IMPLEMENTING POLICY AND INSTITUTIONAL CHANGE VIA PERFORMANCE DISBURSEMENT: EXAMPLES FROM THE PHILIPPINES, BANGLADESH, AND NIGER

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EXECUTIVE SUMMARY

Performance disbursement designs are currently being used on a limited basis by AID in the Philippines, Bangladesh, and Niger to implement policy reform and related institutional changes. Performance disbursement operates on the basis of conditionality. Funding is divided into a series of tranches which are disbursed on the basis of satisfactory progress in implementing policy and institutional reforms. Policy and institutional changes are similarly divided into a sequence of revisions. Benchmarks are established to track progress toward achieving ultimate policy objectives. Periodic joint assessments involving AID and the host country determine whether the conditions of the performance disbursement agreement have been met, or whether progress has been satisfactory under unpredicted adverse conditions to warrant the release of the next tranche. These funds are then used for purposes mutually acceptable to AID and the host country, although not necessarily for activities related specifically or exclusively to the policy and institutional changes.

AID should carefully monitor and evaluate on-going use of performance disbursement to better understand the strengths and weaknesses of the approach. The effectiveness and management requirements of performance disbursement should be of particular concern to the Agency. If AID is to make wider use of this approach, a case for performance disbursement should be developed which explains the basic concept, identifies conditions which warrant use of performance disbursement, and provides a defense of the approach as a legitimate mode of development assistance.

The major advantages of performance disbursement are as follows:

-- Performance disbursement provides a mechanism for assisting the host country to take important, but difficult actions. Potential negative reaction to policy changes from groups adversely affected by the reforms constitutes a strong disincentive for action. By dividing policy change into a series of revisions implemented over a number of years, performance disbursement introduces changes gradually, provides for a period of adjustment, and permits assessment of public reaction to the reforms. In principle, funds linked to these reforms counterbalance or "soften" the adverse effects of policy change by (a) providing additional development resources or (b) compensating those adversely affected by the policy changes.

-- Performance disbursement circumvents some of the problems associated with other modes of assistance in the following ways:

- strengthening or giving greater visibility to the linkage between cash transfers and the development activities for which those funds are used

- providing a means of control over disbursement and use of funds by establishing benchmarks for tracking progress toward policy objectives

- avoiding some of the more restrictive aspects of Commodity Import Programs (CIPs) and PL 480 programs

-- A strong commitment to policy change is required by AID through its funding of the process, and by the host country through its implementation of reforms.

-- By establishing benchmarks for adequate performance prior to implementation, AID and the host country are more likely to share a mutual understanding about what has to be done before subsequent tranches are released.

-- Performance disbursement is applicable to a wide range of policy and institutional changes in various sectors.

-- Within the process of improving the policy environment and strengthening institutional capacities, performance disbursement can also support physical "bricks and mortar" outputs of standard projects.

Major issues concerning the use of performance disbursement are as follows:

-- The conditions under which performance disbursement constitutes an appropriate funding mechanism are unclear at this time.

-- How much a given policy change is "worth" (i.e., what level of funding should be tied to a specific change) is largely a matter of judgment and dependent on the particular circumstances and conditions prevalent within the host country.

-- Compatibility with U.S. Government regulations and interests is still unclear. This includes Treasury regulations concerning the timing of the release of funds, congressional acceptance of the performance disbursement approach to economic assistance, monitoring- and auditing requirements, and refund rights and procurement regulations.

-- Performance disbursement is a high-risk activity for both AID and the host country. Policy reforms can be reversed or ignored after funds are released. For the host country, the potential for adverse reaction to policy changes poses a serious threat. Moreover, there is no assurance that the policy reform will have the anticipated beneficial effects.

-- The design of a performance disbursement project is staff intensive for both AID and the host country. Technically well trained, experienced economists and policy analysts are required. This might present a serious problem for some developing countries where such people are typically in short supply.

-- Although policy changes can be completed in a comparatively short period of time, the institutional development necessary to sustain those changes typically takes much longer. Therefore, performance disbursement alone might not adequately address institutional requirements.

-- The management demands of performance disbursement will not necessarily be less than those of other modes of assistance except as cash transfers eliminate contracting and commodity procurement requirements. Programming of funds for specific activities similar to those of standard project designs increases the staff intensity of performance disbursement. An alternative is to target funds on broad areas of use; this limits AID management concerns about the use of funds primarily to compliance with agreements on policy changes.

Based on the current experience with performance disbursement, the following should guide further use of the approach:

-- The host country should be strongly committed to changing the targeted policies.

-- Performance disbursement should not be used to induce policy reform, but rather to facilitate progress in changes which are already underway or are likely to occur in some limited fashion.

-- There should be good political rapport between the U.S. and host country governments. AID, the Department of State, and the U.S. ambassador should concur on the importance of the specific policy changes.

-- The policy and institutional changes supported by AID should be consistent with the Mission's overall development program and should mesh with the policy initiatives of other donors.

-- To minimize management demands on AID staff, programming of funds should focus on broad areas of use rather than on specific, project-level activities.

-- Funding has to provide sufficient incentive for change without being excessive. In general, funding levels should depend on the importance of the change, the size and condition of the host country's economy, and total donor assistance to the country.

-- Funds should be channelled through the host country's central agency responsible for the national budget (e.g., the Ministry of Finance) so that it can control the use of funds and generate a paper trail, where necessary, for auditing purposes (e.g., for local currency uses).

-- Cash transfers earmarked for activities related to policy changes being supported by performance disbursement will generate the maximum incentive for implementing policy reform when these changes are also of high priority to the host country.

-- The host country must have adequate numbers of well-trained economists and policy analysts to negotiate the conditionalities of performance disbursement.

-- The implementing agency must be capable of the actions required of it under the performance disbursement arrangement.

-- If possible, the policy changes to be made should be timed to minimize potential adverse effects.

-- A sound and practical monitoring and evaluation system must be part of the performance disbursement design, to track implementation of policy and institutional changes and to assess progress toward achievement of policy objectives.

-- Part of the funds provided through performance disbursement should be set aside to cover costs of technical assistance. In most cases, technical advisers will be needed by the host country to continue work on policy-related problems and to assist with implementation of policy reforms.

-- Criteria for adequate progress and the disbursement of funds must be taken seriously by AID and the host country. However, external conditions and other uncontrollable factors might impede host country performance. Such adverse elements must be considered during the review of progress.

-- Follow-on projects to lend additional support to institutional changes might be a necessary adjunct to performance disbursement.

1. INTRODUCTION: PERFORMANCE DISBURSEMENT FOR

IMPLEMENTING POLICY REFORM

Greater emphasis on policy dialogue in recent years has resulted largely from the general recognition that policy constraints constitute a major impediment to efficient use of economic and social resources in developing countries. Policy reform, therefore, is considered necessary to accelerate development, particularly in light of the severe economic problems currently confronting many countries. Active involvement with policy reform is not entirely new to AID. For roughly a decade beginning in the late 1950s, considerable effort was directed to policy issues. AID subsequently focused on the project mode of development assistance, de-emphasizing policy dialogue in the process. A return to policy reform as a vehicle for more rapid development will engage AID's present staff in activities with which most have only limited experience. At this juncture, an important consideration for the Agency is whether its standard approaches to project design and existing project management systems are sufficiently attuned to AID programs which will increasingly concentrate on policy reform and related institutional changes.

Standard project designs offer limited opportunities for supporting policy reforms and related institutional changes. Where the changes are quite specific and narrowly defined, the project mode is probably adequate; however, projects are generally ill-suited for broader, more comprehensive reforms. The World Bank's experience with structural adjustment loans supports this view. The Bank has found that projects are too narrowly focused on an individual line ministry (or, worse yet, an implementing agency whose perspective is even more limited) instead of the policy-oriented ministries, such as Planning and Finance. Policy reform typically requires several comprehensive changes to be made simultaneously as a package to be effective. Projects, however, are best designed for a limited and closely interrelated set of discrete activities. If too many subactivities are bundled together, projects become overly complex and difficult to manage. Dividing a set of policy reforms among several projects poses equally difficult problems of coordinating project activities. Finally, project implementation would be seriously disrupted if progress toward policy objectives did not justify subsequent disbursement of funds.

AID continues to experiment with alternative project design and management approaches which attempt to accommodate better the particular requirements of technical assistance projects. However, alternative approaches, such as rolling or process designs, have focused primarily on institution-building objectives, and it is questionable whether these designs are equally applicable to policy reform. Moreover, it remains largely unproven whether these designs are superior to more structured designs and whether they are viable in light of their greater management demands at a time when AID staff is being reduced.

To move beyond mere dialogue about policy and institutional reform and to engage actively in changing policies, AID needs a mode of assistance which (a) provides the leverage necessary for forwarding reforms required to overcome policy and institutional constraints, and (b) helps the host country cope with the shocks or negative effects of these reforms. For the most part, the policy dialogue AID has engaged in with developing countries has been a relatively passive, consultative function of identifying and recommending policy changes. Although such discussions are necessary to heighten the host country's awareness of the need for policy reforms, the next step is to support the implementation of those recommendations by committing economic assistance to making those changes.

Three USAID Missions -- in the Philippines, Bangladesh, and Niger -- are currently supporting policy reforms and corresponding institutional changes via a performance disbursement mechanism -- funds are disbursed on the basis of progress in achieving policy reform objectives. The purpose of this paper is to provide a better understanding of this innovative approach to development assistance. First, the basic concept of the performance disbursement model is discussed. Then, brief descriptions are presented to show how the three Missions are using this design for quite different policy objectives. The paper concludes with a review of the apparent strengths and weaknesses of the approach and issues which need to be resolved.

2. THE PERFORMANCE DISBURSEMENT MODEL

The idea of a performance disbursement design was developed by Herbert Morris (General Counsel, Bureau for Asia) based on several project proposals to link funding to policy and institutional change. In a memorandum to senior AID administrators ("Performance Disbursement: Birds-Eye View," June 14, 1983), Morris stated:

> "The concept of performance disbursement centers on the agency disbursing its funds to pay for or "buy" policy changes, institutional or other performance progress, or budgetary performance. It substitutes payment for these objectives for payment essentially for "bricks and mortar" or services under the rationale that while funds may literally be used to purchase supplies or services, the real purpose is to obtain performance, as defined above, not necessarily or closely related to the supplies or services."

The basic mechanism of performance disbursement is the release of funds contingent on the host country enacting specific reforms, changes, or improvements in policies and/or procedures. Funds are divided into a series of tranches which are disbursed when adequate progress has been made toward previously established objectives. Progress is determined by the attainment of certain benchmarks which lead to ultimate policy and institutional objectives. For example, the policy change is divided into a sequence of gradual revisions rather than one large, sweeping reform measure. As changes are made within a set time period, subsequent tranches are released to the host country. Use of this sequenced approach serves two major functions: (a) it establishes the basis for assessing progress toward agreed-upon objectives necessary for the subsequent release of funds, and (b) it minimizes the potential "shock" or adverse reaction possible from sudden policy changes, making the process more palatable to the host country.

A key feature of performance disbursement is that the satisfactory implementation of policy changes, institutional improvements, or organizational accomplishments, not the effects produced by those changes, triggers the release of funds. That is, funding is not contingent on hypothesized improvements in the sector or national economy which are expected to result from the changes. For example, when AID and the host country mutually accept the need for agricultural policy changes to encourage growth in the sector, the disbursement of funds is tied to implementation of the reforms, and subsequent tranches are released as progress toward ultimate objectives is made. The anticipated impact of those changes (e.g., private sector growth, increased production and farmer income) does not have to be demonstrated for continued funding.

In large part, tying funding to implementation of the policy or institutional reform rather than to the effects of those reforms is necessary due to the intangible nature of policy and institutional change. That is, the short-term effects of policy reform and institutional development are very difficult to link directly to some observable change within a sector or the national economy. In most cases, isolating the effects of the policy changes from those of other causal factors will be impossible. On the other hand, the long-term impact of creating a policy environment which fosters economic growth, reduces unnecessary government control in the private sector, and minimizes economically unsound investments of public funds can contribute as much if not more to national development over the long term than the more tangible outputs of standard projects. Furthermore, the time between implementation of the policy change and realization of the benefits resulting from the change will be substantial in most cases. In short, the effects of policy and institutional changes are simply not a practical basis for disbursing funds.

This means that disbursements have to be made largely on the conviction that the reforms are necessary and correct and will ultimately benefit the country. Although some might question the legitimacy of this reasoning, it is precisely the same line of argument AID uses to encourage policy and institutional changes in the first place. "Staying the course" during implementation is simply a matter of remaining consistent with AID's own initial development rationale for policy reform and institutional change. (More crassly, it means AID puts its money where its mouth is.)

At the expense of belaboring the point, it is important to recognize that what AID funds are "purchasing" via performance disbursement is, in fact, some type of performance by the host country. Morris cites the example of intermediate credit institution (ICI) projects as a precedent for performance disbursement. The primary objective of ICI projects is an improvement in institutional performance. That is, what counts in ICI projects--what AID provides funding and technical assistance for--is the ability of the lending institution to efficiently manage loan funds. It is the administration of the funds rather than the specific activities for which those funds are used which is of principal concern. In effect, what AID supports is the creation of conditions necessary for greater, more sustainable development (e.g., in ICI projects, improved loan management prevents decapitalization and makes funds available to more borrowers over time). Although AID funds are used for actual loans, what those funds are tied to and "purchase" is improved performance of the lending institution.

Performance disbursement can also be viewed as a variant of fixed amount reimbursement (FAR). Morris argues that instead of merely disbursing funds on the basis of satisfactory completion of specific, tangible outputs, the FAR model applied to policy and institutional change is equivalent to a performance disbursement design. He points out that disbursing only for the "bricks and mortar" output encourages the host country to complete construction with little if any regard for the organizational and institutional underpinnings required for proper use and maintenance (e.g., constructing irrigation canals while ignoring the need to organize farmers into water users associations). To correct for the overemphasis on physical outputs, performance disbursement could be tied to progress achieved in addressing the organizational requirements of development projects as well. However, a potential problem of this arrangement is that it is more difficult to demonstrate organizational progress than it is to meet construction standards for physical outputs. Nonetheless, just as standards are established under F.A.R. arrangements, criteria for what constitutes organizational and institutional progress can be developed prior to project implementation (e.g., the successful operation of a water users association for at least twelve months). Disbursement would then be contingent on progress in both areas - physical and organizational.

AID has used other modes of assistance which employ conditionality for the release of funds, such as Commodity Import Programs and PL 480 Programs. Performance disbursement offers one major advantage over these other funding arrangements. Unlike CIPs and PL 480, performance disbursement funding is not tied to specific purposes or commodities. This gives AID and the host country an additional degree of flexibility about the use of performance disbursement funding. The specific use of the funds are established during the design of performance disbursement, but the potential range of activities for which funds could be used is quite broad. In short, because large multi-year cash transfers can be targetted for purposes of high priority to the host country, performance disbursement can create a strong incentive to make policy and institutional change.

Performance disbursement designs could be used for a broad range of projects and programs AID currently funds. This section describes three current applications of the approach to illustrate this potential.

LRM will assist the Government of the Philippines (GOP) further decentralize development activities to the local level. To do this, LRM focuses on strengthening the capacities of provincial and municipal governments to plan and implement development projects targetted on the local poor. What distinguishes LRM from preceding decentralization efforts is its emphasis on encouraging the private sector and the people who will benefit from the projects to participate with local government in both the planning and implementation of development activities. In this regard, LRM is very much a self-help type of project that attempts to re-orient local governments to identify existing resources -- both financial and human -- in the community and to mobilize those resources to accomplish development objectives beneficial to the local poor.

A major objective of LRM is to strengthen provincial government capacities to formulate their own development strategies. Governments will conduct studies to help them better understand the causes of poverty in the provinces and the specific problems affecting the poor. A provincial development strategy based on the findings of these studies will be formulated to guide the selection of appropriate subprojects, such as small road improvements, bridge construction, and cattle distribution. Future subprojects will concentrate on income generation as provincial governments gain experience with planning and implementation. An effort will be made to involve the private sector in the planning and implementation of subprojects (e.g., contracting with local firms to carry out the subprojects).

Planning as well as project implementation is not to be purely a function of government. Rather, the local poor are to participate at each stage -- from strategy formulation through project implementation. However, little is known about how to organize the poor so that they can play a more central role. Therefore, LRM will support experimentation with alternative approaches for incorporating the needs and interests of the poor into development activities. For example, a private voluntary organization known and trusted by a community might be able to help people identify and agree on what their common needs are and what types of projects they would support. Input of this sort would then be used to formulate provincial strategies and select appropriate projects.

To increase the amount of revenue available to provincial and municipal governments to fund development activities, LRM will support the improvement of local government financial administration. For example, better accounting systems, accurate forecasting of revenues, improved collection procedures, and expanded systems of real property tax will contribute to greater mobilization of financial resources by government for local development activities.

A performance disbursement mechanism tied to satisfactory performance of the planning cycle is used to advance LRM's decentralization and institution-building objectives. First, the provincial government undertakes the research needed to formulate a development strategy focused on the needs of the local poor (or it contracts with local institutions -- e.g., colleges--to conduct the studies). This strategy is submitted to the Regional Development Council which is responsible for supervising and coordinating local government activities. The Council will review provincial strategies and assess them on the basis of the following criteria: adequacy of the analysis of the poverty groups; focus of the strategy on poverty groups; participation in the planning process by municipalities, barangays, and the poor; involvement of the private sector; and mobilization of local financial human resources for implementation.

After Regional Development Council approval of the provincial strategy, the provincial government develops an annual program plan including a brief description of proposed projects and estimated costs. These plans are then incorporated into the Regional Development Investment Plan which the Office of Budget and Management reviews. The next step is to develop a subproject plan, including required economic, social, and environmental assessments. Proposals are then submitted to the Regional Development Council, which evaluates them on the basis of the following criteria: consistency with the province's development strategy; design soundness indicated by feasibility studies; adequacy of counterpart funding; participation by the local municipalities, barangays, and the poor in project selection and design; and adequacy of the evaluation plan. When subproject plans are approved by the Council, funds are then released by the Office of Budget and Management directly to the provincial government to cover project costs for 1 year. Subsequent funding is then contingent on progress made in subproject implementation.

Although this process might seem rather torturous at first, the various units involved are already in place and operating. The key change supported by LRM is the direct disbursement by the Office of Budget and Management to the provincial governments, thus circumventing line ministries. AID and the Philippines Government consider this a significant step toward true devolution of authority to local governments. The importance of this procedural change is that it should enable local government to undertake development activities which are more likely to benefit poverty groups in their area. The incentive to make this change is reinforced by the performance disbursement mechanism. When the transfer is made, AID reimburses the Philippines Government for 70 percent of the total amount released to the provincial government.

It is important to recognize exactly what AID is funding via performance disbursement. Six million dollars has been authorized for the first phase of LRM (two additional phases are anticipated). Project funds are directed largely toward establishing modes of operation (e.g., the provincial development planning cycle), procedures for supporting local development efforts (e.g., the Regional Development Council approval process and direct funding to provincial governments), and a development orientation targeted on the local poor and drawing on local resources as much as possible. These changes are expected to contribute to more effective and sustainable development in rural areas. Although the specific outputs of subprojects completed by provincial governments are certainly important, LRM is concerned primarily with the performance of government at several levels. For example, the first year a province participates in LRM, AID considers adequate performance to be (a) attainment of the various planning criteria established for provincial strategies and subprojects, and (b) the release of funds from the Treasury to the local governments. As LRM progresses and participating provinces gain experience with the process, successful implementation of subprojects and evidence that they benefit the poor will become additional criteria for AID reimbursement. Thus, in later stages of LRM, performance by local government will be supported in addition to short-term development impact resulting from the subprojects. LRM illustrates an important difference between performance disbursement designs and standard AID projects. On the one hand, it can be argued that Development Assistance funds are being used for standard project purposes. When AID reimburses the Philippines Government for funds released to the provincial governments, it adds to a revolving fund available for capital development, employment generation, and their subproject activities (funds are loaned to the provincial government). On the other hand, changes in government performance constitute a higher priority objective than the subprojects in LRM. Focusing project implementation on performance criteria, in effect, increases the total output of the project. That is, in a standard capital development project, funds "buy" physical outputs. But with a performance disbursement model, like that used by LRM, funds are still made available for the physical outputs (i.e., the subprojects), but they also support improved development management by local governments. In effect, the same expenditure produces two outputs--one physical, the other institutional.

3.2 Bangladesh: Rural Finance Project (Funding: $75 million Development Assistance)

The Rural Finance Project provides $75 million in local currency costs released in three tranches to support a package of policy and institutional changes to reform the rural banking system of Bangladesh. The main objective of the project is to develop a self-sustaining system of rural finance which mobilizes savings and provides adequate credit to farmers and small entrepreneurs. An economically viable rural banking system is considered essential for increasing agricultural production and generating additional employment opportunities in rural areas.

Rationalizing interest rates will be a major reform carried out under the Rural Finance Project. Prior to the project, the Bangladesh Government set interest rates low in order to make credit available to farmers and rural businessmen. Ceilings on agricultural and rural industrial loans were set at 12 percent and 13 percent, respectively. However, the rates were too low to sustain an economically viable banking system independent of Government support. Rates paid on time deposits were higher than rates charged for loans. The return from lending was simply too small to cover the costs of funds, administration, and bad debts. Consequently, for the system to remain operable, the Government had to provide additional funds to the banks, in effect, subsidizing rural credit from the Government budget. Similarly, refinance rates set at 6 percent constituted an additional Government subsidy which did not encourage banks to mobilize savings or to improve their loan management procedures. Given such a system of subsidies, expansion of rural credit (necessary for adoption of improved agricultural technology) depended on increased Government funding. This meant that not only would subsidization of the system become increasingly expensive for the Government, but budget constraints would limit credit expansion and, consequently, the adoption of improved agricultural technology. In short, the Rural Finance Project will assist the Bangladesh Government in establishing the linkages among lending, savings, and refinance rates necessary for a viable banking system and the expansion of rural credit.

To facilitate rationalization of interest rates, the Rural Finance Project will support (a) rate increases to a level sufficient for the development of a self-sustaining banking system and (b) establishment of an Advisory Committee on Interest Rates. An earlier experimental pilot project tested alternative lending and savings rates to estimate how much of an increase would be required. The experiment showed that 24-percent interest rates for loans would be sufficient to make the banking system marginally profitable without discouraging borrowing, and 14 percent to 15 percent for savings would be high enough to encourage increased deposits. These rates have been set as targets to be worked toward during the course of the Rural Finance Project. To ensure that the proper linkages among interest rates are maintained, the Advisory Committee on Interest Rates periodically reviews the rate structure and makes adjustments according to current conditions.

In addition to interest rate rationalization, the Rural Finance Project will support increased efforts to mobilize rural savings via more effective promotional strategies and campaigns, relaxation of savings restrictions (i.e., minimum deposit requirements), and additional advertising. The project will also provide technical assistance to improve loan management. In particular, poor loan recovery is believed to result from a number of interrelated factors, including accounting procedures, lending practices, branch staffing, attitudes toward forgiveness of loans, legal procedures, and attitudes toward collateral and the quality of bank inspection. Improvements in each of these areas will be made during the project.

The funding of the Rural Finance Project has been divided into three tranches to be disbursed annually. AID uses Development Assistance grant funds to purchase local currency from the central bank of Bangladesh. This local currency finances the Bank's rediscount facility which, in effect, capitalizes the rural credit system. However, it is important to understand that what the project "purchases" is a package of mutually reinforcing policy and institutional reforms. The project is not concerned with the actual use of loan funds by borrowers. The fundamental policy change being made is the elimination of Government-subsidized credit. The Bangladesh Government's new policy will be to encourage the development of an economically self-sustaining, efficient banking system which relies on savings mobilization for expansion. Rationalization of interest rates, savings mobilization, loan recovery improvement, and related procedural and management improvements are simply different aspects of the new policy.

Satisfactory performance by the Bangladesh Government consists of implementing a long list of agreed-upon changes. Progress toward interest rate rationalization will be reflected by rate restructuring and, in particular, an increase in lending rates to approximately 24 percent. The establishment and operation of the Advisory Committee on Interest Rates, including the staffing of a technical unit to conduct necessary studies and recommend changes to the Advisory Committee, constitutes another progress benchmark. In the area of savings mobilization, market research of savers' attitudes, review of savings restrictions, funding for savings campaigns, and promotional efforts via radio, TV, and other media will also indicate progress. Procedural and loan management changes will be made to improve loan recovery, and actual loan recovery rates should reflect progress in this area. Other actions which will constitute progress include (a) increasing penalty interest on overdue loans, (b) improving accounting systems to better track overdue loans and interest accrued on these loans, (c) establishing a system of reserves for classified loans and for writing off bad debts, and (d) conducting a study of banking, legal, political, and sociological factors affecting loan recovery.

Bank management changes will also be instituted for tracking implementation of policy reforms. The Inspection Department of the Bangladesh Bank will be strengthened (via additional staff, training, and technical assistance) so that it can exercise better oversight of rural branch bank operations. Training courses for officers and staff will be developed to provide standardized instruction about banking procedures. Plans to expand the banking system and increase the number of rural branches will be developed. Lending procedures concerning loan application, approval, and restrictions will be reviewed to identify needed changes. Within the Bangladesh Bank, the Agricultural Credit Review Department, which is responsible for project implementation, will be strengthened via increased staff, training, and assistance from technical advisers. The U.S. Federal Reserve Board will also provide technical assistance to the Bank to improve internal operations and foreign exchange transactions. In short, progress toward implementing policy reforms will be reflected by a variety of Bangladesh Government actions to improve institutional performance.

It is important to recognize that disbursements are made on the basis of the establishment of the necessary pre-conditions for a viable banking system rather than the actual creation of such a system. Prior to the first disbursement, the Bangladesh Bank had to increase interest rates on agricultural loans, increase the penalty rate for late repayment, and establish a re-discount facility. For administrative and management objectives, progress consisted of plans and subsequent actions to implement policy changes and effect institutional improvements. For example, prior to disbursement of the second tranche, the Bangladesh Bank had to provide documentation to AID on the following points: (a) a plan for increasing the staffing of the Agricultural Credit Department; (b) a Bank order which establishes the Interest Rate Advisory Committee and specifies its authority, duties, composition, officers, participation by other Government agencies, and frequency of meetings; (c) a plan for establishing a Technical Unit in the Research Department, specifying its staffing, authorities, responsibilities, and reporting; (d) a draft contract for obtaining an interest rate adviser; and (e) information acceptable to AID on the country's savings mobilization. The third tranche will be contingent on the implementation of these and other planned changes. Clearly, it can be argued that all of these actions are necessary to achieve the objective of establishing a self-sustaining banking system. But that is not the same as disbursing against the actual fact -- i.e., a functioning system exists -- as is done in fixed amount reimbursement. Performance disbursement used in this fashion assumes that the desired goal will subsequently emerge as a result of these preparatory actions.

3.3 Niger: Agriculture Sector Development Grant (Funding: $15 million Sahel Development Program, $17 million Economic Support Fund)

The Agriculture Sector Development Grant (ASDG) provides $32 million to the Government of Niger to support major agricultural policy reforms. The policy changes are designed to reduce Government intervention in agricultural input supply, cereals marketing, and cross-border trade. While diminishing the role of Government in these areas, the policy reforms are expected to encourage the private sector (including cooperatives) to assume functions previously performed by parastatals. In general, the policy reforms supported by ASDG will contribute to more efficient resource allocation within the sector, while the use of grant funds to meet recurrent costs of on-going projects will give continuity to existing Government development investments.

To increase supply and use of agricultural inputs, the

Government of Niger will restructure its input subsidy program. Studies conducted to guide the design of ASDG determined that the existing subsidy system actually limited the availability of inputs. Input supply was controlled by the Government, which set annual subsidy and price levels. When funds allocated for input subsidies were completely expended, no additional inputs were purchased. Hence, the total amount of inputs available each year was dependent on Government funding levels. It was determined that the supply of inputs through this system fell short of existing demand. Consequently, the subsidy system impeded increased use of agricultural inputs.

Under ASDG, the Government of Niger will reduce subsidies on inputs and let the market determine input prices. First, this will increase the availability of inputs. Even though input prices will increase, it is believed that unmet demand is sufficiently great to lead to increased use of inputs even at higher prices. Subsidy reductions will also reduce Government expenditures or allow the Government to use these funds for more productive investments. Second, the Government will obtain additional savings by replacing the parastatal (Centrale d'Approvisionnement) which had controlled input supply with a cooperatively owned and managed organization competitive with private sector dealers. Third, the reduction of Government controls on input supply is expected to encourage the private sector (including cooperatives) to supply and establish prices for agricultural inputs.

A second key reform to be carried out during ASDG concerns the Government's agricultural price and marketing policies. In an attempt to reduce seasonal price fluctuations and guarantee adequate national food supplies, the Government established a parastatal (Office des Produits Vivriers du Niger -- OPVN) responsible for cereals marketing, monitoring cereals needs, maintaining reserve stocks, and managing food aid. However, OPVN has been unable to stabilize prices largely as a result of the way in which it purchases and sells grain (i.e., it has a fixed budget for purchases, announces the official price approximately 1 month before harvest, then stops purchasing when funds are expended). OPVN also attempts to regulate consumer prices as well as producer prices, although a parallel unofficial market operates openly in Niger. In short, the operations of OPVN have been ineffective and have contributed to various adverse conditions, such as periodic market gluts and shortages, subsidization of consumer prices at the expense of producers, significant price fluctuations, and exploitation by traders and merchants of both producers and consumers.

In response to these problems, the Government of Niger has agreed to make the following policy reforms: (a) liberalize internal grain marketing; (b) reorient the role of OPVN away from primary marketing to one in which the agency facilitates a free, competitive market through the use of grain reserves; (c) adopt a tender and bid system for OPVN grain purchases; (d) reduce OPVN grain reserves while encouraging increased storage by cooperatives and villages; and (e) eliminate national pricing for cereals.

Two other areas of policy reform supported by ASDG concern freer cross-border trade, particularly with Nigeria, and improvement of the agricultural credit system. The Government of Niger will continue its efforts to decentralize and streamline licensing for cross-border trade. License fees will be made proportional to the value of the commodity traded, and restrictions on the export of cowpeas and peanuts will be eliminated. An agricultural credit study will be funded to improve the understanding of the informal credit markets and identify possible reforms in Government policy which would increase access to credit nationwide.

ASDG funding has been divided into four tranches which will be disbursed as the Government of Niger makes satisfactory progress toward implementing policy changes in the above areas. In this regard, ASDG refines the conditionality of performance disbursement by dividing policy reforms into a series of clearly delineated revisions and by specifying corresponding progress benchmarks. Prior to disbursement of subsequent tranches, the Government of Niger and AID will jointly assess progress to date (e.g., whether the benchmarks have been reached and, if not, what factors are impeding implementation of reforms).

To provide an objective basis for these annual performance reviews, the Ministry of Rural Development is responsible for providing data about the implementation of policy changes. For example, rather than making sudden cuts, a schedule of graduated subsidy reductions on agricultural inputs will be followed. Prior to disbursement of the second tranche, the Government will lower subsidies to a level not to exceed 50 percent of the final delivered cost of the input. In the following years, the total aggregate subsidy will be reduced to 30-45 percent, and then to 25-30 percent. A method for calculating the amount of subsidies on agricultural inputs will be developed and used throughout ASDG to track implementation of these reductions.

Other types of monitoring data will consist of simple checklists of proposed and implemented changes in the organization and operation of the two parastatals, Centrale d'Approvisionnement and OPVN (e.g., reorganization of Centrale d'Approvisionnement as a cooperative agency competitive with the private sector, elimination of nationwide cereal prices, reduction of grain reserves). Process-oriented data which describe management or procedural changes, such as the use of a tender and bid system, will also reflect implementation of policy reforms. Similarly, ASDG will fund an agricultural credit study. A criterion for disbursement will be undertaking the study and acting upon its policy recommendations. Periodic assessment of licensing records will provide additional data on the liberalization of cross-border trade and streamlining of the licensing process. In short, ASDG has developed a comprehensive monitoring and evaluation system to track policy reform and related institutional changes. Clearly, the information these systems will provide is essential for the performance disbursement mechanism of ASDG.

It is important to understand what ASDG funds are supporting. Three million dollars will be used for technical assistance to the Ministries of Rural Development and Planning to help implement policy changes and to continue work on identifying additional needed reforms. Specifically, a Policy Analysis Unit will be established in the Ministry of Rural Development for this purpose. With the remaining $29 million, AID will purchase local currency to establish a special account. These funds will be used primarily to cover recurrent costs of on-going projects, necessitated by the adverse economic conditions Niger has experienced (i.e., the fall of uranium prices and the drought). The infusion of funds into the national development budget combined with policy reforms is expected to contribute to overall economic stabilization and to growth in the agricultural sector. But the linkage between funding and policy reform, and the targeting of funds on recurrent costs of on-going projects, also accomplishes multiple objectives. Specifically, ASDG supports standard project outputs through its funding of recurrent costs while, at the same time, forwarding policy and institutional reform.

Although the direct effects of policy and institutional improvements supported by ASDG are rather elusive, covering recurrent costs of on-going projects will produce tangible and important benefits. Assuming that the Government of Niger implements changes as planned so that tranches are released on schedule, project continuity will be better assured, contributing to the performance of those projects receiving ASDG funds. If additional funds were not available, certain components of these projects would be delayed by years, if not eliminated. In short, ASDG is "purchasing" both policy and institutional reforms, as well as improved project performance.

However, the linkage between ASDG funds and recurrent costs of on-going projects poses a potential problem. The success of ASDG in contributing to project performance depends on the satisfactory implementation of policy and institutional changes by the Government of Niger. If that does not occur, release of subsequent tranches should be delayed. But this will interrupt the implementation of projects receiving ASDG funding, which thus could cancel partially or wholly ASDG's contribution to project performance. If this happens, USAID/Niamey could find itself caught between a rock and a hard place.

4. ISSUES PERTAINING TO WIDER APPLICATION OF PERFORMANCE DISBURSEMENT DESIGNS

4.1 Positive Features of Performance Disbursement

The preceding examples of performance disbursement illustrate one approach to linking development assistance to policy and institutional change. The major strength of the performance disbursement design is that it facilitates taking important but difficult actions which should ultimately benefit the society as a whole. From the point of view of the host country, policy changes often pose certain negative consequences. Policy reforms often challenge vested interests, threaten the employment of individuals operating under the old system, and can lead to greater austerity or increased costs for specific groups. Such adverse effects are particularly unpalatable when the benefits of policy change are comparatively intangible or directed toward improvements over the long term. Equally important, the dynamics of policy change are at best only partially understood. It is unclear, for example, whether reforms which only go "halfway" toward desired objectives or whether changes in only some of the policies affecting a sector will lead to genuine improvements. Quite understandably, developing countries are reluctant to make policy changes which pose political risks even when the government recognizes the economic need for reform.

Performance disbursement provides a mechanism to offset or at least cushion some disruptive consequences of policy reform. All policy changes adversely affect some group which had benefited from the preexisting policy. Ordinarily, host country leaders are reluctant to change policies for precisely this reason. To encourage them to take the necessary action, there must be some compensation for the negative consequences of the policy change.

Performance disbursement can provide the incentive in two ways. First, the funds obtained via performance disbursement constitute additional development resources. In principle, the benefits resulting from the use of these funds can counterbalance the negative effects of policy changes. Second, resources could also be used in various ways to reduce the costs imposed on those who are adversely affected by the policy change. Disbursing funds in tranches over a number of years can ameliorate adverse effects by permitting reforms to be made gradually, thus, in effect, creating a period of adjustment. Theoretically, this should make the change more acceptable to the host country because (a) it reduces the likelihood of negative consequences produced by sudden changes, and (b) it allows close monitoring of the effects of and response to policy change over time, so the reform process could be halted before major problems are created.

Other positive characteristics of performance disbursement include the following:

-- Performance disbursement circumvents some of the problems of alternative modes of program funding. The conditionality of performance disbursement makes the development impact of cash transfers more tangible than other mechanisms. The benchmarks for tracking progress in implementing policy changes link funding to development activities more clearly than a balance of payments cash transfer. The benchmarks also introduce a sense of control over the program which should be more acceptable to critics of nonproject assistance. Performance disbursement can also avoid some of the restrictive aspects of CIPs and PL 480 programs. For example, funding is not necessarily tied to the purchase of specific commodities or to particular types of development activities (e.g., food for work). In this regard, performance disbursement can accomplish some of the objectives of cash transfer while providing a more flexible mechanism than other types of program funding.

-- Performance disbursement forces a demonstration of commitment on both sides: the host country and the donor. AID demonstrates the importance it attributes to policy reform through funding related to these changes. The host country demonstrates its concurrence on the need for reform by implementing new policies.

-- Performance disbursement requires establishing standards and criteria for acceptable performance prior to implementation. This feature leads to a clear and common understanding between AID and the host country concerning what has to be done before subsequent tranches are released.

-- The design is applicable to a wide range of policy-related activities -- from fairly specific actions, as in the case of Local Resources Management in the Philippines, to very broad reforms throughout the sector, as in the Rural Finance Project in Bangladesh and the Agriculture Sector Development Grant in Niger.

-- Although policy changes are the central focus of the disbursement mechanism, the design can be used to obtain both institutional improvements (as in the efforts to further the decentralization process and strengthen local government capacities through Local Resource Management funding) and physical outputs (e.g., the subprojects which local governments implement). Therefore, the disbursement can "purchase" more than policy change.

-- As an approach to institutional development, performance disbursement places the responsibility for making improvements squarely on the host country. By tying funding to institutional changes, procrastination and foot-dragging possible under other approaches become readily apparent under performance disbursement designs.

-- In principle, performance disbursement provides a mechanism to quickly shut down or delay AID support if policy and institutional changes are not made or if external conditions over which the host country has little or no control change, making the reforms impractical or impossible.

4.2 Potential Problems With Performance Disbursement

In large part, the problems associated with performance disbursement stem from the nature of policy and institutional reform rather than from the design per se. In his original memorandum on performance disbursement, Morris cites several key issues which need to be resolved:

-- The conditions under which performance disbursement constitutes an appropriate mode of development assistance are unclear. The capability and commitment of host country implementing agencies are key factors, but it is difficult to determine whether they are sufficient at the outset and equally difficult to predict whether they will remain so during the course of the program.

-- How much a change is worth is an open question. The objective is to provide enough incentive to the host government to make the change without engaging in financial overkill. The size and condition of the host country's economy, the level of donor assistance, and the importance or comprehensiveness of the policy reforms should influence funding levels. However, funding might also be determined by specific economic problems, which was the case for Niger's Agricultural Sector Development Grant. Given AID's limited experience with this design, there is no commonly acceptable formula for arriving at the correct funding level.

-- Compatibility with U.S. Government regulations and interests poses an important question for broader use of performance disbursement. These factors include (a) Treasury regulations concerning the timing of the release of funds to the host country; (b) congressional reaction to a mode of assistance which runs contrary to the preference of some Congressmen that development assistance go to traditional goods and services types of programs; (c) monitoring, auditing, and refund rights; and (d) the applicability of procurement regulations.

In addition to Morris' concerns, additional issues can be raised about the use of performance disbursement designs.

-- Performance disbursement is a high-risk activity for both the host country and AID. As described above, the potential for unanticipated negative effects resulting from policy changes is a strong disincentive to the host country. There is also no guarantee that the changes will produce significant improvements. In some cases, it will be very difficult to determine whether improvements which do occur resulted from the policy change. For AID, there is no assurance that policy reforms will not be reversed or ignored after funds have been disbursed. A sudden change of government can quickly undermine the entire effort.

-- Present Agency staff have limited direct experience with the design and implementation of policy reform programs. Because of the complexity and unpredictable negative effects of policy change, AID should be cautious about the types of changes it forwards and focus only on policies which are most obviously in need of reform. An important management issue for AID in this regard is obtaining high-quality expertise in the areas where policy changes will be made. There are also definite ethical considerations warranting additional caution (i.e., encouraging a developing country to borrow to carry out policy changes which later prove to have been incorrect or ineffective). Until more experience is gained in this area, performance disbursement should be applied only when conditions clearly warrant such an approach to development assistance.

-- The experience of USAID/Niamey with the Agriculture Sector Development Grant indicates that the design process for performance disbursement involving major policy changes is very staff intensive for both AID and the host country. Moreover, the caliber of staff required can pose a serious problem for countries like Niger which have few highly trained economists and policy analysts. This can be crucial for the negotiation of conditionalities for performance disbursement. The host country must understand and fully accept the conditions for the release of funds. That includes carefully analyzing the policy and institutional changes it is agreeing to make. Otherwise, the host country might enter into an agreement with AID to make certain changes which it later comes to realize are simply unacceptable. Similarly, AID will need high-quality analysts (both direct hire and contractors) who understand the complexities of policy reform, are knowledgeable about the host country, have the necessary rapport with their counterparts to discuss sensitive political issues, and have the high language proficiency mandatory for negotiating the conditionality of performance disbursement.

-- The management demands posed by performance disbursement will not necessarily be less than those of other modes of assistance. As the programming of funds provided via performance disbursement increases, management demands increase commensurately for both AID and the host country. Where funds are tied to specific project activities, such as in Local Resource Management, management requirements for implementation will be comparable to, if not greater than, standard projects.

At the other end of the continuum, cash transfers linked to implementation of policy reforms, as in the Agriculture Sector Development Grant, should lessen management demands, at least for AID, particularly those related to technical assistance contracts and commodity procurement. That is, implementation becomes a part of the continuing policy dialogue. AID's management concerns will concentrate primarily on impediments to policy and institutional reform which might interfere with release of subsequent tranches.

-- There might be an inherent conflict between the time perspective of policy reform and associated institutional changes. Although policy reform is generally viewed as producing long-term development impacts, it focuses on existing constraints to accelerated growth in the short term. To maintain the policy change, institutions have to adjust to new modes of operation, or, perhaps, entirely new institutions have to be established. The policy changes can be made in a few years via performance disbursement design, whereas institutional development typically takes much longer. In short, performance disbursement might produce the desired policy changes, but fail to adequately support the institutional development necessary to sustain the changes.

4.3 Further Development and Use of the Design

The AID Policy Paper, Approaches to the Policy Dialogue, offers some general guidelines relevant to the use of performance disbursement. However, performance disbursement is a relatively new approach for many of AID's present staff, particularly in the use of cash transfer tranches, and more specific guidance is needed. Therefore, current applications of performance disbursement ought to be monitored and evaluated closely to learn as much as possible about its strengths and weaknesses and to resolve some of the above issues. At this point, the following suggestions are made concerning future applications of performance disbursement.

-- There should be a strong commitment on the part of the host country to making the policy and institutional changes. This was clearly the case in the examples from the Philippines, Bangladesh, and Niger.

-- Related to the preceding requirement for host country commitment, performance disbursement should not be used to induce or impose an unsupported change or reform. Rather, it will be most effective when used to facilitate or further changes already underway or quite likely to occur in some limited fashion.

-- There should be good political rapport between the United States and the host country government. This will facilitate the discussion of sensitive political issues and negotiation of conditionalities for disbursement of funds. Even more fundamental, a good working relationship will be necessary so that AID's introduction and forwarding of policy issues will not create undue friction between the United States and the host country. In this regard, the specific policy reforms USAID supports will have to be acceptable to the U.S. ambassador and the Department of State.

-- The policy reforms and related institutional changes supported by performance disbursement should be consistent with (a) the Mission's development program as articulated in its Country Development Strategy Statement and (b) other donor activities, particularly those of the World Bank and the International Monetary Fund (IMF).

-- Present use of performance disbursement has focused on economic and financial management policies. However, the approach should be equally applicable to policies in education, health, population, and other sectors.

-- Although performance disbursement could be applied to a broad range of policy and institutional reforms, this approach should be used to concentrate on key sector constraints resulting from existing policies. The degree to which funds are programmed for specific purposes will depend on the type of development problems being addressed. However, management demands for AID will increase as programming of funds moves from broad areas of application to specific purposes.

-- The funding level of performance disbursement designs has to be sufficient to provide an adequate incentive for the host country to carry out reforms as far as necessary or possible. However, excessive funding for policy change will probably raise the ante for subsequent policy initiatives supported by AID.

-- Funds provided through performance disbursement should be earmarked for specific types or categories of use and channelled through the central agency responsible for the national accounts (typically, the Ministry of Finance). This will allow the host government to exercise control over the use of funds and generate a paper trail for auditing purposes.

-- A major advantage of performance disbursement over other modes of assistance is that resources can be provided to the host country which are relatively unencumbered by U.S. regulations.

-- The "untying" of funds contributes significantly to the incentive for implementing policy changes that is created by performance disbursement. In some cases, this incentive effect could be diminished by narrow programming of funds for specific activities or commodities. Doing so increases management demands for AID and can introduce various U.S. regulations concerning procurement, contracting, and the like. The type of funds might also interfere with obtaining the maximum effect from performance disbursement. Local Resource Management and Rural Finance demonstrate that performance disbursement can be funded through the Development Assistance account. However, it might not be possible to support certain types of policy reforms using Development Assistance funds because use of these funds must fit within one of the Agency's functional accounts. This suggests that the Economic Support Fund and other special program funds (e.g., Sahel Development Program, Economic Policy Initiative) might be more appropriate funding sources. In short, cash transfers earmarked for broad categories of development activities related to the policy reforms being implemented, which are also of high priority to the host country, will maximize the incentive effect of performance disbursement.

-- The host country will need adequate numbers of high-quality staff to negotiate the conditionalities of disbursement. This should be taken into consideration in timing the design process. For example, it might be too demanding to develop a performance disbursement project at the same time the host country is engaged in discussions with the World Bank or IMF.

-- A thorough assessment of the implementing agency's capabilities to make desired changes is absolutely necessary. Obviously, it makes no sense to tie disbursement to conditions and actions which are beyond the institutional capabilities of the host country agency.

-- Careful monitoring of policy implementation is essential for adequate management of the process. In this regard, Niger's Agricultural Sector Development Grant, with its well-defined series of clear benchmarks for assessing progress and performance, constitutes a model for future performance disbursement designs. Adequate funding should be provided to cover host country budget and technical assistance costs for monitoring and evaluation systems.

-- Part of the funds provided through performance disbursement should be set aside to cover the costs of technical assistance. In most cases, a technical assistance team will be needed to strengthen analytic capabilities of the host country to continue work on policy-related problems and help identify the ways and means for implementing policy changes. The expertise of the technical assistance team will be determined by the type of policy changes involved (e.g., agriculture, banking, health).

-- AID needs to strike a balance between a too liberal and a too rigid adherence to meeting performance objectives. On the one hand, it is important for AID to show a genuine commitment to the process of policy reform, including a willingness to delay or cut off funding when host country performance is inadequate. In other words, the conditionalities of performance disbursement have to be taken seriously. On the other hand, external conditions, unrealistic initial assumptions about what is feasible, and other unexpected or uncontrollable factors might interfere with the host country's ability to meet annual performance objectives. In such cases, performance should be assesed on its adequacy in light of these problems.

-- Follow-on projects directed toward institutional development might be necessary to better ensure that policy changes undertaken during the performance disbursement program are fully institutionalized.

Making a Case for Performance Disbursement

In Herbert Morris' original formulation of the concept, he recommended that AID develop a strong case for educating those both within and outside of the Agency about the utility and legitimacy of performance disbursement as one means of accomplishing development objectives technical assistance. The Agency needs to take action on that recommendation. A better understanding of the design and its application is a necessary first step. The issues surrounding acceptable use of performance disbursement need to be resolved in light of existing regulations. The conditions under which performance disbursement is an appropriate mode of assistance should be clarified. Guidance concerning "how to do" performance disbursement should be developed, including (a) host country, AID, and technical assistance staff requirements for design and implementation; (b) funding levels and appropriate use of funds; (c) timing of policy changes and release of funds; and (d) monitoring and evaluation requirements.

Particular attention should be directed to the staffing issue because that will largely determine whether wider use of performance disbursement is feasible. In particular, greater use of this approach will increase the need for sound analysis of the policy environment and the implications of policy reform. This will require staff who are primarily analysts and whose skills differ from those needed for managing standard AID projects. Although AID can contract for such expertise to some extent, in-house analytic capability will be necessary for adequate monitoring and assessment of progress toward achieving policy objectives. The question, therefore, is whether AID currently has sufficient numbers of competent analysts to manage properly performance disbursement programs.

When AID understands better how performance disbursement can be used, an educational effort should be developed to gain acceptance of the approach. In particular, charges that AID is "bribing" the host country to make changes which it ought to undertake on its own should be dispelled. The complexity of the policy dialogue process leading to actual reforms has to be clarified for such critics. What performance disbursement "purchases" should also be explained. The intangible nature of outputs from performance disbursement -- policy and institutional reform -- leads to charges that such use of development funds is a poor investment. What needs to be pointed out is that it has been clearly documented time and again that the tangible outputs of standard "bricks and mortar" projects do not ensure sustained development. The limited success of many projects has been due partially to the neglect of fundamental policy problems which undercut or precluded project impact. Performance disbursement provides a means for AID to assist host countries to correct the most obvious and serious of these problems.

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