operations is higher relative to the comparators. While social sector expenditures as a share of GDP have, on average, slightly decreased in HIAL countries, interpretation of these results must take into account the short time since the start of HIAL and the many gaps in social expenditure data.

Conclusion

The HIAL initiative is aimed at enhancing adjustment lending programs through improved country selection and better design. The initiative emphasizes client ownership, stakeholder consultation and participation, the need to address social concerns, and particular attention to the specific conditions of each country—issues germane to the CDF. The HIAL initiative is associated with more positive policy outcomes in fiscal adjustment, exchange and interest rate policy, and structural reforms in the HIAL study countries than in the two IDA comparator groups (countries in Sub-Saharan Africa without HIALs and countries outside of Sub-Saharan Africa). The initiative was also associated with faster growth, lower inflation, improved current account balance, more stable foreign exchange reserves, and a sustainable debt path, outdistancing the comparators. There were more poverty-focused operations in the HIAL group, but social expenditures decreased slightly as a share of GDP while rising modestly in non-HIAL Sub-Saharan Africa countries.

Annex 3. Reforming Social Sector Policies: A Political Perspective

Social sector reforms lay at or beyond the periphery of structural adjustment efforts of the 1980s, and major reforms in health education and pension systems proved to be slow, modest, and subject to erosion or reversal.¹⁷

Why Are Systemic Reforms in Social Sectors So Difficult?

To a large extent, the problems of social sector reforms also appear in other areas requiring extensive institutional and organizational changes. The five main factors that affect the politics of reform are absence of blueprint, multiple actors, long time horizon, dense information requirements, and low apparent costs of delay. If many actors must cooperate to implement a reform, that means potentially many veto actors, which increases transaction and enforcement costs. Long time horizons also imply many potential veto opportunities and mean that the benefits of reform are often not apparent to users for some time. Lack of information may in itself stall action while the iterative nature of the reform process implies that new information may alter perceptions and reopen debate.

On a spectrum of types of reform, at one end would be macroeconomic reforms, guided by a clear technical consensus and requiring basic economic indicators, readily available

in all but the least sophisticated countries. Delaying action has extremely high costs, affecting much of the population immediately and directly.

Toward the far end are systemic reforms in education and health services. Here multiple models are available, and only limited consensus exists among technical specialists regarding basic principles of reform. Even after agreement is reached implementation is extremely complex and involves high up-front costs, long time horizons, sophisticated information requirements, and many actors. Further, these complications are reinforced by the fact that there is no evident and compelling costs to postponing action.

Somewhere toward the middle of the spectrum are systemic reforms entailing more organizational restructuring and legal changes, for example, financial sector reforms. These types of reforms also involve a large spectrum of actors and long time horizons. Considerable amounts of detailed information are needed, and the mechanisms to collect and analyze this data often need to be created or upgraded. Postponing reforms implies direct and clear costs for some groups but only indirect or delayed and often hidden costs for many others.

Several additional characteristics of social sectors further complicate major systemic changes. Entitlement psychology is an obvious impediment and refers to the benefits that are guaranteed by law or even by a country's constitution and are viewed not as privileges but as rights. Principle-agent problems also arise. In a greater degree than in other public services, the quality of output in health and education depends on the motivation and initiative of the service providers themselves. For example, what happens between teacher and student, or between health worker and patient, largely determines the effectiveness of schooling or health care. In part for this reason, it is hard to monitor and measure workers' efforts and performance fairly. Thus principle-agent oversight problems are acute.

What Circumstances and Tactics Bring About Social Sector Reform?

For all these reasons major institutional reforms in social services are extremely difficult, but they do happen. The specific circumstances and the process of reform varies from country to country, but certain themes emerge in most reform processes. Among these themes are the emergence of new advocates of reform, weakened resistance among vested interests, growing receptivity to new ideas and (with respect to pension reforms) the key role of a new paradigm or model.

New Advocates of Reform. In the 1990s social sector reforms have been incorporated into the agenda of reoriented economic strategies and structures. Growing recognition of links between successful market-oriented economic strategies and more efficient and effective social services has created new and powerful advocates for social sector reforms. The broadest links relate to the need to consolidate fiscal reforms in the context of democratic pressures. This balancing act requires medium-term fiscal considerations that increase the efficiency and effectiveness of the services and transfers instead of squeezing social sector outlays as a whole. High payroll taxes are a second, more specific link between evolving market strategies and social sector reforms. Often, payroll taxes add 50 percent to the basic wage bill, distorting and discouraging investment and job creation. A third link focuses on the quality of labor. Open market development strategies put a premium on efficient and flexible labor, which becomes more valuable once liberalization opens the doors to imports and creates the need to compete for markets at home and abroad. Savings constitutes a fourth link between economic strategy and social sector reform. Partly priva-

tized pension systems may provide a rapidly growing pool of savings and investment to boost economic growth.

The connections between fiscal considerations, effective open market strategies, and social sector reforms have begun to draw some advocates, the most obvious and central of whom are the ministries of finance. In addition, they have also begun to draw progressive business leaders, NGOs, and nonprofit organizations into the debates on reform.

Defused Resistance to Social Sector Reforms. The fact that social sector reforms have been implemented in a fair number of cases reflects not only new stakeholders, but also unexpected weaknesses in the organized opposition to such reforms. For instance, pensioners' resistance to social security reforms often turns out to be manageable once current pensioners are assured that any shortfall in social security revenues will be covered from the general budget. Service providers unions are also not always effective opponents of social sector reforms because they are often slow to grasp the implications of complex reform proposals, or they view specific reforms as marginal to their interests.

Growing Receptivity to New Ideas. The mid- and late 1990s have seen much greater interest in alternative models and the rapid growth of transnational networks among specialists, aided in part by heightened efforts by the World Bank and the regional development banks to spread information and analysis of experiences in social service sectors in different countries.

With regard to pensions, a new paradigm lay ready at hand in the Chilean experiment of the 1980s. This model offered a radical alternative and galvanized debate, and although most countries did not adopt reforms directly modeled on the Chilean experience, the alternative model and its substantial technical backing provided a way to move beyond old debates.

In health and education, specialists increasingly agree on certain basic principles, such as the desirability of separating funding from delivery of health services and the importance of introducing some degree of competition among providers of health and education services.

New actors and increased receptivity to new ideas mean that the political process of social sector reforms will now unfold in quite a different political climate than initial macroeconomic measures. If early stabilization efforts were reasonably successful, then widespread public perceptions of acute crisis are likely to have faded. In some countries perceptions of acute crisis were never widespread. In others poorly designed stabilization measures may have left most groups disillusioned about "reform programs." In all these scenarios, effective social service reforms will have to be designed, launched, and implemented in the context of politics as usual, even if the impetus and rationale for such reform come from perceptions of a deep-rooted structural crisis.

Endnotes

1. See pp.10-11.
2. See Prebsich Lecture, October 19, 1998, p.11.
3. See, for example, *Assessing Aid, and Aid and the Political Economy of Policy Change*, 1998.
4. The general implications from the HIAL study are discussed in Annex 5.2. The narrower focus at this point is the relation between tranching and disbursement arrangements and economic impact of the programs.
5. See OED 1999 Study on HIAL and Dollar and Svensson 1998.
6. See Dollar and Svensson 1998, page 4.
7. Annex 5.2 also draws on OED 1995, 1997, DEC 1996, Dollar and Svensson 1998, and Killick and others 1998.
8. The Africa Region has the largest number of adjustment operations.
9. Dollar and Svensson (1998) argued that whether or not a country has an adjustment program is not a very good predictor of who actually reforms. On the other hand, a few political economy factors—political stability, democracy, social division, and leader’s time in power—can successfully predict the outcome of adjustment lending 75 percent of the time.
10. The CPR is a measurement of the first criteria of the HIAL Working Group, which is assessing the country’s own reform before negotiation of the adjustment loan.
11. See *External Evaluation of the ESAF*, p. 37.
12. Institutional capacity-building remains *a sine qua* for stronger ownership, without which the borrower easily succumbs to the many pressures to volunteer ownership.
13. Single tranche operations were selected in cases where the track record of reform was still limited, or where the information base on the country was rudimentary. Single tranche operations are expected to be embedded in a longer-term reform program. For instance, HIAL program in Chad, Madagascar, and Niger envisaged a series of single tranche operations rather than a one-time event.
14. For post-effectiveness, a typical Sub-Saharan Africa country had to meet six conditions for release of a floating tranche, compared with nine conditions in non-Sub-Saharan Africa countries.
15. Annex 5.3 draws heavily on Nelson (forthcoming).

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