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POLICY CONDITIONS IN WORLD BANK INVESTMENT LENDING: A STOCKTAKING

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ABBREVIATIONS AND ACRONYMS

AFR	Africa Region
APL	Adaptable program loan
BP	Bank Procedure
CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CODE	Committee on Development Effectiveness
DPL	Development policy lending
EAP	East Asia and Pacific Region
ECA	Eastern Europe and Central Asia Region
ESSD	Environmental and Socially Sustainable Development Network
FM	Financial Management
FY	Fiscal year
HD	Human Development
HNP	Health, Nutrition, and Population
IBRD	International Bank for Reconstruction and Development
ID	Institutional development
IDA	International Development Association
IEG	Independent Evaluation Group
IMF	International Monetary Fund
INF	Infrastructure Network
LCR	Latin America and Caribbean Region
MIS	Management Information System
MNA	Middle East and North Africa Region
OP	Operational Policy
OPCS	Operations Policy and Country Services
PAD	Project Appraisal Document
PDO	Project Development Objective
PPAR	Project performance Assessment Report
PREM	Poverty Reduction and Economic Management Network
PRSC	Poverty reduction support credit
PSD	Private sector development
PSG	Public sector governance
QAG	Quality Assurance Group
QEA	Quality at entry
SAP/BW	Systems, Applications, and Products/Business Warehouse
SAR	South Asia Region
SWAp	Sector Wide Approach
TTL	Task Team Leader

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EXECUTIVE SUMMARY

1. On July 21, 2005, the Executive Directors asked Management to undertake a review of policy conditions as applied to Bank investment lending to complement the review of conditionality in development policy lending (DPL) that had been prepared for the fall 2005 meeting of the Development Committee. This paper responds to that request.

2. ***Sources and Coverage of Paper.*** The paper is based on a detailed review and analysis of conditions in over 500 investment lending operations approved in FY96-97 and FY03-05, a review of recent Project Performance Assessment Reports by the Independent Evaluation Group, analysis of Bank Management Information Systems (MIS) data, discussions with many Sector Boards, interviews with selected sector directors and other managers, and a survey of borrowers across sectors in all Regions. The paper takes stock of the Bank's recent experience, reviews current practice in the use of both non-standard project-specific conditions and sector policy conditions in investment lending, and assesses the evidence on the effectiveness of sector policy reform conditions attached to investment lending operations.

3. ***Declining Use of Conditionality.*** The review finds that over the past decade the Bank's overall use of nonstandard conditions in investment lending has declined. The decline in the number of sector policy conditions attached to investment operations has been particularly significant. Sector managers indicate that policy reform conditions attached to investment lending have not always been effective, in part because they are seen as Bank-imposed, so the borrower has little ownership of them or commitment to implement them; and also because the investment lending dialogue is with line agencies, which tend not to have convening power for preparing policy reform proposals, particularly when reform involves more than one sector or addresses fiscal, regulatory or legal issues. The anecdotal evidence of sector managers is that in the past borrowers often failed to comply with sector policy conditions, which led the Bank to waive them, losing credibility, and resulting in minimal movement on sector reform.

4. ***Costs.*** Bank MIS data show that operations with sector policy conditions attached take longer to prepare and to become effective than operations with project-specific conditions (or those without any non-standard conditions). However, there is no significant difference in the monetary cost to the Bank of preparing or supervising operations with the two kinds of conditions. This implies that the additional cost imposed by sector policy conditions is borne by the borrower, largely in the form of delays, as when loan disbursement is linked to the uncertain speed of sector policy reforms. Borrowers confirm that, while the content of Bank sector policy conditions is reasonable, these conditions often result in project delays.

5. ***Fiduciary and Safeguard Conditions.*** Bank MIS data show that spending on fiduciary requirements is around 14 percent of Bank administrative spending on lending and around 8 percent of spending on country services. In addition, they show that projects that required actions under the Bank's environmental and social safeguard policies tend to cost more and take longer to prepare than others. However, borrowers generally rate the Bank's fiduciary and safeguards requirements as reasonable in light of the benefits gained. At the same time, their feedback points to room to increase the Bank's efficiency in processing projects.

6. ***Conclusions.*** On the basis of the experience of sector managers, feedback from QAG, and some evidence from IEG, this paper concludes the following:

- Policy conditions in investment lending, as in DPL, are more likely to result in sector policy reform when there is clear borrower ownership, commitment, and demand at the sector level, and when the appropriate central ministry (such as the Ministry of Finance) is part of the dialogue and supports the agreements reached. Under these circumstances, sector reform requirements can be addressed through the judicious use of sector policy conditions in investment operations. Sector policy reform conditions may also be warranted, and effective, in large operations with significant macroeconomic effects. In addition, policy reform requirements may be addressed up front, during project preparation, or in parallel with lending.

- While project-specific controls should continue to be built into the design of each investment lending operation, in most cases overarching governance and policy issues are likely to be more effectively addressed through other mechanisms than policy conditions alone.

- The Country Assistance Strategy should be the starting point for discussions on sector policy reform, and development policy lending can complement investment lending by addressing key policy pre-conditions. Analytic and advisory activities, possibly supported by technical assistance, can serve as useful vehicles to build borrower ownership, consensus for reform, and agreement on prerequisites to investment lending in the sector. Finally, a flexible approach to monitoring movement on reform commitments—such as through Letters of Sector Policy associated with investment loans or through a dialogue on reform (as a precursor to or in parallel with lending operations)—may also be useful in moving forward the agenda on policy reform.

POLICY CONDITIONS IN WORLD BANK INVESTMENT LENDING: A STOCKTAKING

I. INTRODUCTION

1. Since the World Bank began using policy-based loans, there has been considerable debate around the use of conditions in Bank lending. Many borrowers and outside commentators have criticized the Bank for "excessive" use of policy conditionality in its operations. Over the last decade, the Bank has increasingly recognized ownership as key to the effectiveness and development impact of conditions, and thus has been concerned with ensuring that there is borrower ownership of such conditionality. In October 2004, the Development Committee asked Bank Management to undertake a review of the Bank's "policy and practice on conditionality."[1] In response, Management prepared a review of the conditionality associated with Bank development policy lending,[2] which the Executive Directors discussed on July 21, 2005. During that discussion, Executive Directors asked Management to also prepare a review of the policy conditions that have been applied to Bank investment lending. This paper responds to that request.

2. ***Sources and Coverage.*** The paper is based on a detailed review and analysis of conditions in over 500 investment lending operations approved in FY96-97 and FY03-05, a review of recent Project Performance Audit Reports by the Independent Evaluation Group, analysis of Bank Management Information Systems (MIS) data, discussions with many Sector Boards, interviews with selected sector directors and other managers, and a survey of borrowers across sectors in all Regions. The paper documents the evolution of World Bank lending and the use of conditions attached to investment lending, takes stock of the Bank's recent experience, and reviews current practice with conditions applied to projects. More specifically, it examines the extent to which non-standard conditions in investment lending are project-related or cover broader sector policy areas, the differences between Regions and Networks in the use of such conditions, and the evidence on the effectiveness of sector policy reform conditions attached to investment lending operations. With regard to the Bank's fiduciary and safeguards policy conditions, which are mandatory governance requirements that apply to all Bank projects, the paper presents borrower feedback on the overall reasonableness of these requirements in light of the benefits gained, as well as recent data on the costs of their application for both the Bank and borrowers.

3. ***Key Messages.*** This first-ever systematic analysis of conditions in Bank investment projects notes that project complexity in the form of sector policy conditions attached to individual lending operations was high in the late 1990s. It presents evidence that such complexity has not always been efficient or effective in achieving policy reform, and finds that the use of sector policy conditions in investment lending has declined significantly over the past decade. In this regard, the paper underlines the utility

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1 *Development Committee Communiqué*, October 2, 2004.

2 *Review of World Bank Conditionality: Summary Findings* (SecM2005-0390), July 7, 2005.

of using complementary instruments to address policy distortions and the centrality of the CAS dialogue in helping create an environment in which investment lending would have a sustainable development impact. While borrowers generally rate the Bank's policy, fiduciary and safeguards requirements as reasonable in light of the benefits gained, they also point to room for further improvement in terms of the delays associated with Bank project processing.

4. ***Structure of the Paper***. Section II of this paper describes the evolution of Bank lending over the past few decades in response to changes in the paradigm for development assistance and in the Bank's operating environment, and draws a distinction between conditions that address project-specific aspects and those that address sector policy reforms. Section III takes stock of the incidence of conditions over the past decade and discusses the impact of project and sector reform conditions on project preparation and supervision costs. Section IV presents recent data on the costs of application of the Bank's fiduciary and safeguard requirements, while Section V presents feedback from borrowers, Section VI discusses other possible vehicles for policy reform, and Section VII summarizes the conclusions.

II. WORLD BANK LENDING

5. From its earliest days through the 1960s, the Bank took a project-by-project approach to development assistance, focusing on capital-intensive infrastructure projects. By the late 1970s, however, it had become clear that the policy and institutional environment in which projects were implemented was a major determinant of the performance of the Bank's growing project portfolio. Indeed, in many borrowing countries, policy-induced distortions were so severe that projects could not be expected to succeed no matter how well designed they were. Over the years, as more was learned about the necessary conditions for successful development and poverty reduction, the paradigm for development assistance changed—away from bricks and mortar alone, and toward developing sound policies and institutions. This section[3] describes how the Bank's approach and instruments evolved in tandem with these changes in the paradigm for development assistance (Annex A provides more details) and presents a typology of conditions in investment lending.

A. Evolution of World Bank Lending

6. As the importance of country ownership to the sustainability of reforms (and, therefore, of investments) became clearer, the Bank steadily increased the country focus of its development assistance, moving away from narrowly defined, project-based approaches to longer-term, country-, program- and sector-wide approaches designed to "put borrowers in the driver's seat," build local capacity, and improve governance. In the early 1990s the Bank started using the Country Assistance Strategy (CAS) as a

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[3] This section draws from *Supporting Country Development: World Bank Role and Instruments in Low- and Middle-Income Countries* (SecM2000-435), July 21, 2000, and *Infrastructure: Lessons from the Last Two Decades of World Bank Engagement* (SecM2006-0046), February 8, 2006.

framework for developing lending programs that were more closely aligned with the country's own priorities and strategy for development,[4] and that focused on the areas in which the Bank could best add value. The menu of non-lending instruments[5] became more closely integrated with lending: the CAS was supported by economic and sector work on poverty, human development, public sector management, and private sector development.[6] The approach was buttressed by the use of country budgets (which had been introduced in 1987), decentralized country departments in the field (beginning in 1996), and the country-based Comprehensive Development Framework.

7. ***Attention to Policy Reform.*** By the 1990s, local capacity building, sector policy reform, and institutional development had become increasingly important components of investment projects.[7] In September 1997, the Bank introduced adaptable program loans (APLs) to bring a longer-term perspective and greater implementation flexibility to investment lending. A series of APLs was expected to build on the achievements of each successive loan to support the creation and maintenance of a strengthened policy and institutional framework and of country ownership of the reform program.[8] By 2002, policy reform was an objective in four out of five Bank operations, with investment projects just as likely as adjustment operations to include policy reform as an objective.[9]

8. ***Evolution of Instruments.*** As the use of sector-wide and programmatic approaches grew, the design and coverage of investment and adjustment[10] operations began to converge. By the second half of the 1990s, investment projects had become fairly complex, addressing sector policy issues through loan covenants that required policy reform and institutional actions to improve the operating environment within which the projects were to be implemented. At the same time, adjustment operations began to cover institutional issues, including supporting policy and institutional reforms and the creation of the enabling environment for efficient public and private sector development.[11]

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4 Initially, the CAS (which started out as the Country Program Paper) was a purely internal Bank note. Today it is not only shared with the government, but also prepared in a consultative and participatory manner involving the government, civil society, and other stakeholders to ensure broad ownership of development priorities and understanding of the role of external assistance.

5 Non-lending instruments include analytic and advisory services, economic and sector work, research, capacity building, non-lending technical assistance, aid coordination, training, and knowledge-sharing activities.

6 The focus on the country as the unit of account was institutionalized through successive internal reorganizations of the Bank along geographic lines (see Annex A).

7 See *Fourth Quality-at-Entry Assessment* (CODE2002-0014), March 26, 2002.

8 *Fourth Review of Adaptable Lending* (CODE2005-0067), July 25, 2005. In 1999, IEG found that stronger institutions are associated with a 20-percentage point increase in the likelihood of a project's outcome being rated satisfactory; see *1999 Annual Review of Development Effectiveness*, Report No. 20180, November 30, 1999.

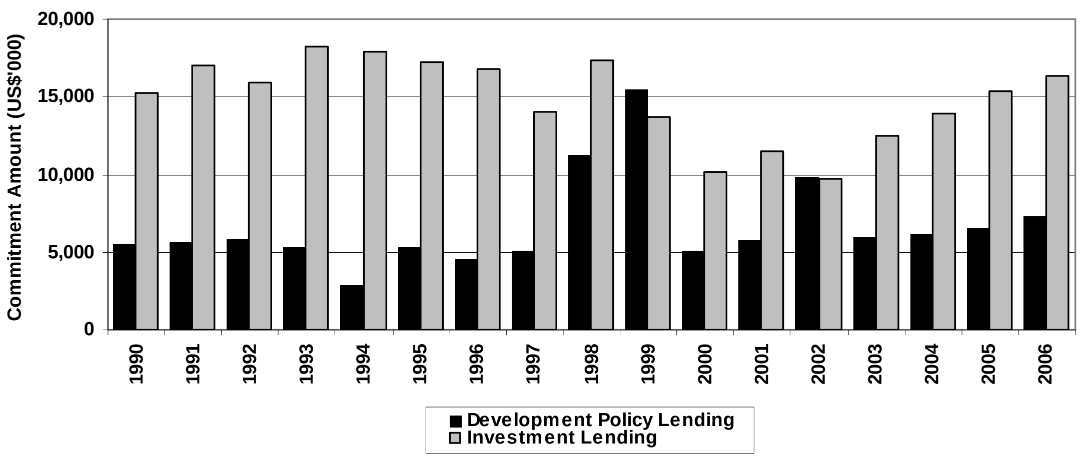
9 *Fourth Quality-at-Entry Assessment* (CODE2002-0014), March 26, 2002.

10 Adjustment lending provided financial/budget support to countries implementing "structural adjustment," usually in response to a balance of payments shock.

11 This led the Bank to revamp the instrument and replace it with development policy lending (DPL) in 2004.

9. ***Decline in Investment Lending.*** Bank investment lending peaked in the mid-1990s (see Figure 1); then the volume of Bank lending as a whole, and of investment lending in such core sectors as infrastructure and agriculture, started to decline. In particular, IBRD borrowers, which increasingly sought and gained access to capital markets, complained about the time it took to prepare Bank-financed projects and the burden imposed by the multitude of fiduciary, safeguard, and other requirements attached to them.[12] In response, in July 2000 Management constituted a Bankwide task force to investigate the extent to which the cost of doing business with the Bank was contributing to the decline in investment lending.[13] At the same time, the Bank realized that it had often been overambitious in setting the scope of reforms to be leveraged by individual investment projects. Linking the disbursement of loans to the uncertain speed of sector-wide reforms had increased the riskiness of the investments financed and affected their performance. Moreover, in countries with suboptimal policies, the Bank had avoided lending altogether rather than seeking an approach that was better calibrated to the pace of reform, financing simpler, less risky projects that would still produce important results while building the basis for future operations.[14]

Figure 1. IBRD/IDA Lending Volumes – FY90-06



10. ***Modernization of Investment Lending.*** In 2003, to more flexibly respond to client demands and varying country circumstances and thus enhance the effectiveness of Bank lending, Management launched an effort to modernize and simplify the Bank's investment lending policies, products, and procedures. This initiative has increased the Bank's emphasis on institutional development, on leveraging country capacity as part of project design, on more effective implementation and on achieving measurable results. The modernization exercise has resulted in updated and revised policies, streamlined procedures and documentation, harmonized rating criteria, and the mainstreaming of

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12 See *Enhancing World Bank Support to Middle-Income Countries: Revised Version* (SecM2004-0071/1), April 20, 2004.

13 *Cost of Doing Business: Fiduciary and Safeguard Policies and Compliance* (SecM2001-0469), July 17, 2001.

14 "Disciplined Use of Conditionality in Lending Operations," September 14, 2004; memo to staff from James W. Adams, Vice President, Operations Policy and Country Services.

fiduciary and safeguard work through the integration of review and clearance processes in project teams.

11. ***Changing Approach to Conditionality.*** The emphases of the modernization agenda, awareness of the need to build ownership of policy reform, recommendations of the Quality Assurance Group (QAG),[15] the Independent Evaluation Group (IEG),[16] and the Bankwide Working Group on Enhancing World Bank Support to Middle Income Countries, and the experience that sector policy conditions attached to investment lending had often had limited success in achieving policy reform led Management, in late 2004, to issue guidance[17] on the use of conditions in investment lending. In view of the fact that responsibility for decisions on policy reforms often lies with central ministries rather than the line ministries with whom the investment lending dialogue is conducted, this guidance recommended that country and task teams draw on strong analytic work, regular engagement in policy dialogue, and development policy lending to advance major policy reforms rather than using sector policy conditions attached to individual investment operations.

B. Conditions in Investment Lending

12. This section briefly discusses the conditions applied to Bank investment lending. For each operation, the Bank and borrower enter into an IBRD Loan or IDA Financing Agreement (referred to as a Legal Agreement) that sets forth the amount of the loan, credit, or grant and the terms and conditions on which it is made.[18] Contractual "terms and conditions" include *conditions of effectiveness or disbursement*, which are essential prerequisites for the Bank to disburse funds for the project,[19] and *covenants*, which set out

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15 In 2003, QAG recommended that Regions initiate measures designed to reduce the number of conditions of effectiveness and disbursement in loans; see *Quality at Entry in FY02 (QEA5): A QAG Assessment* (CODE2003-0018), April 16, 2003. In 2004, QAG noted that there was still room to move effectiveness conditions further upstream in the policy dialogue: "Panelists' judgments indicate that there are still too many effectiveness conditions in several operations and the time needed to declare an operation effective is often under-estimated"; see *Sixth Quality at Entry Assessment,* QAG, January 21, 2004.

16 A number of Country Assistance Evaluations provide evidence of the role technical assistance and investment loans can play in promoting institutional development. IEG has emphasized that the sustainability of benefits requires that these operations be part of a broader reform program, and that linking technical assistance and investment lending with policy reforms supported by adjustment loans also improves the probability of success. See *Country Assistance Evaluation Retrospective – OED Self-Evaluation*, Report No. 31982, April 5, 2005.

17 "Disciplined Use of Conditionality in Lending Operations," September 14, 2004; memo to staff from James W. Adams, Vice President, Operations Policy and Country Services. Available at: http://intranet.worldbank.org/WBSITE/INTRANET/UNITS/INTOPCS/INTCOUNTECONOMICS/0,,contentMDK:20280081~pagePK:64137152~piPK:64136883~theSitePK:388784,00.html

18 OP 7.00, *Lending Operations: Choice of Borrower and Contractual Agreements.* Other legal agreements may include IBRD Guarantee Agreements and Project Agreements (with project implementing entities). These legal agreements would also include covenants and/or conditions concerning the implementation and operation of the project. The term 'Legal Agreement' refers to any of these agreements, including IBRD Loan and IDA Financing Agreements.

19 Other conditions, such as conditions of negotiations or conditions of Board presentation are not contractual conditions in the sense that they must be complied with before any agreement is signed between the Bank and the borrower.

the contractual obligations or undertakings of the borrower. Both sets of requirements are specified in the applicable Legal Agreements, and are included, in part to ensure that the project achieves its development objectives, and in part to enable the Bank to comply with its fiduciary obligation to its shareholders to ensure the efficient use of its funds for the purposes intended.[20]

13. ***Conditions.*** Effectiveness conditions must be fulfilled before the Legal Agreement enters into effect[21] and funds can be disbursed. The Bank may specify additional conditions—disbursement conditions—for funds allocated to particular categories to be disbursed. If conditions for disbursement are not met, the Bank will not disburse the funds allocated to the particular category until the borrower meets them, and, if this is not achieved, may cancel the relevant part of the loan.

14. ***Covenants.*** Covenants obligate the borrower to take specific actions and, while they are normally dated (e.g., requirements to be fulfilled by a specified date), in some cases they may cover ongoing obligations through the life of the project (e.g., ensuring that the borrower maintains an acceptable financial management system) and, therefore, do not have a date associated with them.[22] After the Legal Agreement becomes effective, the Bank may exercise its contractual remedies (e.g., suspension, cancellation, acceleration) if the borrower does not comply with its covenants.[23] Covenants in the legal agreements for investment lending generally cover the following: debt service and repayment, actions to comply with the Bank's policies (e.g., fiduciary and environmental

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[20] "In the investment-lending context, the Bank ensures that its 'productive purposes' requirement is achieved through specific legal covenants that require the borrower to carry out a project (designed to achieve specific productive and development objectives) with due diligence and efficiency," *Review of World Bank Conditionality* (SecM2005-0390/2), July 8, 2005.

[21] A distinction is made between 'standard' and 'special' conditions of effectiveness. Standard conditions of effectiveness apply to all loans; they require the borrower to show that the execution and delivery of the legal agreements on behalf of the borrower have been duly authorized or ratified by all necessary governmental and corporate actions. Special conditions of effectiveness are specific to a particular loan; they pertain only to actions that are essential for initiating the implementation of the project, or that need to be taken early on to ensure project success. The legal agreements terminate if the conditions for effectiveness are not met by the date specified in the legal agreements. See OP 13.00, *Signing of Legal Documents and Effectiveness of Loans and Credits*.

[22] OP 7.00 provides guidance on loan covenants as follows: "The undertakings, or covenants, that are included in the contractual documents set out the parties' obligations with clarity and specificity. The covenants are tailored to the specific responsibilities of the contracting party (i.e., borrower, guarantor, or implementing entity). In particular, covenants must not require the party to cause certain actions to be taken by an entity over which it cannot exercise the necessary control. Covenants should cover aspects that are essential for the operation. Covenants must be (a) reasonable in number; (b) realistic and reasonable in substance and in their time horizon and monitorable; and (c) consistent with other covenants with the same parties. The Bank does not stipulate covenants that require the member to enact legislation, and tries to work within existing law to the extent possible. If enactment of particular legislation is necessary to achieve the project's objectives, the appropriate steps to be taken for such enactment should be clearly defined; and such enactment is made a condition of negotiation, Board presentation, effectiveness, or disbursement, rather than a covenant."

[23] Bank remedies may also be invoked when specific conditions are realized, as, for example, when there is a reversal in the borrowers' policy framework or a change in legislation that makes the project unlikely to be completed as intended.

and social safeguard policies), implementation and flow of funds,[24] monitoring and evaluation, and periodic reporting to the Bank.

15. ***Aspects Covered.*** This review is focused not on the typical Bank requirements for lending—such as those covered by the standard covenants—but on non-standard conditions that are tailored to the development objectives of the specific project being financed. Such requirements may be conditions of effectiveness or disbursement, or dated covenants. They may be narrowly focused on project-specific needs or broader, covering sector policy changes. In addition, since the particular conditions and/or covenants resulting from the application of the Bank's fiduciary and safeguard operational policies are often considered the main cause of the "high cost of borrowing from the Bank,"[25] the paper discusses them briefly in section IV. For the rest of this paper, the term "conditions" is intended to cover both covenants and conditions.

16. ***Other Requirements.*** Borrowers must also meet other requirements in connection with loans—for example, requirements that must be met before a loan can be considered, "triggers" for the operation,[26] aspects related to project appraisal (e.g., the requirement to conduct and disclose environmental assessments), or prerequisites (sometimes loosely referred to as conditions) for loan negotiation or Board presentation. These requirements are not included in the Legal Agreement and are not, therefore, formally considered conditions.[27] The Bank's legal remedies apply only to conditions included in the applicable Legal Agreement.

17. ***Project Conditions and Sector Policy Conditions.*** This paper distinguishes broadly between conditions that relate solely to project implementation or the quality of the assets being financed by the loan, and sector policy reform requirements that "go beyond" the project and necessitate borrower actions at the sector-wide or economy-wide level. Depending on project objectives, both types of conditions may require the reform

[24] These are usually process requirements, such as, requirements to set up implementation units, appoint project management, prepare and adopt operations manuals, etc., in order to ensure readiness for implementation.

[25] *Cost of Doing Business: Monitoring Framework for Follow-Up* (SecM2001-0469/1), August 10, 2001.

[26] While not the focus of this paper, Annex B presents the findings on triggers in the small number of APLs in the PADs reviewed.

[27] While conditions for appraisal, negotiation and Board presentation precede and therefore are not included in the Legal Agreements, they play an important role in loan processing especially in determining the time required for project preparation.

of institutional arrangements and/or actions to enhance capacity in existing or new institutions.[28]

- ***Project conditions*** are those that are critical to the financial (and economic) viability of the project, including the standard project covenants (e.g., those relating to audits) that apply to all Bank projects, and dated covenants on aspects such as setting up offices, hiring certain staff, and so on. Beyond this are *non-standard conditions that are tailored to the particular project under consideration and that derive from the project's specific development objectives (PDOs)*: for example, a dated covenant requiring the achievement of specified financial performance ratios for a public utility; improved tariff collections; or the imposition of new user charges or tariffs. In this paper, "project-specific conditions" refers to this subset of non-standard conditions; Box 1 presents examples of such conditions from a sample of projects reviewed for this paper.

Box 1. Examples of Project-Specific Conditions

The following projects illustrate the use of project-specific conditions in relation to key PDOs.

- ***Uganda Environmental Management and Capacity Building project (FY96).*** PDOs: Build capacity for environmental management at national, district, and community levels; strengthen capacity in selected districts and initiate a process for communities to address natural resource degradation and problems of local concern. Conditions: Approval of statute establishing the National Environmental Management Agency under the Ministry of Natural Resources.
- ***India Bombay Sewerage Disposal project (FY96).*** PDOs: Strengthen the capacity of Municipal Corporation of Greater Bombay's water supply and sanitation department and sustain the financial viability of the provision of water and sanitation services in Greater Bombay. Conditions: Internal cash generation through tariff increases (as needed) to cover at least 35% of capital expenditures per year; required use of cash surpluses for asset replacement.
- ***Croatia Coastal Cities Pollution project (FY04).*** PDOs: Improve the quality of Croatia's Adriatic coastal waters to meet EU ambient quality standards in the participating municipalities in a financially and operationally sustainable manner by strengthening the institutional arrangements for financing and management of wastewater management in Croatia. Conditions: Establishment of a new institution for monitoring coastal pollution under applicable commercial law prior to effectiveness; achievement of financial ratios through tariffs for the life of the project.
- ***Jamaica National Community Development project (FY03).*** PDOs: Provide basic services and temporary employment opportunities in specified communities and promote social and community development, especially among poor people. Conditions: Legal registration of communities.

- ***Sector policy reform conditions*** refer to broad sector policy changes *going beyond actions required strictly for project viability*: for example, requiring enactment or amendment of legislation;[29] executive action, such as adoption of

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[28] For instance, policy reform may require the creation of new entities or the restructuring or reorganization of existing entities so that they may implement the new policies. In general, managers advise that changes to institutional arrangements should be prerequisites to the project and addressed in the dialogue around project identification and preparation rather than being included as project or policy conditions.

[29] Enactment of laws would be a condition of effectiveness or disbursement and not a dated covenant to the extent enactment of laws is not under the control of the Executive.

formal rules and procedures, issuance of regulations,[30] or establishment of new institutions; privatization of state entities,[31] and so on. Since sector policy reform conditions often involve fiscal, legal or regulatory changes they may require action by entities outside the sector. Box 2 presents examples of such conditions in a sample of projects reviewed for this paper. "Beyond project" conditions are motivated by the need to improve or ensure project viability, so the distinction between project and sector policy conditions is often blurred[32] (as can be seen from the examples in Box 1 and Box 2). In this paper specific policy or regulatory changes that are required for project financial viability are categorized as project-specific if they are necessary to the achievement of the PDOs. Thus the issuance of implementing regulations associated with land titling decrees in a land titling project is considered a project-specific condition.

Box 2. Examples of Conditions that go Beyond the Project

The following projects illustrate the use of sector policy conditions in relation to key PDOs.

- ***Cambodia Phnom Penh Power Rehabilitation project (FY96).*** PDOs: Support the rehabilitation of Phnom Penh's power distribution system; create suitable conditions for development and efficient operation of the power sector with the involvement of the private sector. Conditions: Sector-wide reforms: the enactment of an Electricity Act satisfactory to IDA; creation of an autonomous regulatory body; and financial performance benchmarks for the utility such as reduction of accounts receivable and achievement of specific financial ratios (including one for a minimum 6% financial rate of return on all assets).
- ***Kyrgyz Republic Power and District Heating Rehabilitation project (FY96).*** PDOs: Improve the efficiency, reliability, and environmental impact of the power and district heating system; introduce appropriate financial management in, and restructure along commercial lines, the Kyrgyz National Energy Holding Company; attract private sector interest in petroleum exploration and production. Conditions: Enactment of energy and electricity laws and legislation for petroleum exploration and development; funding and implementation of a social safety net program; achievement of financial ratios for the power company.
- ***Honduras Trade Facilitation & Productivity Enhancement project (FY04).*** PDOs: Increase the productivity of Honduras private sector and thus improve its competitiveness. Conditions: Establish competition policy institute, approve severance payment plan, create transport regulatory agency.
- ***China Tianjin Urban Development II project (FY03).*** PDOs: Develop and carry out physical and institutional measures to enhance the efficiency and equity of urban waste water management and transportation systems. Conditions: Raise sewage tariffs to cover operation, maintenance, and depreciation costs of all sewage sector assets from Jan. 1, 2006 or earlier; implement sector institutional reforms covering organization, financing, and regulation of sewage services and their commercialization, and an institutional plan for the transport sector.

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30 Possibly a dated covenant agreed with the borrower to the extent regulations are under the control of the Executive.

31 This would be a condition of effectiveness or disbursement since a dated covenant could force a poorly timed sale.

32 In some instances staff feel that the *raison d'être* of Bank engagement is to improve performance more broadly in the sector. This is particularly true of the urban/water sector, where improved policies and institutions are considered to be central to better quality of the assets being financed and to service quality and delivery. Sector managers have stated that if the Bank is to make an effective contribution in this sector, policy and sector reform conditions are inevitable.

III. STOCKTAKING: POLICY CONDITIONS IN INVESTMENT LENDING

18. This section examines the use of policy conditions in investment lending, the differences among Regions and Networks in the use of these conditions, and the changes in such use over the past decade (Annex C provides further details on all of these areas).[33] The findings are based on a comprehensive desk review of a representative sample of Project Appraisal Documents (PADs) approved in FY96, FY97, FY03, FY04, and FY05[34] for specific investment projects (which constituted 66 percent of total investment operations in 2005) and APLs, which, as a program based version of specific investment loans, are a small but increasingly important investment lending instrument.[35]

A. Principal Findings

19. Figures 2 and 3 display the changing incidence of project-specific conditions and sector policy reform conditions in investment lending by Region and by Network. Investment operations in FY96-97 generally tended to include non-standard conditions related to the investment, and operations were often conditioned on the implementation of a Letter of Sector Policy that stipulated the adoption of specific sector policy and institutional reforms. At the low end, 65 percent of investment lending operations in LCR were subject to non-standard project-specific or sector policy reform requirements, while at the high end 96 percent of operations in SAR were subject to conditions of one kind or the other. In terms of Networks, HD had the lowest incidence of conditions at 69 percent, while INF had the highest at 88 percent. The data for FY03-05 show a noticeable decline in the use of non-standard conditions—especially those that extend beyond the project—among all Regions and Networks. For the Bank as a whole, the incidence of investment lending conditions declined from 80 percent in FY96-97 to 36 percent in FY05.

20. ***Incidence of Project-Specific Conditions.*** The share of Bankwide investment lending operations that included project-specific conditions, at 55 percent in FY96-97, declined to 29 percent in FY03-04 and was 33 percent in FY05. The aggregate figures hide significant variation across Regions and Networks: for instance, the incidence of project-specific conditions dropped from 60 percent to 50 percent in EAP, and from 88 percent to 18 percent in SAR, between FY96-97 and FY05. Project-specific conditions applied to more than 50 percent of infrastructure operations throughout the period, while in ESSD the incidence declined from 69 percent to 29 percent over the period.

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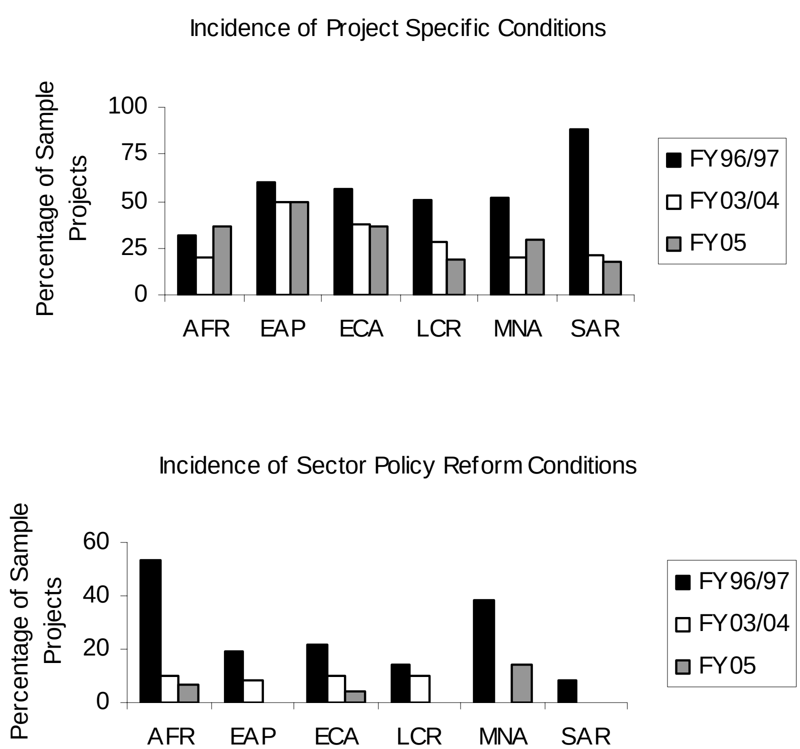
[33] Operations which include <u>both</u> non-standard project-specific conditions and sector policy reform conditions are classified as having sector policy conditions.

[34] The review covered a random sample of 50 percent of lending approvals (excluding technical assistance, supplemental, learning and innovation, emergency recovery, and financial intermediary loans) in this period: 189 loans/credits approved in FY96/97, 191 loans/credits approved in FY 03/04, and 123 loans/credits approved in FY05. This provides a confidence level of 95 percent (and a margin of error of +/– 5 percent) that the data are representative Bankwide. The sample is representative at the Regional level with 90 percent confidence and a margin of error of +/– 10 percent.

[35] The sample includes 36 APLs from FY03-05: 8 in AFR, 2 in EAP, 8 in ECA, 14 in LCR, 3 in MNA, and 1 in SAR.

21. ***Incidence of Sector Policy Conditions***. In FY96-97, the incidence of sector policy reform conditions varied from a low of 8 percent in SAR to a high of 53 percent in AFR.[36] The Bankwide incidence of such conditions dropped from 25 percent in FY96-97 to 7 percent in FY03-04 and 3 percent in FY05. There were significant declines in the infrastructure network, where 38 percent of projects included broad sector policy reform conditions in FY96-97, and only 12 percent of projects in FY03-04, and 7 percent in FY05; and in the private sector development/finance and human development networks, in which the use of such conditions declined from 29 percent to 0 percent and from 22 percent to 3 percent, respectively, during this period.

Figure 2. Project and Sector Policy Reform Conditions in Investment Lending – by Region[37]



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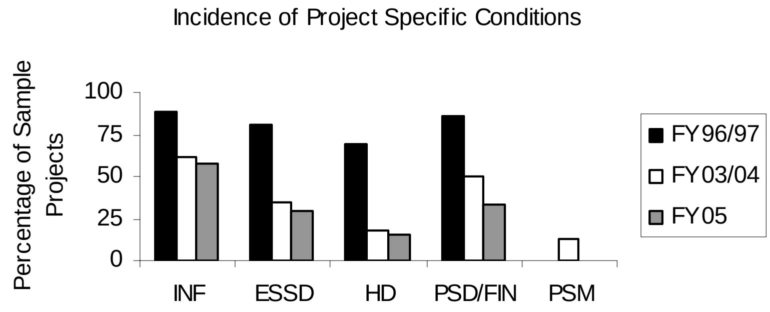
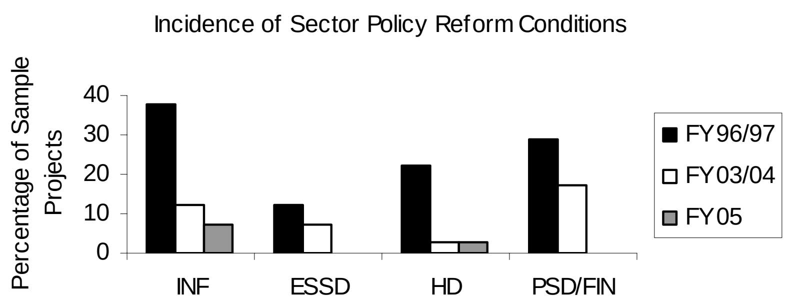
36 It included such examples as a forestry transport investment project that finances roads but seeks actions to open the operations of the railways to competition. The Uruguay Forest Products Transport project, approved in FY97, had as PDOs the facilitation of cost-efficient transport of forestry products from forest to port of exit by rehabilitating transport infrastructure. Conditions included the privatization and concessioning of railways, port facilities, trucking, and log handling.

37 Sample size of 189 projects in FY96/97; 191 projects in FY03/04; 123 projects in FY05.

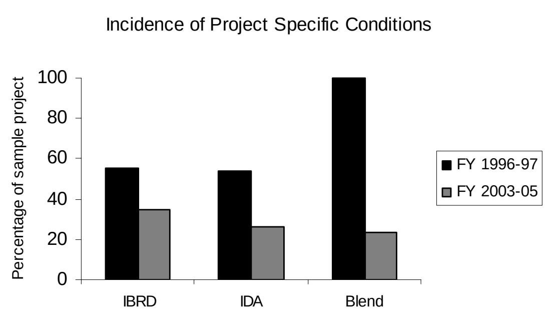
Figure 3. Project and Sector Policy Reform Conditions in Investment Lending – by Network[38]

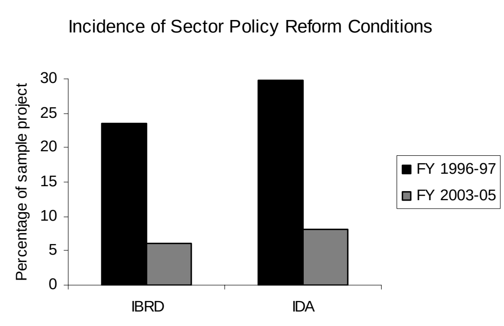




22. ***IBRD and IDA.*** Policy and institutional frameworks in low- and lower-middle-income countries are more likely to contain serious distortions than those in upper-middle-income countries.[39] Thus it is not surprising that the incidence of sector policy conditions in IDA countries was consistently higher than in the IBRD countries in the sample. At the same time, as Figure 4 shows, there was a significant decline in the use of sector policy reform conditions across the board between FY96-97 and FY03-05. Sector policy reform conditions were not observed in the blend countries in the sample.

Figure 4. Project and Sector Policy Reform Conditions in IBRD/IDA/Blend countries





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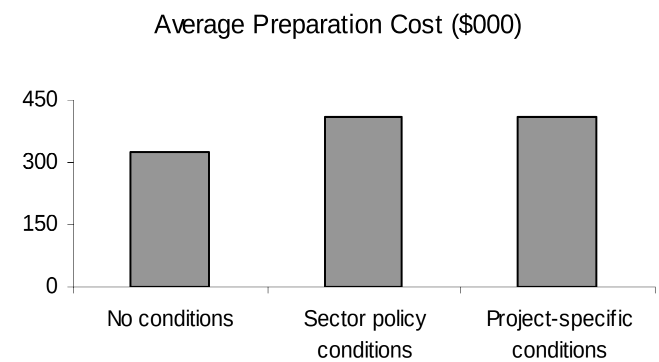
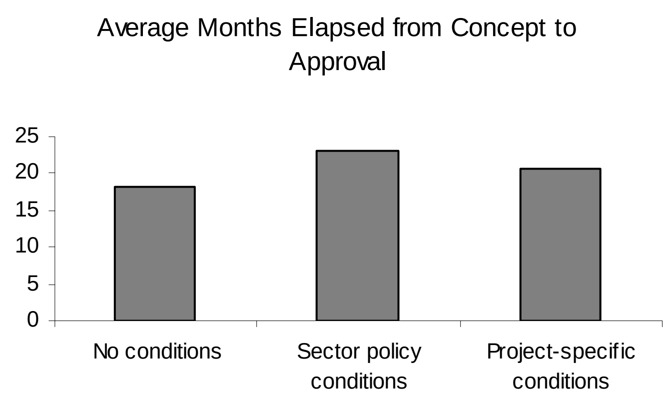
38 Sample size: 189 projects in FY96-97; 191 projects in FY03-04; 123 projects in FY05.

39 In 2002, QAG noted that IBRD-funded operations were more likely to achieve structural and sector policy reform than IDA operations, largely because of difficulties in implementing reforms in poor countries with weak institutions; see *Fourth Quality-at-Entry Assessment* (CODE2002-0014), March 26, 2002.

23. ***Project Processing.*** Average real project preparation costs for the FY96-97[40] projects reviewed were not significantly different for operations with sector policy conditions (40 projects with average preparation costs of US$411,000) vis-à-vis those with narrowly focused project-specific conditions (96 projects with average preparation costs of US$408,000).[41] However, the average preparation costs for projects without any non-standard project or sector policy conditions (34 projects with average costs of US$325,000) was significantly lower. The average time elapsed from concept to Board approval for projects without non-standard conditions was 18 months, for projects with only project-specific conditions 21 months, and for projects with sector policy conditions 23 months. Thus processing projects with non-standard conditions attached to them is costlier for the Bank and takes longer than if there are no special conditions attached.[42]

Figure 5. Effect of Conditions on Project Preparation Costs and Time – FY96-97





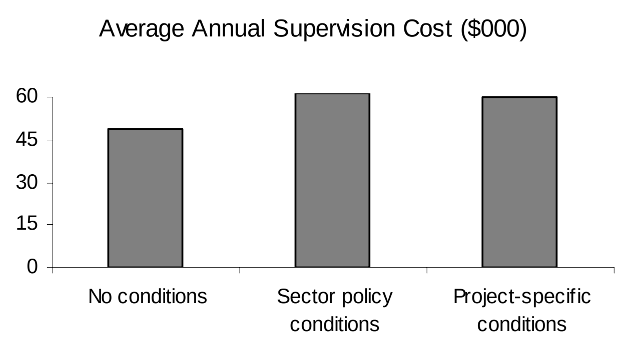
[40] The sample of 2003-05 project approvals with sector policy conditions (18 projects) is too small for meaningful aggregate comparisons.

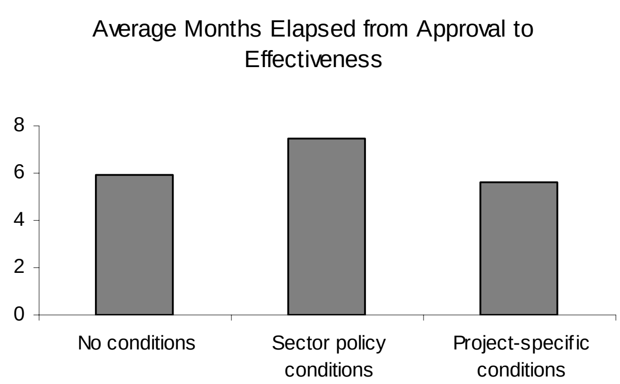
[41] Data from SAP/BW for the projects reviewed for the stocktaking of investment lending conditions (section IV). Outliers with preparation time greater than 4 years were dropped.

[42] These analyses of costs and time spent are based on simple cross-tabulations; while they do not control for other factors affecting project costs and time (including project complexity and the number of components), in large samples they can provide a robust indication of the differences across types of projects.

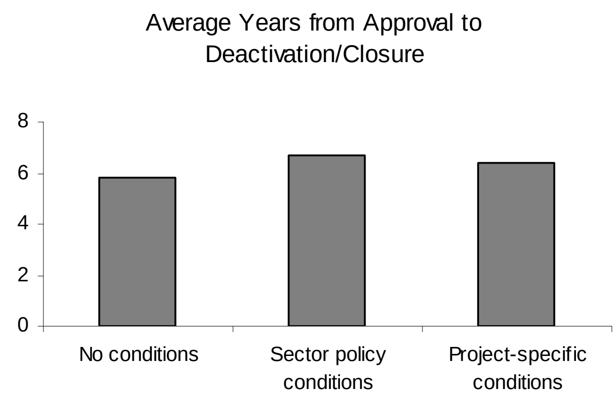
24. ***Project Implementation.*** By requiring specific borrower actions as conditions of effectiveness or disbursement, the inclusion of non-standard conditions in an investment lending operation would be expected to result in a longer lag between approval and effectiveness than if there were no such conditions, as well as slower disbursement (and implementation). Interestingly, the average time elapsed from approval to effectiveness for projects without non-standard conditions was 6 months—moderately higher than the average for operations with narrowly specified project conditions, at 5.6 months. However, both were significantly lower than the time to effectiveness for operations with sector policy reform conditions (7.5 months). In an effort to keep conditions of effectiveness to a minimum, some Regions have indicated that they now use a "readiness filter" when bringing projects to the Board so that project implementation can proceed with minimal delays after approval. Projects with non-standard conditions are generally implemented at a slower pace than others, as can be seen from the average time elapsed between approval and completion: 5.8 years for operations without non-standard conditions, 6.4 years for operations with narrow, project-specific conditions, and 6.7 years for projects with sector policy reform conditions. For the FY96-97 projects reviewed, average annual supervision costs were significantly lower (at US$49,000) for projects without conditions than for projects with project-specific conditions (US$60,000) or those with sector policy reform conditions (US$61,000).[43]

Figure 6. Effect of Conditions on Project Supervision Costs and Time – FY96-97





[43] Cost data are in constant dollars.



25. ***Inference from Cost and Time Delays.*** There is no significant difference in the monetary cost to the Bank of preparing or supervising operations with sector policy conditions and operations with project-specific conditions. However, the preparation and supervision costs associated with projects that have no non-standard conditions attached are significantly lower. In terms of time taken, operations with sector policy conditions attached take longer to prepare and to become effective than operations with project-specific conditions (or those without any non-standard conditions). Project processing or implementation delays are not unexpected when complex policy reforms are being executed. However, to the extent that strong ownership of reforms and consensus around them can reduce such delays, it would be important to use complementary instruments to build borrower ownership and commitment when attaching policy conditions to investment projects.

B. Effectiveness of Policy Conditions in Investment Lending

26. This section presents evidence on the extent to which sector policy conditions have been able to achieve their objectives. It is based on a review of recent QAG and IEG reports (Country Assistance Evaluations, sector studies, and Project Performance Assessment Reports, or PPARs), and on consultations in spring 2005 with Sector Boards that represent the bulk of Bank lending. The general message from these sources is that projects are more likely to be effective when they are focused and simple, with a few critical loan conditions that are within the control of the line agency responsible for project implementation.

27. ***QAG Findings***. In 2003, QAG expressed concern about the appropriateness and realism of project conditionality.[44] Panelists pointed to a tendency to rush the project preparation phase, which meant that task teams often included as conditions of effectiveness activities that should have been completed before Board presentation. QAG panelists identified the number of conditions of effectiveness and disbursement as a factor in project implementation delays and underlined the need for the Bank to take

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[44] *Quality at Entry in FY02 (QEA5): A QAG Assessment* (CODE2003-0018), April 16, 2003.

seriously its own dictums about simplifying conditionality. They noted that less-than-satisfactory operations were characterized by a complex approach, an overly ambitious reform program, and project goals that went beyond the implementing agency's capacity. They specifically attributed many weaknesses in IDA operations to the failure to properly align project design with the more difficult environment in low-income countries, noting that this problem was exacerbated by the tendency to submit IDA operations to the Board without ensuring full readiness of the first year's program. In conclusion, QAG recommended that the Regions initiate measures to reduce the number of conditions of effectiveness and disbursement, underlining that key actions ought to be completed before Board presentation rather than being specified as conditions of effectiveness or disbursement.

28. ***Review of PPARs.*** As noted earlier, conditions are attached to projects in part to ensure that they achieve their development objectives. Since the achievement of development objectives can be gauged only once a project is completed, a review of recent PPARs was conducted to examine the association between project/sector policy conditions and ratings on achievement of objectives in a sample of recently completed operations. PPARs, which IEG prepares for 25 percent of completed projects each year, rate projects in terms of their outcome (taking into account relevance, efficacy, and efficiency), sustainability of results, and institutional development (ID) impact.[45] While a more detailed analysis would need to be conducted to assert causality, the association between project conditions and outcome/ID impact ratings points to the likely effectiveness of conditions in helping to achieve PDOs.[46] Seventy-six percent (37 out of 49) of the PPARs for investment lending operations issued in the 12 months from April 2005 to March 2006 were reviewed, covering 36 projects approved between February 1990 and July 1998, and one outlier from 1978. Box 3 provides examples of the objectives and the ratings for ID impact and outcome in a sample of the projects assessed by IEG. (Annex D provides more details.)

[45] IEG's outcome rating assesses the extent to which the project's major relevant objectives were achieved, or are expected to be achieved, efficiently. The institutional development measure evaluates the extent to which a project improves the ability of a country or region to make more efficient, equitable, and sustainable use of its human, financial, and natural resources. See IEG guidelines at: http://wbln1023.worldbank.org/oed/OEDDocLib.nsf/intrapgname/oldratingsdefs.

[46] In the PPARs, IEG does not explicitly analyze the relationship between project or policy conditions and the achievement of policy reform or other development objectives; hence, without deeper analysis, causality cannot be inferred. Research on the factors that determine "success" in policy conditionality—why some projects with policy conditions succeed and others fail—is beyond the scope of this paper.

Box 3. Rating against Objectives in a Sample of the Projects Assessed by IEG

Selected projects covered in recent PPARs, with conditions shown as project-specific (P) or sector policy reform (S) requirements.

- ***Uganda: Cotton Sub-sector Development project (1994); P, ID Impact High, Outcome Satisfactory.*** Objectives included improved performance in the industry through liberalization of cotton processing and export marketing, and establishment of an efficient regulatory framework for the industry.
- ***Mexico: Agricultural Productivity Improvement Project (1998); P, ID Impact Negligible, Outcome Unsatisfactory.*** The objective was to increase capitalization of small farmers and improve their productivity and income, through increased access to activities supported by three ongoing programs and transfer of appropriate technologies.
- ***Yemen: Taiz Water Supply Pilot Project (1996); S, ID Impact Modest, Outcome Unsatisfactory.*** The objectives were to mitigate the immediate water shortage in Taiz by increasing supply, identify new water sources, develop a process and institutional framework for decentralized water resource management, and prompt private sector participation in the management of water and wastewater utility services.
- ***China: Zhejiang Power Development Project (1995); S, ID Impact High, Outcome Satisfactory.*** The objectives included promoting power sector reform, covering commercialization and corporatization of the power enterprise; promoting competition in generation; and encouraging alternative financing strategies.
- ***India: Madhya Pradesh Forestry Development Project (1995); P, ID Impact Modest, Outcome Moderately Satisfactory.*** The objective was to help the state government implement its Joint Forest Management strategy: to strengthen the state's Forestry Department, increase forest cover by improved management based on the participation of local communities, upgrade forest research and extension, and conserve biodiversity.
- ***Romania: Railway Rehabilitation Project (1996); P, ID Impact High, Outcome Highly Satisfactory.*** The objectives were to support and deepen the restructuring process that the railways and Government had initiated, and to support policy measures embodied in the new railway law, the restructuring action plan, and performance contracts agreed between Government and passenger companies.

29. ***Findings from PPAR review.*** Overall, the PPARs reveal that projects approved in the 1990s focused strongly on sector policy reform and institutional restructuring to, among other things, facilitate greater private participation. A review of the conditions specified in the PADs for these projects showed that 87 percent of investment lending operations with project-specific conditions were rated Highly Satisfactory, Satisfactory, or Moderately Satisfactory on achievement of outcomes—significantly higher than the 71 percent of projects with sector policy reform conditions that received the same ratings on the achievement of outcomes. While the evidence is not conclusive, it suggests that project-level actions or conditions, which are derived from narrowly defined PDOs, are associated with higher success in achieving their objectives than are sector policy reform conditions, which are derived from broader policy reform objectives. (Figure 7 depicts the distribution of outcome ratings by type of condition.) Support for the proposition that in some circumstances investment lending operations may not be the best vehicle for achieving broader sector policy reform also comes from the results on ID impact (illustrated in figure 8). Only 35 percent of investment lending operations with sector policy reform conditions were rated High or Substantial on ID, while almost double that share (69 percent) of operations with project-specific conditions were rated High or Substantial on ID. Annex D presents IEG's comments on selected projects to illustrate the basis for the outcome and ID ratings. However, the four Chinese power sector projects in the sample (two with conditions going beyond the project and two with

project-specific conditions; all rated High on ID and Satisfactory on outcome) demonstrate that where there is clear government commitment, sector policy reform can be achieved through investment lending operations.

Figure 7. IEG Outcome Rating and Conditions[47]

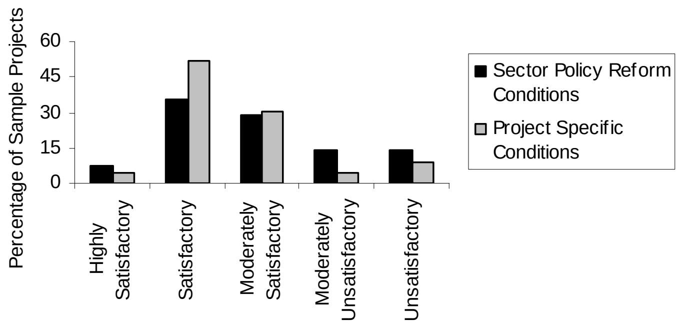
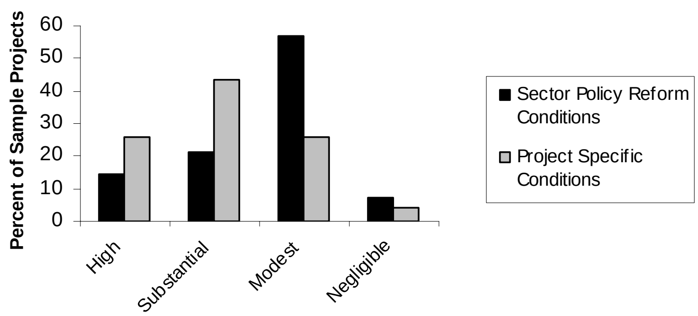


Figure 8. IEG Institutional Development Rating and Conditions



30. ***Sector Board Perspective***. Sector managers have provided detailed anecdotal evidence that sector-wide policy conditions in investment lending have not always been effective in achieving policy reform objectives. Their experience is that borrowers have often not met covenants on policy actions related to investment operations, with the result that sector policy conditions attached to investment lending have had a limited impact. This experience has led them to explore alternative approaches to moving the policy reform agenda forward (see section VI). Sector managers noted that borrowers often see conditions that go beyond the scope of the specific investment project as Bank-imposed and not their own. They also pointed out that, in the past, staff often felt that an investment lending operation would not be approved unless it contained substantive policy and institutional "reform elements," and as a result, policy letters detailing reform commitments became commonplace.[48] The development of sector strategies and the internal review process further reinforced the tendency toward greater project complexity.[49]

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47 None of the projects in the sample was rated Highly Unsatisfactory.

48 Sector managers also identified another factor: removing reform elements renders projects less "interesting" from a professional perspective for staff working on them.

49 See *Enhancing World Bank Support to Middle-Income Countries: Revised Version* (SecM2004-0071/1), April 20, 2004.

31. ***Investment Lending and Policy Reform.*** Sector managers also emphasized that sector policy conditions in investment operations have not always been an efficient mechanism for achieving policy reform because responsibility for implementation usually rests with sector ministries. Sector ministries and line agencies generally do not have the "convening power" for preparing sector policy reform proposals, particularly when such proposals affect more than one sector. Moreover, in matters of legislation and action on sensitive issues such as tariffs or user charges, the key actors are Ministries of Finance or Planning and not the technical/line ministries, which are responsible for project implementation. This makes it hard to predict the timing of reform, and the result has sometimes been noncompliance with loan covenants and delays in the availability of funds for project implementation. On occasion, these delays have increased project costs unduly and undermined the economic and financial viability of the project; the Bank was led to waive loan conditions, undermining its own credibility as well as undercutting the policy agenda.[50] From this experience, the Bank concluded that conditionality in investment lending should generally not go beyond what is essential to produce/protect the expected benefits from the investment.[51] Managers noted, however, that the preparation of investment projects provides an important entry point for the Bank to discuss policy reform and associated institutional change prerequisites with both central ministries and the line agencies.

IV. FIDUCIARY AND SAFEGUARD CONDITIONS

32. All projects the Bank finances must meet the Bank's fiduciary and safeguard policy requirements.[52] As Board-mandated conditions for doing business with the World Bank, these requirements are quite different from sector policy reform or similar project-specific conditions. Although not the focus of this paper, this section examines the application of these requirements since they are often considered a leading contributor to the "cost of borrowing" from the Bank as well as to the cost of project preparation and supervision by the Bank. The Bank's financial management (FM),[53] procurement, and disbursement requirements are designed to provide assurance that loan proceeds are used only for the purposes for which the loan was granted, with due regard to economy, efficiency, and the sustainable achievement of the project's development objectives.

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[50] Analysis of waivers of loan covenants was not possible for this paper because the Bank does not maintain systematic data on waivers.

[51] *Infrastructure: Lessons from the last Two Decades of World Bank Engagement* (SecM2006-0046), February 8, 2006.

[52] Key Bank fiduciary policies are OP/BP 10.02, *Financial Management*; OP/BP 11.00, *Procurement*; and OP/BP 12.00, *Disbursement*. The World Bank's environmental and social safeguards policies and procedures are OP/BP 4.01, *Environmental Assessment;* OP/BP 4.04, *Natural Habitats;* OP 4.09, *Pest Management*; OP/BP 4.12, *Involuntary Resettlement;* OP 4.10, *Indigenous Peoples;* OP 4.36, *Forests;* OP/BP 4.11 *Physical Cultural Resources;* OP/BP 4.37, *Safety of Dams*; OP/BP 7.50, *Projects in International Waterways;* and, OP/BP 7.60, *Projects in Disputed Areas.*

[53] Financial management arrangements refer to budgeting, funds flow, accounting, internal control, financial reporting, and auditing arrangements for the entity or entities to which Bank resources are transferred. These arrangements are agreed with the Bank during project preparation and monitored by Bank staff during implementation.

Likewise, the Bank's environmental and social safeguard requirements are intended to help ensure the environmental and social sustainability of investment projects by integrating such aspects into the decision-making process. Fiduciary requirements apply to all operations, but the safeguard requirements are not triggered by all projects.[54]

A. Contribution to Cost of Doing Business

33. The FY01 task force on the cost of doing business with the Bank examined the Bank's implementation of its fiduciary and environmental and social safeguard policies to understand the impact of these policies on the cost of preparing and implementing projects. Since then, QAG's regular reports on the quality of the portfolio at entry have provided a picture of the evolving application of the Bank's fiduciary and safeguards policy requirements. This section presents relevant findings from both sources.

34. ***Task Force Findings.*** The task force on the cost of doing business with the Bank conducted a desk review of 50 projects under implementation, reviewed Bank budget data, and carried out in-depth consultation with clients in 10 selected countries that represented roughly 40 percent of the Bank's FY0l portfolio/pipeline.[55] The task force concluded that while borrowers felt that the Bank's requirements were justified and, indeed, added value, the implementation costs incurred by both the Bank and borrowers could be reduced through better management practices aimed at increasing clarity, reducing delays, and supporting capacity building in client countries.[56] In response, Management clarified the environmental and social safeguard requirements and took some other significant steps to reduce the time and cost of project processing and implementation: (a) acceptance of financial reporting based on borrower systems, and of the borrower's own audited financial statements; (b) delegation of procurement actions to country offices; (c) simplification of clearance procedures during project preparation; (d) initiation of assessments of environmental and social impacts early in project processing; and (e) working toward policy harmonization with other development partners.

35. ***QAG Findings.*** Like the cost of doing business study, QEA4 identified some key weaknesses in the application of Bank fiduciary requirements: the absence of procedures for fast and effective resolution of internal Bank disagreements on fiduciary aspects of project design, and instances in which the exercise of appropriate judgment in project

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[54] The safeguards policies apply to all projects; however, the requirements of the policies are triggered by the specific activities encompassed by the project. For example, while all investment projects need to be screened for environmental impacts under OP 4.01, *Environmental Assessment*, if there are none then no environmental assessment is required.

[55] *Cost of Doing Business: Fiduciary and Safeguard Policies and Compliance* (SecM2001-0469), July 17, 2001.

[56] The cost to the Bank in FY0l of applying these policies was imputed at $83 million (based on the number of staff engaged in these areas), approximately 20 percent of the total administrative budget for lending services. The cost to borrowers of complying with these policies was estimated at about $118-215 million annually, with roughly 60 percent of this amount being incremental (all borrowers incur costs for public procurement, financial reporting, and safeguard work, even if no Bank financing is involved).

design and processing was negated by a narrow interpretation and application of the Bank's fiduciary requirements. A recent QAG assessment[57] points to progress in addressing such weaknesses. In addition, sign-off on procurement and financial management is being provided by accredited team members in the great majority of projects. However, for social and environmental safeguards, sign-off largely continues to be provided by Regional specialists outside the task team, although task team leaders are more satisfied when safeguard specialists are part of the task team.

B. Data on Spending and Time Taken

36. Measures of the "burden" of the Bank's requirements include the cost of project preparation and supervision, the time it takes to prepare projects, and delays in implementation.

37. ***Preparation and Implementation***. Bank MIS data for investment operations show that the average real cost incurred by the Bank in preparing projects (called completion cost in SAP/BW) has declined[58] by around 5 percent—from $385,000 to $367,000—between FY96-97 and FY04-05. Project preparation cost declined in all Regions except EAP and all Networks except HD and PREM, and for projects in EA category B. Over this period, project preparation time also declined from an average of 21 months to 17 months, except in EAP, where the number of category A projects increased. No significant difference was observed between IBRD and IDA in preparation cost or in the time taken to prepare projects. Between FY96-97 and FY04-05, the number of months between project approval and effectiveness declined in all Regions except EAP, and in all networks except PREM and PSD. This pattern is consistent with less complex, better prepared projects being presented to the Board with fewer effectiveness conditions overall.[59] (Annex D includes a detailed breakdown by Region and Network.)

38. ***FM and Procurement Spending.*** Consistent estimation of the costs of project related fiduciary work across Regions is difficult because organizational structures differ as do cost recording practices: in some Regions fiduciary staff belong to separate FM and procurement units; in others they belong to large operations core services units, which also include staff working on other aspects of quality control.[60] Table 1 presents FY05 Bank budget expenditures (on staff, consultants, and travel) for FM and procurement by Region.[61] To provide context, these numbers are normalized by total Regional spending on country services (lending, economic and sector work, and country

57 *Quality at Entry in FY04-05 (QEA7): A QAG Assessment*, December 7, 2005.

58 Constant US$ of 2000. This excludes technical assistance, emergency recovery, and additional/ supplemental loans.

59 A comparison of average annual supervision costs across the two periods is not very meaningful: supervision tends to be heavier at the start of implementation, and projects approved in FY 2004-05 are still in the early phase of implementation, while many FY 1996-97 approvals are closed or near closing.

60 There is even less comparability across Regions in practices for recording spending on safeguards compliance.

61 Similar data is not available for safeguards spending.

program support) and the total Regional administrative budget for lending (the amount spent on project preparation and supervision). The share of FM and procurement in the total administrative budget for lending varies from 8.7 percent in AFR to 20.3 percent in MNA; and as a share of Regional spending on country services it varies from 5.2 percent in AFR to 10.2 percent in SAR. Some of the variation across Regions reflects the difference in the proportion of local vs. international staff working on FM and procurement, although the variance in the share of fiduciary staff in total Regional staff is narrower—between 7.6 percent in AFR and 11.7 percent in MNA. Since sector staff (and staff in the Legal department) may also devote time to FM and procurement work, which is not captured by FM and procurement time recording data, the numbers on fiduciary spending may be biased downward. (In addition, the share of FM and procurement spending devoted to direct project support is not easily estimable since fiduciary staff not only support lending but also conduct economic and sector work and provide technical assistance and training to counterparts. While all of this has a project-level impact it is usually not directly attributed to specific projects.[62]) On average, across Regions FM and procurement account for 14 percent of administrative spending on lending and 8 percent of spending on country services (see Table 1).

Table 1. FY05 spending on Procurement and Financial Management, by Region[63]

Category	*AFR*	*EAP*	*ECA*	*LCR*	*MNA*	*SAR*
Spending on FM	3,860	2,033	3,623	3,327	1,733	4,207
Spending on procurement	3,664	2,625	4,688	4,573	2,876	2,322
Total	7,524	4,658	8,311	7,900	4,609	6,529
Administrative budget expenditure on lending	86,240	46,317	63,149	56,000	22,728	33,314
Total spending on country services	145,871	73,374	102,544	85,757	50,393	64,288
FM and procurement as a share of administrative budget spending on lending	8.7%	10.1%	13.2%	14.1%	20.3%	19.6%
FM and procurement as a share of total spending on country services	5.2%	6.3%	8.1%	9.2%	9.1%	10.2%
FM and procurement staff as a share of Regional staff (GE+)	7.6%	10.5%	7.7%	8.8%	11.7%	10.4%

62 Data from LCR provide a sense of the magnitude of fiduciary costs as a share of total Regional spending on project preparation and supervision. In FY05, spending on FM in project preparation, $471,890, was 1.71 percent of total LCR spending on project preparation ($27.6m); and spending on procurement in project preparation, $336,670, was 1.22 percent of Regional spending on project preparation. In FY05, spending on FM and procurement in project supervision as a share of LCR spending on supervision ($30.3m) was 2.75 percent ($833,870) and 5.85 percent ($1,773,130), respectively. The share of spending on FM and procurement in both project preparation and supervision (and the absolute value of spending) have increased significantly since FY00.

63 Spending is in US$000. Regional expenditures on country services and on lending were obtained from SAP/BW; data on procurement and FM were taken from "A Best Practice Review of Procurement, Financial Management and Quality Assurance Practices in the six Regions of the World Bank" mimeo, January 2006, ECA Operations Policy and Services Department.

39. ***Incidence of Safeguards.*** Of the 307 investment projects approved in 2004-05,[64] in only 15 percent were no actions required under the Bank's safeguard policies: 83 percent required actions under OP 4.01, *Environmental Assessment*; 42 percent required actions under OP 4.12, *Involuntary Resettlement;* and 23 percent required actions under OD 4.20, *Indigenous Peoples*.[65] Thirteen percent of investment projects were classified as EA category A projects and 55 percent as EA category B projects.[66]

40. ***Effect of Safeguards on Preparation Time and Costs.*** Table 2 shows a significant difference in average preparation time between FY04-05 projects that did not require measures under the safeguard policies and those that required action under at least one. There was no significant difference between the time taken to prepare EA category A and category B projects; however, both category A and B projects took longer to prepare than category C projects. As would be expected, the average cost of project preparation was significantly higher for projects in EA category A than in category B. The cost of preparing projects that involved resettlement or affected indigenous peoples[67] was also higher than the cost of preparing projects that did not. The lag between approval and effectiveness was not significantly different for projects that required action pursuant to the environmental and social safeguards than for projects that did not. One explanation may be additional staff attention to these projects during preparation since the safeguards policies require most critical safeguards actions to be completed by appraisal—thus Bank requirements are addressed up front and potential problems identified and dealt with early, leading to fewer delays in effectiveness.

Table 2. Project Processing and Incidence of Safeguards, FY04-05

Project Feature	***Number of projects***	***Average preparation cost (USD, thousands)***	***Average months from concept to approval***	***Average months from approval to effectiveness***[68]
Safeguard Triggered				
▪ None	45	337.33	13.51	6.36
▪ At least 1 policy triggered	262	372.27	17.42	5.97
▪ Environmental Assessment (OP 4.01)	256	372.14	17.57	5.91
▪ Resettlement (OP 4.12)	129	409.41	19.93	6.35
▪ Indigenous Peoples (OD 4.20)	71	403.21	19.66	6.26
EA Category				
▪ A	41	439.83	18.75	6.75
▪ B	168	361.88	17.45	5.81
▪ C	70	340.09	13.50	6.19
All projects[69]	307	367.15	16.84	6.02

64 Systematic tracking of the safeguard policies triggered (by project) commenced only in FY01.
65 The revised policy, OP/BP 4.10, *Indigenous Peoples*, became effective in FY06.
66 See OP 4.01, *Environmental Assessment,* for this categorization of projects.
67 Large projects tend to trigger multiple policies (including EA), so these numbers do not reflect the incremental cost of addressing resettlement or indigenous peoples issues alone.
68 Excludes projects that never became effective.
69 Of the 28 projects categorized as FI, 6 never became effective.

41. ***Implications.*** While there has been a significant decline in project processing times and costs between FY96-97 and FY04-05 and borrowers generally rate the Bank's fiduciary and safeguard requirements as being reasonable, their feedback also points to room for further improvement (see section VI). Management will assess the efficiency and effectiveness of the application of the Bank's fiduciary and safeguards policies as part of its regular monitoring of the portfolio. The experience of often limited effectiveness of conditions going "beyond the project" suggests that project specific controls should continue to be built into the design of each investment lending operation in high risk fiduciary environments but that, in most cases, broader efforts *beyond the use of policy conditions attached to individual projects* will be needed to improve the wider fiduciary and governance environment.

VI. FEEDBACK FROM BORROWERS

42. In March 2006, Management surveyed 194 sector counterparts in 66 active borrowing countries across all Regions and sectors to ask whether they considered the Bank's loan conditions to be reasonable in light of the benefits gained.[70] Because the 2001 Cost of Doing Business study identified delays in project preparation and implementation as key aspects that borrowers felt the Bank should address, survey respondents were also asked to estimate the average *avoidable* delays in project preparation and implementation due to loan requirements. The survey covered procurement, financial management, and environmental and social safeguard requirements, as well as project-specific actions (e.g., meeting technical or institutional requirements) and sector reform or policy changes required for Bank loans. Responses were received from counterparts in 13 sectors across 44 countries[71] covering all Regions, and also from counterparts in central ministries (e.g., Ministries of Planning, Finance, and the like)[72] in 18 countries. It should be noted that borrowers do not always make a distinction between covenants or conditions for negotiation, Board presentation, or loan effectiveness or disbursement – for them, these are all 'conditions' of Bank investment

[70] Counterparts in three sectors were surveyed in each of the 66 IBRD/IDA countries with at least three investment lending operations (specific investment or APL) approved since FY04. The three sectors selected were the ones with the largest operations (in four countries operations covered only two different sectors). Sector managers were asked to identify key counterparts in their sectors in the countries selected and were the point of contact with borrowers.

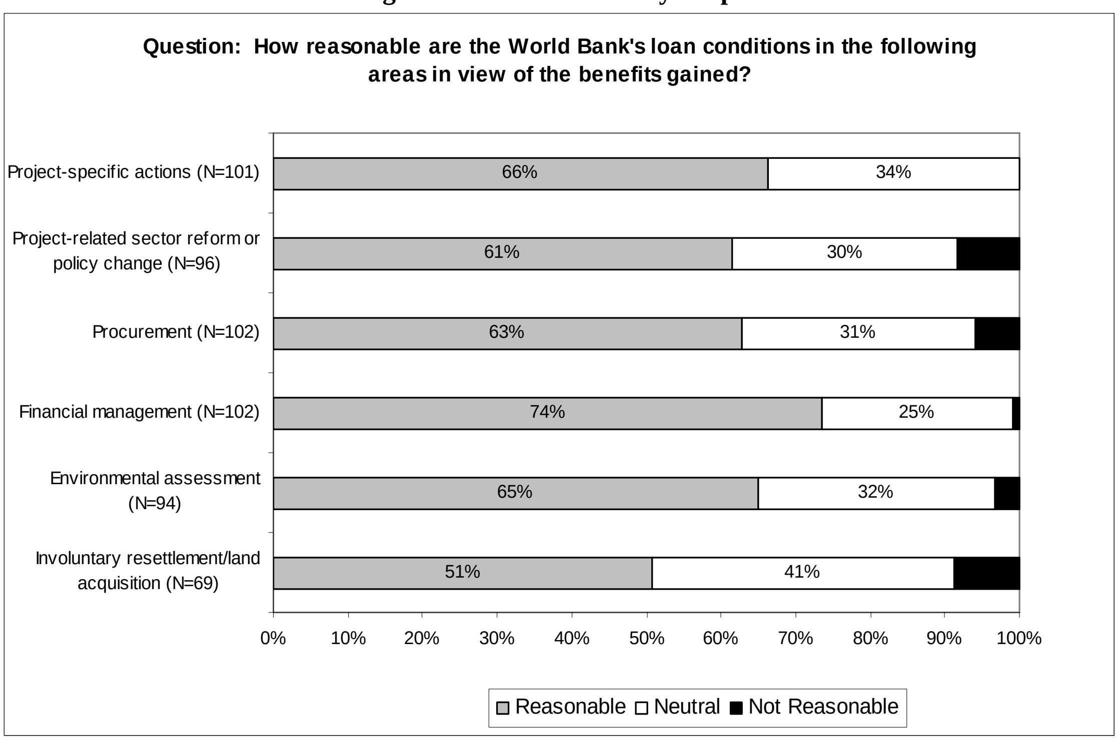
[71] Responses covered the following sectors: education, energy, environment, financial sector development, health, PSD, PSG, rural, social development, social protection, transport, urban, and water supply and sanitation. Responses were received from the following countries: Burkina Faso, Dem. Rep. of Congo, Ethiopia, Mali, Mozambique, and Zambia in AFR; China, Indonesia, Kingdom of Cambodia, Laos, Mongolia, Philippines, and Vietnam in EAP; Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Croatia, Georgia, Kazakhstan, Macedonia, Moldova, Poland, Romania, Russia, Serbia & Montenegro, Tajikistan, Turkey, and Ukraine in ECA; Argentina, Brazil, Colombia, Guatemala, Honduras, Mexico, and Peru in LCR; Egypt, Morocco, and Tunisia in MNA; Afghanistan, Bhutan, India, Pakistan, and Sri Lanka in SAR.

[72] In several countries the Ministry of Finance is the government's official interlocutor with the Bank so surveys sent to the line agencies were completed by that Ministry.

lending and their perceptions, reflected in their responses, are based on this broader interpretation of "loan conditions."

43. ***Reasonable Requirements.*** Overall, respondents felt that Bank requirements are reasonable in view of the benefits gained.[73] Ratings were most positive for the Bank's FM/ accounting/expenditure reporting/auditing requirements, with 74 percent of respondents rating them favorably. This was followed, in order, by project-specific technical and institutional requirements, environmental assessment requirements, procurement/ contracting/purchasing procedures, project-related sector policy reform requirements, and finally, resettlement/land acquisition policy requirements. (Figure 9 illustrates the pattern of responses received.) Among the Regions, ECA respondents tended to consider the Bank's requirements on different aspects most reasonable (almost across the board), with very high ratings for FM and procurement requirements and project-specific actions. Borrowers from MNA and AFR generally rated the Bank's requirements as less reasonable than did borrowers in other Regions.[74] Line ministries generally rated the Bank's requirements as more reasonable on FM, procurement, and environmental assessment than did central ministries, though the difference in ratings was not very large. Borrowers also generally felt more satisfied with the contribution of Bank staff during project preparation and appraisal than during project implementation or monitoring. A detailed breakdown of survey responses is provided in Annex F.

Figure 9. Borrower Survey Response



[73] Borrowers were asked to rate the Bank's loan conditions (including policy/processing and procedural requirements in different areas) on a scale from 1-6 (Not Reasonable to Reasonable) in response to the question: "How reasonable are the World Bank's loan conditions in view of the benefits gained?"

[74] The small number of respondents in some Regions mean that these comparisons are not very robust.

44. ***Project Processing Delays.*** Borrowers were asked to identify specific Bank requirements that lead to delays and inefficiencies in project processing and to draw on their experience with Bank-funded projects approved in the past two years to estimate the average *avoidable* delay caused by the Bank's requirements.[75] Overall, the largest avoidable delays in project preparation were attributed to project-related sector policy reform requirements, followed by land acquisition/resettlement requirements, project-specific actions, procurement, environmental assessment, and FM requirements. The average length of avoidable delays due to each of these causes varied from 2.1 months to 3.7 months—an amount that would be quite significant if the delays were sequential. Across the board, central ministries estimated longer delays, and longer average annual delays in project implementation, than line agencies/ministries did. The ranking of causes of delay in project implementation is fairly similar to that of causes of delay in project preparation; the longest annual delays were attributed to project-related sector policy reform requirements (2.1 months), followed by involuntary resettlement/land acquisition (2 months), procurement requirements (2 months), project-specific actions (1.7 months), environmental assessment (1.6 months), and FM requirements (1.4 months). It should be noted that since borrowers were asked to respond in light of their experience over the past two years, these figures reflect the higher borrower and Bank effort required in the early years of project implementation.[76]

45. ***Overall Message and Caveats.*** While 61 percent of responding borrowers feel that the sector policy reform conditions attached to investment lending are reasonable in view of the benefits gained, these conditions are also associated with the largest *avoidable* delays in project processing of all sources identified. It appears that borrowers indeed recognize and agree with the need for a sound policy and institutional context for investments. At the same time, the message on large avoidable delays will benefit from in-depth follow-up.[77]

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75 The survey was designed to capture borrower perceptions rather than data on delays; hence the *ranking* of different causes of avoidable delays in project processing is more robust than the exact magnitudes estimated.

76 In the 2005 staff survey, staff also indicated that there is room for improvement in project processing, although it is important to bear in mind that staff views reflect internal Bank processes and aspects other than project conditions: "The 2005 survey for the first time asked staff whether internal processes and procedures allowed them to deliver high-quality services to clients. Just over half (56 percent) of respondents gave favorable ratings." E-mail to staff from the President of the World Bank, February 3, 2006.

77 While the survey respondents come from a diverse set of Bank clients across Regions and sectors, of necessity, they are people who know and work with the Bank and have close and continuing relationships with task teams. As a result, their views may not be representative of the views of people who are less close to the Bank.

VI. Vehicles for Policy Reform

46. Instrument options to help a country improve its policy and institutional environment vary by country and sector. IEG's 2005 review of country assistance evaluations[78] showed that the success of reforms in a given sector often depends on complementary reforms in other sectors. IEG concluded that specific investment and technical assistance loans, which allow the Bank to build relationships with counterparts and to combine advice with financial assistance (especially to sector ministries) can be useful vehicles for promoting institutional development, but that for benefits to be sustainable these operations should be part of a broader reform strategy. IEG also pointed to a high correlation between timely economic and sector work and favorable country outcomes. In this context, sector managers pointed out that in countries in which the Bank has a wide-ranging program (e.g., Brazil, China, India, Nigeria, Ukraine), there are numerous analytic, advisory, and other nonlending activities from which to choose appropriate vehicles for furthering the policy reforms needed in a particular sector. Where lending programs are smaller, as in many IDA countries, correspondingly smaller administrative budgets are available for nonlending activities, and there may be fewer vehicles through which to address policy reform issues, even though the reform agenda may well be larger and more urgent than that in middle-income countries. However, because of investment lending's often limited effectiveness as an instrument of sector policy reform, even in situations where other instruments are not available or where macro imbalances, lack of progress in policy reform (as in Turkey in the early 1990s), or concerns about governance (as, recently, in Kenya or Azerbaijan) prevent the use of DPL, *in most cases it would still not be productive to add sector policy reform requirements to individual investment operations unless key pre-conditions such as borrower ownership, commitment, capacity, and demand at the sector and central levels have been verified*.[79]

A. Opportunities for Policy Dialogue

47. Opportunities for policy dialogue are built into the Bank's country-centered operational model. Over the years, Consultative Group meetings, country portfolio performance reviews, the preparation of investment operations, dissemination of analytic and advisory work, work with donor sector groups, and so on have been used to engage the borrower in a dialogue on policy. Today, the CAS provides the framework and, frequently, the vehicle for identifying and addressing policy reform priorities.

48. ***CAS Dialogue***. Good practice in CAS preparation involves detailed discussion with stakeholders in the country to reach understanding on key issues, including reform priorities and sequencing. Since the CAS can articulate the basis for dialogue on major sector issues, as well as specify the use of Bank instruments such as economic and sector

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[78] *Country Assistance Evaluation Retrospective – OED Self-Evaluation,* Report No. 31982, April 5, 2005.

[79] Sector managers indicated that staff are now advised to avoid including broad sector policy conditions in investment lending operations and to minimize conditions of effectiveness by ensuring that actions considered necessary for the success of the project are completed before Board presentation.

work, nonlending technical assistance, and DPL in support of the sector policy reform agenda, discussions around the CAS are a natural vehicle for policy reform. As an example, the FY05 CAS for India specifies "guidelines for engagement" in certain sectors, which lay out the sector-specific conditions that have been found to be necessary for project success; investment lending in different sectors will be channeled more broadly to states that are able to comply with these guidelines. IEG's CAEs have often pointed to the benefits of using appropriate combinations of instruments to engage governments in policy dialogue in the context of the CAS. For instance, the CAE for Turkey highlights the importance of building the analytic/knowledge base (inside the Bank and between the Bank and officials in core ministries) for interventions in specific sectors.[80] It also underlines the key role of technical assistance or advisory services in bolstering domestic institutions (such as line ministries) that implement or benefit from Bank lending, and the important contribution of DPL in supporting the key structural reforms identified and analyzed by the Bank.[81]

49. ***Development Policy Lending.*** Development policy lending is a fairly flexible instrument that can carry forward sector policy reform as part of a coherent medium-term program of sector support.[82] DPLs increasingly complement investment lending by including key reform elements as conditions or even triggers for sequential operations,[83] while related investment lending proceeds in parallel. The sequencing of operations and the synergies between different operations can be particularly important when complex institutional reforms are needed. The Bank illustrated this in Armenia's education sector, when it supported the Government's reform program through a specific investment loan and two structural adjustment loans. Policy conditionality in the adjustment loans supported the necessary legal and regulatory changes, while the investment loan supported the Ministry of Education in improving its capacity for analysis and

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80 For instance, an in-depth health sector analysis begun in 2001, followed by dialogue with the government, led to the development of the Health Transition Project, which focused on building the systems and capacities needed to implement the first phase of a comprehensive health system reform program that was subsequently adopted by the government.

81 In Turkey, the Bank made a substantial contribution to moving the reform agenda forward from FY99 to FY04 when adjustment lending operations helped to foster major institutional changes in the financial sector and in agriculture and promoted reform of sector frameworks for energy regulation and regulation of telecommunications, which led to progress in restructuring the power and telecoms sectors and the State Banks. See *The World Bank in Turkey, 1993-2004: Country Assistance Evaluation* (CODE2005-0089), October 7, 2005.

82 The *2004 Annual Review of Development Effectiveness* notes that 83 percent of adjustment operations and DPLs exiting the portfolio in FY00-04 were rated satisfactory on outcomes as opposed to 75 percent of investment operations. In FY05, comparable numbers were 95 percent and 80 percent (see *Development Policy Lending Retrospective* (SecM2006-0319), July 13, 2006). Although these data, particularly for investment operations, do not reflect success in achieving policy reform alone, they are indicative of the comparative strength of DPLs in moving forward policy reform agendas.

83 The 2005 Review of World Bank Conditionality found that the lessons of experience with regard to Bank conditionality—on the need for ownership, simplicity, clarity, transparency and harmonization across donors—were increasingly being incorporated in the Bank's practice in terms of the nature and amount of conditionality seen in DPLs. The review also reinforced the need for the Bank to choose only actions critical for achieving results as conditions for disbursement. *Review of World Bank Conditionality: Summary Findings* (SecM2005-0390), July 7, 2005.

policymaking, decentralized school management, and textbook production.[84] In IDA countries, poverty reduction support credits (PRSCs) have started to play an increasingly important role in moving the sector policy reform agenda forward through sector policy conditions, such as requirements that address weaknesses in the investment climate.[85] Sector-focused DPLs, in which conditionality focuses on sector-specific policy reform, are also becoming more common. Sector-focused DPLs are grounded in the dialogue on sector reform, and a series of such DPLs can provide support to the government's program synchronized with progress on key policy aspects. However, it should be recognized that when multiple sectors are in need of reform, only a limited number of aspects can be addressed at one time.

B. Promising Approaches

50. Sector managers identified some other promising approaches to promote sector policy reform. While it is too early to formally assess the success of these approaches, sector managers say they have helped move the policy reform agenda forward in instances where sector policy reform conditions attached to investment operations have had limited success..

51. ***Letters of Sector Policy***. Like the borrower's Letters of Development Policy required for DPLs, Letters of Sector Policy have sometimes been used in investment lending, particularly for APLs. Since FY03 AFR has adopted a more flexible way of using Letters of Sector Policy: when policy and institutional reform is needed, Letters of Sector Policy are attached to investment operations in order to confirm government commitment to and ownership of the reform agenda. The scope of such Letters of Sector Policy extends beyond the specific investment. They serve as vehicles for an ongoing dialogue on sectorwide reform, but provide flexibility in the pace of reform since they lay out the government's intentions but are not formal, dated, commitments. Minor deviation from the program laid out is not automatically considered the basis for exercise of legal remedies such as suspension of disbursements or cancellation, although such Letters are referenced in the Loan/Credit Agreement and receipt is usually a requirement for Board presentation.[86] Regional staff see this approach as one way to de-link investment project processing from the progress of policy reform, which can then proceed on a parallel track. For example, under the Ethiopia Capacity Building for Decentralized Service Delivery project for urban and water and sanitation services, the Letter of Sector Policy describes the government's intentions and goals on sectorwide reform. Similarly, under

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84 See *2001 Annual Review of Development Effectiveness: Making Choices*, OED, 2002.

85 For instance, policy triggers for the fourth PRSC to Burkina Faso included preparing the telecommunications sector for privatization and the energy sector for private sector participation. Likewise, measures implemented before this PRSC included the finalization and dissemination of studies that were intended to feed into the development of rural diversification strategies, including a proposed Bank investment project on agricultural marketing and diversification. Report No. 28293-BUR, April 14, 2004.

86 Unless a specific event of default is agreed for the investment loan in question, no deviations from the Letter of Sector Policy would be deemed a legally enforceable basis for suspension. Remedies would only be invoked if deviations cause a breach in any of the obligations undertaken under the Loan Agreement.

the Mali Transport Corridors Improvement project, a Letter of Sector Policy sets out the government's plans and timelines for policy and institutional improvements to improve competition and efficiency in the transport sector.

52. ***Agreed Prerequisites to Lending***. Some country units have agreed with authorities on a performance threshold for the policy and institutional environment in different sectors before discussing specific investments. For example, as was mentioned earlier, in the energy sector in India, after years of less-than-effective covenants on tariff and other policy aspects in power projects, the prerequisites for lending in the sector were discussed with the Government and embodied in the CAS. With the new approach, lending proceeds only after country officials and the Bank are able to confirm that the necessary conditions for success of an investment lending operation in energy are in place. In Pakistan, again drawing on unsatisfactory experience with the efficiency of using covenants related to policy and institutional actions in the energy sector, the country department now allocates administrative budget resources to support a continuous dialogue on energy sector issues, which also feeds into building a constituency for reform. In several IDA countries in ECA, where assistance programs usually do not include DPLs, the Bank now begins preparing investment lending operations only when the policy environment is sound. For instance, in the energy sector in the Ukraine, where a series of specific investment loans have been agreed upon, key elements of policy reform have been incorporated in an Energy Policy Framework agreed with the Government. It has been agreed that the policy framework, which includes specific milestones, may form the basis for conditions in forthcoming DPLs. In addition, specific milestones may be used as triggers to initiate the next investment loan in the lending program. Thus, policy or other requirements can sometimes be addressed up front when the Bank is supporting a government program of investment in a sector through sequential investment lending operations or an APL.

53. ***Dual-Track Approach***. With certain borrowers that are committed to policy reform, a dual-track approach has been followed. Policy reform options are analyzed separately, while investment lending proceeds in parallel, broadly keeping pace with the reform process. In the railways sector in China, after attempts to secure tariff increases through project-related loan covenants, which later had to be waived,[87] such a parallel track was agreed in November 2004. Under the accord, the Bank maintains a dialogue on policy reform[88] with China's Ministry of Railways and with the National Development and Reform Commission. This dialogue, in which the Bank contributes international expertise and experience in rail policy matters, is parallel to, but separate from, the progress of lending. By contrast, any advice the Ministry seeks on specific issues of railway operations and technology and rail business processes is provided through technical assistance components of the lending program.

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[87] The Ministry of Railways manages the railway loans that contain the covenants, while tariff increases require approval by the State Council, or national Cabinet.

[88] That is, high-level policy discussions on sector strategy, Government administration of the railway sector, regulation of railways, and methods for widening the financial resources of the industry.

54. ***SWAps.*** A sectorwide approach (SWAp) can be an effective vehicle for pursuing sector policy reform. A SWAp is based on in-depth analysis of sector issues and agreement with the government on a sectorwide program of reform or development, which the Bank (and other partners) may support through a combination of technical assistance, specific investments, and/or financing for a share of defined sector or program expenditures. Rather than attaching sector policy conditions to individual lending operations in a SWAp, financing partners reinforce government commitment and ownership of reforms through joint commitments and agreement on implementation and monitoring arrangements with the government, aligning their financing to performance on program implementation and execution of agreed policy or other reform measures. Following such an approach, comprehensive sector reform or development programs have been agreed and are being implemented (without resorting to policy conditions) in the health sectors in Ghana and Tanzania and education sectors in India, Nepal, and Vietnam.

55. ***Flexibility--Some Conditions Will Remain.*** Policy conditions in investment lending, as in DPL, are more likely to result in sector policy reform when there is clear borrower ownership, commitment, and demand at the sector level, and when the appropriate central ministry (such as the Ministry of Finance) is part of the dialogue and supports the agreements reached. Under these circumstances, sector policy reform requirements can be addressed through the judicious use of sector policy conditions in investment operations. In addition, as described in this paper, sector policy reform can be addressed up front, in the dialogue around project identification and preparation, or in parallel with lending. Notwithstanding this, in the small proportion of projects in which progress on sector policy reforms is urgent and critical for project viability, it is likely that key policy reform actions will continue to be included as conditions. For example, under the following circumstances policy conditions in investment lending are likely to remain relevant.

- ***Supporting champions.*** Sector managers have pointed out that some countries are willing to reform but find it useful—for reasons related to domestic political economy—to have external donor "pressure" in the form of explicit policy or institutional conditions in investment lending operations. In such cases, the use of conditions related to sector policy reform would be appropriate, although there is a risk of reform reversal when a change in government or champion occurs.

- ***"Deal breakers."*** In some cases staff regard resolution of an issue to be central to the success of the investment lending operation. An example is the FY04 Egypt Airport Management project, in which the transfer of management to a private operator was regarded as essential ("make or break") for the project's objectives to be achieved. Inclusion of a condition requiring this action was part of the risk management strategy for the project. Similar cases calling for the exercise of judgment will remain.

- ***High-risk/high-return projects***. During the period reviewed two investment lending operations categorized as "high-risk/high-return" were approved—the Chad-Cameroon pipeline and the Laos Nam Theun hydroelectric dam. The high risk and large potential macroeconomic impact of these projects necessitated prior reforms covering a wide gamut of issues.[89] Investment lending operations of such high significance and visibility will continue to require policy conditions, although they are likely to remain rare because of their relative size and complexity.

VII. CONCLUSIONS

56. Since the Bank began its program of modernizing and simplifying lending in FY04,[90] it has revitalized its investment lending, with a steady increase in lending volumes, significant improvements in quality,[91] and a decline in the cost and time taken to process projects. Today, investment lending accounts for approximately 70 percent of total lending commitments, in line with its historical share of lending and up from a low of 50 percent in 2002. While investment lending is key to the Bank's mission, this paper underlines that it is not always effective as an instrument of policy reform: complementary instruments may need to be used to address policy distortions.

57. ***Generally Fewer Conditions.*** The paper finds that over the past decade the use of investment lending conditions that go beyond the immediate investment or project has declined across all sectors. This is consistent with projects becoming less ambitious, with fewer components that require coordination across sector ministries, and actions necessary for project success largely completed before Board presentation. Necessary requirements for loan effectiveness are also increasingly being met before the project is presented to the Board, although there is scope for further improvement.[92]

58. ***Ownership of Policy Reform.*** Improving the policy environment is an important objective of Bank activity in borrowing countries, since the development impact of investment projects is predicated on the existence of conducive sector policies and institutional frameworks.[93] The Bank's experience, articulated by sector managers, is that in the absence of borrower ownership and commitment, relying on policy conditions in investment lending has often been inefficient and ineffective in achieving sector policy reform objectives. This paper, therefore, concludes that when borrower ownership is weak, it is better to use a combination of other instruments (including the CAS dialogue,

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89 Because of the large impact on the broader economy in each country, the dialogue on reforms was led by PREM staff.

90 *Investment Lending Modernization and Simplification* (CODE2003-0037), June 19, 2003.

91 *Quality at Entry in FY04-05 (QEA7): A QAG Assessment*, QAG, December 7, 2005.

92 QAG panelists felt that project design was "overly elaborate" in the 30-40 percent of operations rated moderately satisfactory in 2005; see *Quality at Entry in FY04-05 (QEA7): A QAG Assessment*, December 7, 2005.

93 "The outcomes of projects are closely correlated with the borrower country policy and institutional environment, as measured by the CPIA ratings," *2001 Annual Review of Development Effectiveness - Making Choices*, 2002.

the dialogue around the development of an investment operation, advisory and analytic work, etc.) to build domestic consensus on sector policy reform rather than simply using policy conditions in investment lending or, indeed, DPL.

59. ***Using the Country Dialogue.*** Better use of the CAS dialogue—that is, working in partnership with countries on the pace of reforms, is arguably the best instrument to move the reform agenda forward. The CAS dialogue can be a valuable starting point for discussing the need for policy reform, developing a clear understanding of reform priorities and sequencing, and reaching agreement on how essential reforms will be achieved. A well-prepared CAS also articulates the use of different instruments—such as analytic and advisory services, technical assistance, and development policy lending—to promote reforms[94] in concert with investment lending operations. In parallel, it may be appropriate to allocate resources to build consensus within the country on the need for reforms. Going forward, country departments may also need to revisit how resource allocation decisions are made to ensure that budget constraints do not result in the imposition of sector conditions through investment lending for want of alternative instruments.

60. ***Using DPLs and Analytic and Advisory Services.*** In the context of a coherent sector reform approach, well designed DPLs can complement investment lending by including key sector policy reform elements as conditions, or even triggers for sequential operations, while related investment lending proceeds in parallel. Analytic and advisory services can also be used to build borrower ownership, consensus for reform, and agreement on prerequisites to lending. The sequencing of operations and the synergies between different operations can thus be exploited when complex policy or institutional reforms are needed.

61. ***Customized Approach.*** Given the heterogeneity of country and sector situations and the range of Bank programs in different countries, it is difficult to fashion a hard-and-fast rule on the use of sector policy conditions in investment lending. When there is clear borrower ownership, commitment, and demand at the sector level, and the appropriate central ministry (such as the Ministry of Finance) is part of the dialogue and supports the agreements reached, sector policy reform requirements can be addressed through judicious use of sector policy conditions in investment operations. In addition, policy reform can be addressed up front, during project preparation, or in parallel with investment lending, for instance, through the flexible use of Letters of Sector Policy, by following an explicit "dual track" in which policy dialogue and related technical assistance proceed on a separate track from lending, or by using SWAps.

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94 For example, the CAS can reflect agreed thresholds in terms of the policy and institutional environment for lending in a sector.

ANNEX A. THE EVOLUTION OF BANK INVESTMENT LENDING

1. ***1940s and 1950s: Reconstruction.*** IBRD's first loans were for reconstruction of physical infrastructure[1] in countries devastated by World War II. Over time, its lending expanded to support development in newly independent countries, although loans for reconstruction continued until the late 1960s.[2] Most early loans financed ports, railways, roads, and power plants.

2. ***1960s: Lending for Physical Infrastructure.*** During the 1950s and 1960s the conditions attached to any given project related to the specific long-term investment and to development of the associated institutions. For revenue-earning entities and utilities, financial performance covenants became standard; for road projects, conditions on maintenance expenditures were routine. The Bank's lending extended to water supply, development finance companies (for small and medium industry), education, and industry. Lending also included large-scale capital-intensive industrial projects focusing on the corporatization of state-owned productive enterprises.[3]

3. ***1970s: The Importance of the Policy Environment.*** Lending for health and nutrition projects began around 1970, followed by lending for urban projects, in which the Bank initially financed sites and services and urban transport. The recognition that even a well-designed investment project in a poor policy environment would not yield anticipated returns led to a focus on economic and sector work (ESW) on the sector policy and institutional environment facing projects. Energy lending, initially for upstream activities such as exploration, began after the second oil shock of 1979; these operations also provided policy advice on opening the sector to large-scale private investment. In 1980, the first structural adjustment loan was made to Turkey in recognition of the poor development impact of the years of project lending that had preceded it. The slogan became "get the policies right first." An Environmental Advisor was appointed in the early 1970s, and the President's Report on each loan began to include statements on the environmental impact of the project being financed.

4. ***1980s: The Privatization Wave.*** Development thinking in this era shifted, bringing a push to reduce the role of the state in productive enterprises and utilities through privatization. In countries where there was no political will to privatize enterprises, the Bank usually sought corporatization with private management contracts.[4] The privatization wave also swept other

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[1] Some program loans were made in the early years for balance of payments support to countries that are now Part I, and to some Part II countries, e.g., Iran.

[2] The last two such loans made in the late 1960s were to Italy and Japan, both for railway transport.

[3] In this period the public sector, public ownership and planning were viewed as playing a central role in economic development. See Myrdal, Gunnar, *An International Economy, Problems and Prospects*. New York, NY: Harper & Bros. 1956.

[4] In the power sector, following disappointing results in terms of institutional viability, service quality, and coverage despite decades of Bank lending, a new "commitment lending" approach was adopted. Poor performance in the sector had been attributed to the absence of a hard budget constraint for public utilities combined with the political difficulty of adjusting tariffs to cover marginal costs; meanwhile, governments were generally fiscally strapped and hence unable to meet their commitments to utilities, leading to acute problems of service quality and coverage. The new approach called for revised regulatory frameworks to permit "unbundling" the sector into generation, transmission, and distribution, and to permit private sector participation to improve efficiency, since private capital would be at risk unless performance ensured a satisfactory return on assets. See *Power for Development: A Review of the World Bank Group's Experience with Private Participation in the Electricity Sector*, OED, 2003.

international financial institutions, with the IMF notably pushing it as providing assurance on fiscal stability.

5. ***1990s: Client "Ownership."*** During the 1990s the interface between the "policy conditionality" required by donors and country commitment and "ownership" of reforms came under scrutiny. Since policy reforms invariably touched upon political economy issues, it was clear that they might not be implemented unless they were owned domestically. The development community continued to maintain that the private sector's key role in development could be facilitated by removing distortions and creating an enabling environment for private sector participation; this push moderated after the 1997 East Asian financial crisis.

6. ***2000: Pragmatism.*** During the past decade, the Bank's approach to investment lending has become more nuanced and pragmatic. The Bank has come to recognize the complementarities between the private and public sectors, to decide that it should remain engaged along the entire spectrum of public-private solutions, with the choice being driven by local conditions rather than ideology.[5]

7. ***Evolution of Bank's Organizational Structure.*** The evolving country focus in development assistance was institutionalized through successive internal reorganizations of the Bank along geographic lines. Before 1972, the Bank was organized into six Area Departments representing geographic regions, and a single Projects Department, which consisted of Sector Departments headed by Directors, and staff. A reorganization in 1972 led to the creation of vice presidencies for each of six geographic regions, with the Bank wide Projects Department broken into six Regional Projects Departments and a Central Projects Staff with a review and advisory function. Each Region had two Country Program Departments, with Country Program Divisions responsible for managing country relations and dialog. The trend of assigning responsibilities for the dialogue to Country Departments went further in the 1987 reorganization when, within each Region, Country Program Departments were placed at the head of a Country Program Division and usually four Projects Divisions.[6] The country budget drove the composition of the country assistance and work programs. At that time central departments housed sector staff in areas such as industry and energy. This direction was further entrenched in 1996/97 when country management units and sector management units were established; responsibility for the country dialogue and strategy rested with the country management unit, while sector operations were the responsibility of the sector management unit. Networks were created in this period: Anchor Sector Departments housed key sector specialists, but most sector staff were part of a Region. In this manner the Bank steadily increased its country focus, with the country replacing the project as the critical unit of account for Bank assistance.

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5 *Infrastructure: Lessons from the Last Two Decades of World Bank Engagement* (SecM2006-0046), February 8, 2006.

6 Agriculture, "Social Sectors" (Education, Population, Nutrition, and Health), Infrastructure, Industry and Energy.

ANNEX B: TRIGGERS IN ADAPTABLE PROGRAM LOANS

1. In view of the increasing use of adaptable program loans and the longer-term perspective they bring to policy reform, this section presents the findings of the review of Project Appraisal Documents as they relate to APL triggers.[7] *Triggers* are the performance milestones or prior actions required to move to the next operation in a series of operations supporting a sector reform or investment program. As *prior* actions or milestones, triggers need to be met during the implementation of the current operation. They are typically not conditions of loan negotiation, Board presentation, effectiveness, or disbursement for the operation they are attached to, and, therefore—unlike formal covenants—are not included in the Loan Agreement.

2. ***APLs and Triggers.*** APLs may support comprehensive sector policy programs, or they may support investment programs with long-term agendas but without comprehensive policy coverage. Triggers vary with the objective of the program: typically triggers for APLs with long-term investment projects focus on institutional and physical implementation and monitoring while triggers for sector policy APLs focus on policy and institutional aspects. The use of APLs has been most relevant for sectoral programs supporting a complex combination of long-term policy and institutional changes that require flexibility in implementation.[8]

3. ***APLs in the Sample.*** The sample of PADs reviewed included only 36 of the 95 APLs approved during FY03-05. While this number is too small to provide reliable information on the types of triggers in APLs, some patterns emerge from the data. It is clear that APLs are seen as a vehicle for dialogue on phased sector reform that will take place over a relatively long period, possibly from 9 to 12 years.

4. ***Trigger Characteristics.*** Triggers are specified most precisely for the phase immediately following the first APL, and they become increasingly general for subsequent phases. The triggers observed in the sample most often relate to processes, outputs, and inputs (e.g., budgets). While some triggers appear to reflect desired outcomes, outcomes usually feature only as part of the monitoring and results frameworks. Table B-1 presents data for the APLs reviewed. Of the two APLs from AFR that included triggers that went beyond the project, one (Mauritania Integrated Agriculture) called for competition in transport service provision as a trigger for the next APL in the series. (The need for competitive transport services was identified under a separate transport project that was then under preparation.) Of the 14 APLs in LCR, 2 (Bolivia Decentralized Infrastructure and Brazil Bolsa Familia) had a policy trigger that called for national scale reforms in regulatory and institutional areas before Phase II and the next APL; the Brazil Bolsa Familia APL also contained a disbursement condition for one project component.

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[7] APLs are formally embedded in a long-term program with clear objectives and predefined parameters to move from one phase to the next. Thus the APL in support of the first phase of a program identifies triggers to move to APLs in support of the subsequent phases of the program, two to four years thereafter.

[8] See APL and Triggers – Guidance Note, OPCS. Forthcoming.

Table B-1. Triggers in APLs

Region	***APLs in sample***	***Projects with project specific triggers***		***Projects with sector/policy reform triggers***	
		#	**%**	**#**	**%**
AFR	8	6	75	2	25.0
EAP	2	2	100	-	-
ECA	8	8	100	-	-
LCR	14	12	85.7	2	14.3
MNA	3	3	100	-	-
SAR	1	1	100	-	-

ANNEX C: SUMMARY TABLES

A. Regional Breakdown of Operations with Non-standard Conditions

FY 1996/97 SAMPLE

Region	*Sample size*	*Projects with conditions*		*Projects with project-specific conditions*		*Projects with sector/policy reform conditions*	
		#	%	#	%	#	%
AFR	34	29	85	11	32	18	53
EAP	37	29	78	22	60	7	19
ECA	36	28	76	20	56	8	22
LCR	37	24	65	19	51	5	14
MNA	21	19	91	11	52	8	38
SAR	24	23	96	21	88	2	8
Total	189	152	80	104	55	48	25

FY 2003/04 SAMPLE

Region	*Sample size*	*Projects with conditions*		*Projects with project-specific conditions*		*Projects with sector/policy reform conditions*	
		#	%	#	%	#	%
AFR	51	15	29	10	20	5	10
EAP	26	15	58	13	50	2	8
ECA	42	20	48	16	38	4	10
LCR	29	11	38	8	28	3	10
MNA	15	3	20	3	20	0	-
SAR	28	6	21	6	21	0	-
Total	191	70	37	56	29	14	7

FY 2005 SAMPLE

Region	*Sample size*	*Projects with conditions*		*Projects with project specific conditions*		*Projects with sector/policy reform conditions*	
		#	%	#	%	#	%
AFR	28	12	43	10	36	2	7
EAP	22	11	50	11	50	0	-
ECA	28	11	39	10	36	1	4
LCR	21	4	19	4	19	0	-
MNA	7	3	43	2	29	1	14
SAR	17	3	18	3	18	0	-
Total	123	44	36	40	33	4	3

B. Network Breakdown of Operations with Non-standard Conditions

FY 1996/97 SAMPLE

Network	Sample size	Projects with conditions		Project with project specific conditions		Project with sector/policy reform conditions	
		#	%	#	%	#	%
INF	69	61	88	35	51	26	38
ESSD	52	42	81	36	69	6	12
HD	54	37	69	25	46	12	22
PSD/FIN	14	12	86	8	57	4	29
Total	189	152	80	104	55	48	25

FY 2003/04 SAMPLE

Network	Sample size	Projects with conditions		Projects with project specific conditions		Projects with sector/policy reform conditions	
		#	%	#	%	#	%
INF	59	36	61	29	49	7	12
ESSD	44	15	34	12	27	3	7
HD	68	12	18	10	15	2	3
PSD/FIN	12	6	50	4	33	2	17
PSM	8	1	13	1	13	0	-
Total	191	70	37	56	29	14	7

FY 2005 SAMPLE

Network	Sample size	Projects with conditions		Projects with project specific conditions		Projects with sector/policy reform conditions	
		#	%	#	%	#	%
INF	43	25	58	22	51	3	7
ESSD	34	10	29	10	29	0	-
HD	34	5	15	4	12	1	3
PSD/FIN	12	4	33	4	33	0	-
Total	123	44	36	40	33	4	3

C. The Changing Incidence of Policy Reform Conditions in Investment Lending

A. By Region

Region	Policy or project conditions (percent of sample projects)			Sector/policy reform conditions (percent of sample projects)		
	FY96/97	*FY03/04*	*FY05*	*FY96/97*	*FY03/04*	*FY05*
AFR	85	29	43	53	10	7
EAP	78	58	50	19	8	0
ECA	76	48	39	22	10	4
LCR	65	38	19	14	10	0
MNA	91	20	43	38	0	14
SAR	96	21	18	8	0	0
Total	80	37	36	25	7	3

B. By Network

Network	Policy or project conditions (percent of sample projects)			Sector/policy reform conditions (percent of sample projects)		
	FY96/97	*FY03/04*	*FY05*	*FY96/97*	*FY03/04*	*FY05*
INF	88	61	58	38	12	7
ESSD	81	34	29	12	7	0
HD	69	18	15	22	3	3
PSD/FIN	86	50	33	29	17	0
PSM	-	13	-	-	0	-
Total	80	37	36	25	7	3

C. By Country Category

Country Category	Policy or project conditions (percent of sample projects)		Sector/policy reform conditions (percent of sample projects)	
	FY 96-97	*FY03-05*	*FY96-97*	*FY03-05*
IBRD	79	41	23	6
IDA	83	34	30	8
Blend	100	23	0	0
Total	80	37	25	7

D. Sector patterns – percent of projects with conditions

(Number of projects in parentheses)

Sector	***FY 1996/97*** Project related conditions	***FY 1996/97*** Beyond project	***FY 2003/04*** Project related conditions	***FY 2003/04*** Beyond project	***FY 2005*** Project related conditions	***FY 2005*** Beyond project
INF						
Energy	30.40 (7)	34.78 (8)	88.89 (8)	-	75.00 (9)	8.33 (1)
Transport	42.31 (11)	38.46 (10)	52.38 (11)	14.29 (3)	40.00 (4)	20.00 (2)
Urban/Water	80.95 (17)	38.10 (8)	40.00 (10)	12.00 (3)	69.23 (9)	-
ESSD						
Rural	69.05 (29)	11.90 (5)	31.43 (11)	8.57 (3)	30.77 (8)	-
Environment	77.78 (7)	11.11 (1)	20.00 (1)	-	28.57 (2)	-
HD						
Education	54.17 (13)	25.00 (6)	15.38 (4)	3.85 (1)	13.33 (2)	6.67 (1)
HNP	46.15 (6)	38.46 (5)	14.29 (4)	-	16.66 (2)	-
Social Protection	31.58 (6)	16.67 (1)	-	-	-	-
PSD/FIN						
PSD	50.00 (3)	50.00 (3)	30.00 (3)	20.00 (2)	66.67 (4)	-
Finance	80.00 (4)	20.00 (1)	50.00 (1)	-	-	-
PREM						
Public Sector/ Governance	50.00 (1)	-	-	-	-	-
Number of projects with conditions	104	48	56	14	40	4
Percent of all projects	55.0	25.4	29.3	7.3	32.5	3.3
Sample size	189		191		123	

E. Preparation and Supervision costs and incidence of Investment Lending conditions, FY 1996-97

(US$ thousands, constant value)

Category	*Average preparation cost*	*Average annual supervision cost*[a]	*Average months elapsed from concept to approval*	*Average months elapsed from approval to effectiveness*	*Average years from approval to deactivation/ closure*[b]
Operations without non-standard conditions	325.15 (34)	49.06 (33)	18.33 (34)	5.93 (33)	5.79 (33)
Operations with non-standard conditions	409.16 (136)	60.54 (131)	21.42 (136)	6.14 (131)	6.49 (117)
Operations with broad sector policy conditions	410.84 (40)	61.24 (39)	23.07 (40)	7.45 (39)	6.72 (34)
Operations with project-specific narrowly focused conditions	408.46 (96)	60.25 (92)	20.74 (96)	5.59 (92)	6.40 (83)

Note: Sample size in parentheses. The analysis excludes outliers. The number of 2003-05 projects with broad policy conditions attached to them was too small for meaningful comparisons

a. Excludes projects that were never effective

b. Excludes projects still under implementation

ANNEX D: EXAMPLES OF PROJECT PERFORMANCE ON AGREED UNDERTAKINGS IEG COMMENTS IN PPARS REVIEWED

1. These Project Performance Assessment Reports (PPARs) reveal that a central feature of the projects approved in the 1990s is sector policy reform and institutional restructuring to facilitate greater private participation.

AFRICA

2. **Uganda: Cotton Sub-sector Development project (1994). (ID Impact High, Outcome Satisfactory)** Objectives included improved performance in the industry through liberalization of cotton processing and export marketing, and the establishment of an efficient regulatory framework for the industry. The liberalization was achieved and the regulatory framework and institutions established. A committed government with appropriate economic and social policies and which promptly passes supporting legislation is credited.

3. **Lesotho: Road Rehabilitation and Maintenance project (1996). (ID Impact Modest, Outcome Moderately Satisfactory)** Objectives included sector institutional and policy reform covering restructuring the Ministry of Works and Transport, and establishing a sustainable road financing mechanism. Although the Letter of Sector Policy calls for routine maintenance needs to be financed through the Road Fund, only 60% of the funding required was provided. A proposal for a semi-autonomous roads agency put to the Cabinet was rejected based on experience in other sectors. When major institutional reform is planned it is important to ensure full government commitment at the highest level.

LATIN AMERICA AND THE CARIBBEAN

4. **Mexico: Agricultural Productivity Improvement Project (1998). (ID Impact Negligible, Outcome Unsatisfactory)** The project, known as ALCAMPO, supported the Alianza para el Campo program which aimed to leverage private investment in agriculture. Its development objective was to increase capitalization of small farmers and improve their productivity and income, through i) improvement of access of small and poor farmers to activities supported by three specific ongoing programs; ii) better integration of the various activities of Alianza; iii) transfer of technologies suited to small farmer production conditions; iv) strengthen production support services; and v) support the Government promoted decentralization process. OED was unable to rate achievement of the first sub objective of increased access, while the second, enhance agricultural services was partially achieved, and strengthening decentralization was not achieved. In summary, OED rated the outcome of ALCAMPO as unsatisfactory. Its ID impact was rated Negligible, sustainability unlikely and a follow on project mooted in the 2002 CAS was dropped. The broader lessons include the need for projects to dovetail with programs but that well designed projects can rarely turn around a poorly designed program; and, that programs as large as Alianza are candidates for impact evaluation, since it appears that much of the investment and income growth attributed to it might have occurred without a subsidy, while subsidies may have leaked to better off groups that do not need them.

MIDDLE EAST AND NORTH AFRICA

5. Yemen**: Taiz Water Supply Pilot Project (1996). (ID Impact Modest, Outcome Unsatisfactory)** The objectives of this project were to i) mitigate the immediate water shortage in Taiz, by increasing supply; ii) identify new water sources to avert a sustained shortage crisis;

iii) develop and test a process and institutional framework for decentralized water resource management; and iv) prompt private sector participation in the management of water and wastewater utility services. The first and main objective, to quickly increase the city's water supply, fell well short of the targeted increase; at 40 liters per second instead of 140 liters per second, it was a very modest achievement. Some progress was made on the second objective – to identify additional water sources. Given the capacity upgrade which IEG found had continued after the project, the second objective's efficacy is rated as substantial. The third objective was competently implemented and much of the infrastructure is still functional. The fourth, promoting private participation was dropped at the Bank's request because the first drafts of the study to assess private sector participation possibilities were inadequate. The outcome was rated as unsatisfactory, sustainability unlikely, and the ID impact as modest, with the note that arrangements for coordination between institutions were weak, with the National Water and Sewerage Agency, which was to play the coordination role being ineffective.

EAST ASIA AND THE PACIFIC

6. **China: Ertan Hydro I and Ertan Hydro II projects (1991, 1995). (ID Impact High, Otucome Satisfactory for both projects)** When the Ertan Hydro I project was approved in 1991, the emphasis was on technology transfer and capacity building with minimal policy content. From 1994 onwards, when the Bank and Government of China undertook the first reviews of sector reform options, power projects nearly always addressed institutional reform issues as part of the design of new power investment lending operations. Although promoting competition in the Ertan II loan seems to have been premature in the prevailing context, and driven by internal Bank pressures, seeking new financing approaches was relevant for a new entity with little exposure to international capital markets. The Ertan Hydropower Development Company (EHDC) was converted into a limited liability company with a Board in 1995. Today its share capital is owned by various entities. The implementation of these two difficult Ertan Hydro projects is because of strong commitment and performance of EHDC.

7. **China: Sichuan Power Transmission project (1995). (ID Impact High, Outcome Satisfactory)** The Sichuan Power Transmission project pursued reform goals of developing Sichuan Electric Power Company (SEPC) into a limited liability company separated from government, financially autonomous and self sufficient, commercially operated, etc. Sector regulation was to be handled by the State. The tariff structure was to be rationalized. The project made a major contribution to institutional reforms in SEPC, which has become a much stronger, commercially-minded company.

8. **China: Zhejiang Power Development Project (1995). (ID Impact High, Outcome Satisfactory)** The Zhejiang project's objectives include promoting power sector reform, covering commercialization and corporatization of the power enterprise, promote competition in generation and encouraging alternative financing strategies, with power sector reform carrying much more weight than in the other projects. At the time of the PPAR, the Bank's relationship with the Zhejiang Provincial Electric Power Company (ZPEPC) stretched back some 20 years. During this period the entity has been transformed. ZPEPC exhibited openness and receptivity to outside help and was able to extract the best of what was on offer. The Bank had considerable positive influence on ZPEPC's corporate culture as well on sector policies. Implementation of some of the covenants in the project took longer than initially foreseen, but was satisfactory.

SOUTH ASIA

9. **India: Madhya Pradesh Forestry Development Project (1995). (ID Impact Modest, Outcome Moderately Satisfactory)** The objective was to help the state government of Madhya Pradesh implement its strategy for the development of the forest sector (Joint Forest Management). Specific objectives were to strengthen the state's Forestry Department, to increase forest cover by improved management based on the participation of local communities, to upgrade forest research and extension, and to conserve biodiversity. The outcome of the project was rated as moderately satisfactory. The Bank froze forestry lending in India after this loan closed. This was more to reduce the risk to the Bank's reputation by avoiding conflict with adversarial NGOs than because of the effectiveness of joint forest management. Nonetheless, OED considers the objectives were substantially relevant, not least because a large percentage of India's poorest depend on forestry directly or indirectly for a living. The objective of strengthening the forest department was partially achieved, as also that of increasing forest cover through participatory management. Strengthening research and extension was not achieved. Compared with the first three objectives more progress was made towards conserving bio diversity. OED found no evidence in terms of a sub component of the fourth objective stimulating private sector investment in the forest sector. The ID impact, which is rated modest, consists of two aspects--capacity building of the Forest Department and village organizations, and strengthening the framework of laws, regulations and incentives bearing on forest management. The Forest Department pushed to decentralize and won support at all levels for the participatory model of forest management, and momentum to create village committees continued after the loan closed. On the other hand there are inconsistencies and lacunae in the legal framework that underpins joint forest management. Elected officials could (in theory) over rule village forest committees, challenging distribution of benefits decreed by the latter. The first lesson is that to mobilize support for resource conservation a long term commitment is needed by government and donor agencies. Second, flaws in the legal and incentive framework need to be addressed.

EUROPE AND CENTRAL ASIA

10. **Romania: Railway Rehabilitation Project (1996). (ID Impact High, Outcome Highly Satisfactory)** The objectives were to support and deepen the restructuring process which the railways and government had initiated; and support policy measures embodied in the new Railway law, the Restructuring Action Plan and Performance Contracts agreed between government and Passenger Companies. Both objectives are considered as fully achieved. The project has led to crucial institutional changes that have established a legal and legislative framework for future viability of the rail sector in Romania. Also the legislation that gives private rail operators open access to tracks has been enacted. The Bank team played an important role in discussions of necessary legal and institutional reforms in the sector, especially at the interface with daily operations and management. The strong advisory role of the Bank in other areas is also credited.

11. **Bulgaria: Railway Rehabilitation Project (1995). (ID Impact Substantial, Outcome Moderately Satisfactory)** The objectives were to support and deepen the restructuring process which the railways and government had initiated; and support policy measures embodied in the new Railway Law, the Restructuring Action Plan, and the Contract Plan between the government and Bulgarian State Railways. The first objective was substantively achieved while the second objective was partially achieved. The project has led to substantial institutional changes leading to the development of a legal and legislative framework for future viability of the rail sector in

Bulgaria. However, the conclusions point to the need for a stronger advisory role of the Bank for complex components such as the MIS, with phased implementation rather than turnkey, given the complexity of the component for a transition country. Also, the Contract Plan could have been more specific on services that are considered by government to be socially necessary, with such services transparent, explicitly defined and fully compensated.

12. **Russian Federation: Enterprise Housing Divestiture Project (1996). (ID Impact Negligible, Outcome Unsatisfactory)** The primary objective was the sustainable divestiture of enterprise housing throughout Russia, by demonstrating in participating cities a combination of housing reforms and investments designed to transfer housing to the private sector and lower its operating cost. Secondary objectives were to ensure, through housing privatization, that housing divestiture does not lead to increases in the volume of public housing; make the divestiture process more affordable for cities and rationalize the flow of funds to the sector by recovery of maintenance and utility fees from tenants; protect vulnerable groups through targeted allowances; rationalize and increase private sector participation in service provision in the sector through competitive bidding for maintenance; reduce costs of maintaining housing and make the process affordable through energy efficiency improvements in divested housing. The primary objective and four of the secondary objectives were assessed as Not Achieved, while two secondary objectives, protection of vulnerable groups and rationalize and increase private sector participation in housing service provision were Partially Achieved. OED found the project objectives as negligibly relevant to the housing sector priorities of GOR or the Bank, because it was trying to attain something that had already been achieved earlier. For not having achieved its objectives but leaving minor development benefits, OED rated the overall outcome as Unsatisfactory, with sustainability being Highly Unlikely, since the project did not generate any resilient benefit stream related to housing divestiture. ID impact is negligible since the project did not increase the efficiency of resource use in the sector in Russia.

Table D-1. List of PPARs reviewed

Region/Country	Project	Date Approved	PPAR Date
AFR-Uganda	Cotton Subsector Development	05/10/1994	06/14/2005
AFR-Uganda	Agriculture Research &Training	12/15/1992	06/14/2005
AFR-Kenya	Arid Lands Resource Mgmt	12/14/1995	10/31/2005
AFR-Mauritius	Port Development & Environmental Protection	06/20/1995	11/29/2005
AFR-Tanzania	Port Modernization	02/27/1990	06/22/2005
AFR-Tanzania	Railway Restructuring	06/13/1991	06/22/2005
AFR-Lesotho	Road Rehabilitation	05/09/1996	01/25/2006
AFR-Niger	Energy	02/23/1998	04/15/2005
AFR-Kenya	Micro & Small Enterprise Training and Technology	04/05/1994	06/24/2005
EAP-China	Ertan Hydroelectric I	07/20/1991	06/27/2005
EAP-China	Ertan Hydroelectric II	08/22/1995	06/27/2005
EAP-China	Sichuan Power Transmission	02/28/1995	06/27/2005
EAP-China	Zhejiang Power Development	02/28/1995	06/27/2005

Region/Country	Project	Date Approved	PPAR Date
EAP-China	Inland Waterways	06/20/1995	12/05/2005
EAP-Indonesia	Industry Technology Development	12/21/1995	07/05/2005
ECA-Bulgaria	Water Companies Restructuring & Modernization	05/26/1994	07/22/2005
ECA-Bulgaria	Railway Rehabilitation	07/06/1995	05/31/2005
ECA-Romania	Railway Rehabilitation	06/18/1996	06/21/2005
ECA-Russia	Bridge Rehabilitation	03/28/1996	05/24/2005
ECA-Russia	Urban Transport	05/16/1995	05/24/2005
ECA-Russia	Housing	11/28/1993	06/24/2005
ECA-Russia	Enterprise Housing Divestiture	05/07/1996	06/24/2005
ECA-Romania	Danube Delta Biodiversity	08/26/1994	06/20/2005
LCR-Mexico	Irrigation & Drainage Sector	12/13/1991	07/22/2005
LCR-Mexico	On-Farm and Minor Irrigation Network Improvement	07/17/1994	07/22/2005
LCR-Mexico	Agricultural Productivity Improvement	12/22/1998	07/22/2005
LCR-Uruguay	Vocational Training and Technological Development	06/23/1978	01/23/2006
LCR-Uruguay	Basic Education Quality Improvement	05/03/1994	01/23/2006
LCR-Uruguay	Second Basic Education Quality Improvement	07/30/1998	01/23/2006
MNA-Yemen	Taiz Water Supply	09/03/1996	02/22/2006
MNA-Yemen	Sanaa Water & Sanitation	05/13/1999	02/22/2006
MNA-Yemen	Land & Water Conservation	05/28/1992	02/22/2006
MNA-Morocco	Large Scale Irrigation Improvement	03/30/1993	06/20/2005
MNA-Morocco	Irrigated Areas Agricultural Services	12/21/1993	06/20/2005
SAR-Bangladesh	Integrated Nutrition	05/30/1995	06/13/2005
SAR-India	MP Forestry Development	03/30/1995	04/28/2005
SAR-India	Agriculture Development	11/12/1992	11/28/2005

ANNEX E: PROJECT PREPARATION AND SUPERVISION

(US$ thousands, constant value)

	Average preparation cost		*Average months elapsed from PCD to approval*		*Average months from approval to effectiveness* [a]	
	FY96-97	***FY04-05***	***FY96-97***	***FY04-05***	***FY96-97***	***FY04-05***
Region						
AFR	390.58	383.69	22.38	18.17	6.57	5.85
EAP	376.64	466.93	20.09	21.54	6.29	6.94
ECA	431.69	336.67	22.10	15.57	5.69	5.68
LAC	330.53	285.05	20.02	12.89	8.43	7.65
MNA	375.59	411.07	19.55	17.81	7.40	5.68
SAR	422.68	351.61	23.67	15.39	5.26	4.05
Network						
ESSD	429.04	395.79	22.88	19.14	7.35	5.50
FSE	371.82	290.21	20.67	10.50	6.17	5.22
HDN	355.55	362.06	20.15	15.22	6.28	5.50
INF	381.37	358.36	21.78	17.33	6.66	6.53
PREM	345.45	350.46	16.42	15.31	4.93	6.23
PSDN	391.39	377.96	17.51	14.60	7.02	7.65
IBRD/IDA						
IDA	379.00	351.97	20.67	16.38	6.06	5.75
IBRD	388.87	392.70	21.63	17.57	7.19	6.37
Blend	392.64	309.63	19.35	15.47	5.83	6.53
EA Category						
A	439.74	439.83	23.57	18.75	7.91	6.75
B	410.77	361.88	21.63	17.45	6.69	5.81
C	339.69	340.09	19.94	13.50	6.34	6.19
Number of projects	339	307	339	307	331	258

Note: Data from SAP/BW. The data cover all investment projects approved in FY96, 97, 04, and 05 except emergency recovery, technical assistance, and supplemental loans. Outliers (with preparation time of four or more years) were dropped for the analysis.

a. Excludes projects that were never effective

ANNEX F: SURVEY FINDINGS

1. How reasonable are the World Bank's loan conditions (including policy/processing and procedural requirements in the following areas), in view of the benefits gained?

Average ratings on a scale from 1 (not reasonable) to 6 (reasonable).

	Project specific actions required		*Project-related sector reform or policy changes required*		*Procurement requirements*		*Financial management requirements*		*Environmental assessment requirements*		*Involuntary resettlement/land acquisition requirements*	
Sector												
Rural	4.50	(16)	4.29	(14)	4.25	(16)	4.67	(16)	4.82	(15)	4.15	(11)
Transport	5.10	(20)	4.66	(19)	5.28	(20)	4.95	(20)	4.63	(20)	4.50	(15)
IBRD/IDA												
IBRD (including Blend)	4.86	(62)	4.61	(59)	4.72	(63)	4.83	(63)	4.47	(58)	4.44	(42)
IDA	4.68	(39)	4.26	(37)	4.28	(39)	4.94	(39)	4.84	(36)	4.22	(27)
Region												
AFR	4.38	(17)	3.73	(17)	3.85	(17)	4.77	(17)	5.04	(15)	4.00	(10)
EAP	4.73	(25)	4.67	(24)	4.37	(25)	4.81	(25)	4.45	(25)	4.24	(23)
ECA	5.06	(35)	4.67	(32)	5.02	(35)	5.00	(35)	4.66	(31)	4.66	(17)
LAC	4.89	(14)	4.54	(13)	4.79	(14)	4.86	(14)	4.42	(12)	4.44	(9)
MNA	4.25	(4)	4.00	(4)	3.80	(5)	4.60	(5)	4.40	(5)	4.25	(4)
SAR	4.72	(6)	4.97	(6)	4.64	(6)	4.92	(6)	4.56	(6)	4.50	(6)
Ministry												
Central	4.82	(18)	4.47	(17)	4.46	(18)	4.73	(18)	4.50	(18)	4.44	(16)
Line	4.78	(83)	4.47	(79)	4.57	(84)	4.90	(84)	4.64	(76)	4.33	(53)
Overall	4.79	(101)	4.47	(96)	4.55	(102)	4.87	(102)	4.61	(94)	4.36	(69)

Note: Number of observations in parentheses.

2. Average *avoidable* delays in project preparation (months) by factor.

	Project specific actions required		*Project related sector reform or policy changes required*		*Procurement requirements*		*Financial management requirements*		*Environmental assessment requirements*		*Involuntary resettlement/land acquisition requirements*	
Sector												
Rural	3.05	(15)	4.16	(14)	2.39	(14)	1.55	(14)	2.12	(13)	2.56	(11)
Transport	2.18	(17)	2.77	(15)	2.58	(15)	1.75	(14)	2.06	(13)	3.78	(9)
IBRD/IDA												
IBRD (incl. Blend)	2.73	(55)	3.49	(52)	2.37	(52)	2.00	(52)	2.08	(47)	2.98	(33)
IDA	3.65	(38)	3.91	(34)	2.94	(34)	2.31	(36)	2.37	(31)	3.79	(25)
Region												
AFR	4.50	(18)	4.95	(17)	3.63	(16)	3.11	(18)	3.32	(14)	4.45	(11)
EAP	3.13	(24)	3.28	(24)	2.76	(24)	1.90	(24)	2.09	(24)	2.88	(21)
ECA	1.86	(30)	3.21	(27)	1.66	(29)	1.46	(29)	1.53	(23)	2.88	(13)
LAC	3.52	(13)	2.95	(11)	2.55	(11)	2.45	(11)	2.16	(11)	3.31	(8)
MNA	5.33	(3)	4.83	(3)	3.75	(2)	3.25	(2)	3.25	(2)	3.75	(2)
SAR	3.03	(5)	4.50	(4)	3.88	(4)	2.50	(4)	2.38	(4)	4.08	(3)
Ministry												
Central	3.70	(18)	4.37	(18)	3.24	(17)	2.78	(18)	2.78	(18)	4.02	(16)
Line	2.96	(75)	3.47	(68)	2.44	(69)	1.96	(70)	2.02	(60)	3.07	(42)
Overall	3.11	(93)	3.66	(86)	2.60	(86)	2.13	(88)	2.20	(78)	3.33	(58)

Note: Number of observations in parentheses.

3. Average annual *avoidable* delays in project implementation (months) by factor.

	Project specific actions required		*Project related sector reform or policy changes required*		*Procurement requirements*		*Financial management requirements*		*Environmental assessment requirements*		*Involuntary resettlement/land acquisition requirements*	
Sector												
Rural	1.63	(14)	2.13	(13)	1.79	(15)	1.18	(14)	1.44	(13)	1.47	(11)
Transport	1.50	(15)	2.00	(14)	1.69	(16)	1.37	(15)	1.50	(13)	1.85	(10)
IBRD/IDA												
IBRD (incl. Blend)	1.51	(51)	2.04	(51)	1.78	(56)	1.25	(52)	1.41	(45)	1.82	(34)
IDA	1.97	(36)	2.26	(32)	2.18	(36)	1.56	(35)	1.83	(29)	2.14	(23)
Region												
AFR	2.41	(16)	2.98	(15)	2.88	(17)	2.06	(17)	2.51	(13)	3.13	(10)
EAP	1.55	(24)	1.72	(23)	1.96	(25)	1.37	(23)	1.38	(21)	1.80	(20)
ECA	1.51	(31)	2.15	(28)	1.53	(30)	1.12	(30)	1.22	(24)	1.46	(15)
LAC	1.45	(10)	1.77	(11)	1.68	(11)	0.95	(11)	1.50	(10)	1.79	(7)
MNA	1.50	(2)	2.00	(2)	2.00	(4)	1.50	(2)	1.83	(3)	2.00	(2)
SAR	1.92	(4)	2.08	(4)	1.57	(5)	1.50	(4)	1.83	(3)	1.83	(3)
Ministry												
Central	1.95	(15)	2.56	(17)	2.06	(17)	1.47	(16)	1.84	(16)	2.73	(13)
Line	1.64	(72)	2.01	(66)	1.91	(75)	1.35	(71)	1.50	(58)	1.72	(44)
Overall	1.70	(87)	2.12	(83)	1.94	(92)	1.37	(87)	1.58	(74)	1.95	(57)

Note: Number of observations in parentheses.

4. Level of satisfaction with the contribution of World Bank staff at different stages of the project cycle.

Average ratings on a scale from 1 (highly unsatisfactory) to 6 (highly satisfactory).

	Project appraisal/ preparation	***Project monitoring/ implementation***
Sector		
Rural	4.68 (16)	4.41 (15)
Transport	5.23 (20)	5.18 (19)
IBRD/IDA		
IBRD (including Blend)	4.91 (62)	4.80 (58)
IDA	4.67 (40)	4.49 (39)
Region		
AFR	4.54 (18)	4.29 (17)
EAP	4.84 (25)	4.68 (25)
ECA	5.00 (35)	4.90 (31)
LAC	4.88 (13)	4.46 (13)
MNA	4.30 (5)	4.80 (5)
SAR	4.78 (6)	4.95 (6)
Ministry		
Central	4.69 (18)	4.47 (18)
Line	4.85 (84)	4.72 (79)
Overall	4.82 (102)	4.68 (97)

Note: Number of observations in parentheses.

ANNEX G: MEETINGS HELD

Sector Boards

1. Private Sector Development Sector Board
2. Transport Sector Board
3. Energy Sector Board
4. Urban Sector Board
5. Water and Sanitation Sector Board (overlapping membership with Urban)
6. Health, Nutrition and Population Sector Board
7. Social Protection Sector Board
8. Agriculture and Rural Development Sector Board
9. Education Sector Board

Other members of sector management

1. Sector Manager, Infrastructure, ECA Region
2. Acting Sector Director, Energy, EAP Region
3. Sector Director, Urban Development, EAP Region
4. Portfolio Manager, Urban Development, EAP Region