

**ELIGIBILITY OF EXPENDITURES
IN WORLD BANK LENDING:
A NEW POLICY FRAMEWORK**

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ABBREVIATIONS AND ACRONYMS

AsDB	Asian Development Bank
AfDB	African Development Bank
AFR	Africa Region
BP	Bank Procedure
CODE	Committee on Development Effectiveness
EAP	East Asia and the Pacific Region
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia Region
FY	Fiscal year
IBRD	International Bank for Reconstruction and Development
ICB	International competitive bidding
IDA	International Development Association
IADB	Inter-American Development Bank
IDC	Interest during construction
LCR	Latin America and the Caribbean Region
MDB	Multilateral development bank
MNA	Middle East and North Africa Region
OECD- DAC	Development Assistance Committee of the Organisation for Economic Cooperation and Development
OMS	Operational Manual Statement
OP	Operational Policy
OPCS	Operational Policy and Country Services Network
PAD	Project Appraisal Document
PIU	Project implementing unit
SAR	South Asia Region

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I. INTRODUCTION

1. The World Bank is engaged in a broad effort to modernize and realign its operational policies and practices. Its objectives are to help borrowers achieve the Millennium Development Goals, and to harmonize the Bank's procedures with those of other donors to better support country capacity and reduce transaction costs. The policies that determine the expenditures that the Bank may and may not finance are a key element of this operational framework.¹

2. ***Purpose of this Paper.*** This paper reviews the relevance of these policies and practices to the Bank's business today. It finds that, over time, a clear disconnect has emerged between expenditures that borrowers need to incur to achieve their development goals, and those that the Bank may finance under its current policies. The paper therefore sets out an alternative framework for managing expenditure eligibility in Bank financing. It proposes that Bank policy should be amended to allow the Bank to finance the expenditures needed to meet the development objectives of the operations it supports, within an overall framework that addresses risks to fiscal sustainability and the appropriate use of Bank resources, and in a way that is consistent with the Articles of Agreement.

3. ***Structure of the Paper.*** Following this introduction, Section II summarizes the limitations that current policies and practices impose on the Bank in funding development expenditures. It proposes a new policy framework for identifying and financing eligible expenditures, and sets out the guiding principles for that framework. Section III examines the current rules and proposes specific changes in each major area of expenditure eligibility—cost-sharing arrangements, local costs, taxes and duties, recurrent costs, land purchases, and other expenditures. Section IV summarizes discussions with Executive Directors and external and internal consultations. Section V summarizes the proposed implementation arrangements for applying the new policy framework, and the expected costs, benefits, and risks. Finally, Section VI summarizes the specific changes to Bank policy for which the approval of the Executive Directors is sought.

II. TOWARD A NEW FRAMEWORK FOR “ELIGIBILITY”

4. The Bank's rules on expenditure eligibility were developed when the Bank mainly financed large projects; borrowing countries had highly restrictive foreign exchange regimes; development practice focused on the transfer of investment capital; and the Bank's country strategies, analytic work, and dialogue paid less attention to the sustainability and transparent management of public finances. In this context, Bank policy provided, for example, that the

¹ This paper mainly addresses the policy framework for investment lending. The proposals would also apply to trust funds and grants, with the agreement of the donors concerned. For proposals to update the Bank's policy on adjustment lending, see *From Adjustment Lending to Development Effectiveness: Update of World Bank Policy* (CODE2003-0061), October 9, 2003.

Bank finance only productive expenditures, that borrowing governments finance a portion of project costs, that the impact on fiscal sustainability of financing local currency expenditures and recurrent costs be assessed and managed, and that acceptable fiduciary arrangements be in place. Over the years, country conditions and approaches to development have changed significantly; for example, many countries introduced liberal foreign exchange regimes. At the same time, the Bank diversified its lending, adding current-expenditure-intensive social and services sectors to its traditional infrastructure projects, financing sector investment programs, and focusing on the impact of public expenditure programs in meeting development objectives.

5. ***Evolving Bank Practices.*** Bank practices relative to eligibility policies have evolved to respond to these changes. Levels of financing of local currency expenditures and recurrent costs are significant, and rising; and more flexibility has been introduced for specific types of expenditure. But the changes have evolved within a framework that treats flexibility as exceptional rather than necessary to meet business objectives, and focuses mainly on compliance at the level of the project, contract, and even individual loan withdrawal application, when much can be more effectively addressed at the country level. The result has been growing costs to borrowers and the Bank, as well as a disconnect between Bank objectives and actual practices and procedures. Although the concerns that underpinned these policies remain valid, the policies need to be updated.

A. Costs, Distortions, and Rigidities

6. The disconnect between operational objectives and the policy framework and practice—or between expenditures that are *appropriate* for borrowers to incur and those that are *eligible* for Bank financing—creates distortions and inconsistencies. For example, despite the Bank’s support for ambitious development goals in social sectors, it is difficult to finance such costs as the salaries of primary teachers or health workers who vaccinate children, except under exceptional circumstances. In contrast, the Bank now has greater flexibility in making payments to those who no longer work, through severance payments. Borrowers may use investment loan proceeds to finance the purchase or construction of assets, but in practice they have difficulty financing the same assets through leasing.

7. ***Choice of Instruments.*** The choice of instruments, particularly between investment and adjustment loans, has at times been unduly affected by differing rules on eligibility for financing. Yet these rules obscure the similarities between the two types of instruments, in terms of how funds actually flow and in their ultimate financing of balance of payments and budget support.² This suggests that, at the country level, the current eligibility framework for

² An essential difference between adjustment and investment lending is the degree of specificity of the activities each finances. Yet both provide borrowers with balance of payments support (by providing foreign currency) and budget support (as the local currency counterpart generated by adjustment loans is normally available to finance budgeted government expenditures). However, the resources made available to borrowers through adjustment operations may be used to finance expenditures that are ineligible for financing under investment loans. For example, investment loans cannot finance normal taxes and duties payable in the borrower’s country, but adjustment loans help fill financing gaps that arise from fiscal origins. Most investment lending is

investment lending adds little if any substantive value, while its procedural intensity and costs may at times lead borrowers to prefer adjustment lending when investment lending would be more appropriate.

8. ***Costs of Lending.*** The complex eligibility policies, and the related disbursement procedures for Bank loan proceeds that they have engendered, add to the costs of investment lending.

- For borrowers, they affect accounting systems, staffing levels, and training requirements; the form and content of quarterly and annual financial reports prepared for the Bank; the scope of work carried out by auditors; contract administration; the preparation of every loan withdrawal application and the associated record-keeping; and the number of payments required to be made to suppliers. The direct financial costs to borrowers are tentatively estimated at up to US\$100 million annually,³ and nonfinancial costs may be even more significant. Current practices can cause distortions in the application of foreign exchange and fiscal policy, in decisions between capital and maintenance investments, in employment conditions and remuneration levels in the public sector, and in behavior by suppliers and project implementing agencies. They also divert attention from country institutions to the special administrative arrangements needed to support the Bank's requirements, and lead to implementation delays (Box 1).
- For the Bank, the direct fiduciary administrative cost of complying with these policies, and related disbursement procedures, may exceed 100 staff years annually, with further time inputs from task team leaders and other operational staff.⁴ The focus on eligibility diverts Management attention and staff resources from the appropriateness of borrower expenditure and more substantive fiduciary concerns. It detracts from attention to results, and limits the Bank's ability to harmonize its procedures with those of other donors.

to countries that are also adjustment borrowers—from FY00 through FY02, the Bank approved new adjustment loans to 60 countries, accounting for almost 80 percent of aggregate new loan commitments in that period.

³ Derived from (a) additional accounting and administrative staff (average of two per project) at US\$45 to US\$60 million; (b) additional audit work (around 25 percent of total audit costs) at US\$25 to US\$30 million; and (c) additional computer systems, software, and training at US\$10 million.

⁴ This is a rough estimate, based on around 25 percent of the approximately 400 staff years that procurement, financial management, disbursement, and legal staff expend annually on fiduciary matters. This work includes drafting loan agreements, reviewing bid packages and contract documentation, reviewing loan withdrawal applications, reviewing statements of expenditure, and reviewing and following up on audit reports.

Box 1. Implications to Borrowers of Bank Expenditure Eligibility and Related Policies/Procedures

Additional costs to borrowers

- *Accounting and budgeting complexities.* Bank eligibility policies, such as that on taxes, and the requirement to separately account for expenditures in local and foreign currencies, require duplicate accounting and classification systems, and add complexity to the budgeting process. Projects require additional staff (as many as double, according to one source). Many borrowers develop special-purpose software to cater to Bank-specific requirements.
- *Expenditure authorization and disbursements.* Borrowers are often required to prepare multiple checks (one for each financing source) for individual supplier invoices. Mismatches in the availability of funds from different sources give rise to disbursement delays, and the need for different expenditure authorization procedures for different financing sources further adds to costs. Rejection or only partial processing of withdrawal applications due to eligibility infractions results in project implementation delays.
- *Audit.* Many auditors are not familiar with the Bank's requirements on eligibility, and fail to satisfactorily audit compliance with the requirement. Those who are familiar need to apply additional audit techniques to address eligibility requirements, adding to costs.

Effect on country capacity and institutions

- *Parallel systems.* The need for parallel processes dilutes the ability of Bank and borrower staff to focus on underlying weaknesses in government systems and institutions. There is little scope for replicating systems and practices used in Bank projects in mainstream government systems.
- *Entrenching project implementation units (PIUs).* Eligibility policies help entrench PIU-based aid delivery platforms, impeding institutional reforms by diverting Bank dialogue and energy from government institutions. There is an overdependence on people who understand the "intricacies" of Bank policies.
- *Weakened country oversight.* Parallel reporting to (or approvals by) the Bank detracts from the accountability of project agencies to their own governments (e.g., project agencies provide annual audited reports only to the Bank and not to the government).

Distorted incentives

- *Disbursements.* Varying eligibility treatment of different categories of expenditures and differential disbursement percentages provide incentives to incur expenditures on the basis of funding availability rather than need.
- *Counterpart funding.* Borrower contributions are substantially determined by expenditure eligibility requirements, rather than considerations of ownership and the optimum mix of debt and government financing. Counterpart funding requirements pose problems for countries or subnational entities with fiscal difficulties, and result in implementation delays.
- *Taxes and duties.* The Bank's policy of not financing local taxes and duties encourages governments to provide tax exemptions, thereby undermining the integrity of the fiscal system.
- *Foreign exchange management.* Requiring that special accounts be held in foreign currency may contravene country foreign exchange rules. It is inconsistent with Bank/IMF advice that government foreign exchange should be held by central banks. Some countries respond by holding special accounts offshore, further undermining foreign exchange management. The growth in local currency costs financed by the Bank has substantially reduced the foreign exchange risk of allowing special accounts in local currency.
- *Capital vs. maintenance.* The bias in favor of financing capital expenditure skews public expenditure allocation. The marginal return on investment is often greater from financing maintenance costs on existing assets.
- *Staffing.* The policy of financing only incremental operating costs leads to use of contract staff rather than regular government staff. Differential remuneration rates undermine equity.
- *Local suppliers.* Differential disbursement ratios for local and foreign expenditures may create distortions in favor of costs denominated in foreign currency and increased perceived payment risk by local suppliers. Some suppliers "bury" ineligible expenditures (e.g., local insurance costs) elsewhere in their prices.

Source: Discussions with borrower staff working on 20 Bank-financed projects in the agriculture, education, financial, fisheries, forestry, health, housing, irrigation, public sector management, private sector development, rural, social protection, and transport sectors in Albania, Cambodia, Egypt, Ethiopia, India, Morocco, and Russia; also, discussions with Bank staff.

B. Toward a New Approach

9. This paper suggests that there are more effective mechanisms to meet the objectives of the original policies—mechanisms that are more supportive of the Bank’s operational objectives, more “capacity-friendly,” better able to support harmonized processes with other donors, and more cost-effective.⁵ The paper proposes that the Bank amend its operating policies to allow it to finance the expenditures needed to meet the development objectives of the operations it supports. These changes would be part of the Bank’s ongoing program to simplify and modernize investment lending.⁶

10. **Guiding Principles.** The proposed new eligibility policy rests on three guiding principles: (a) expenditures to be financed in whole or part by Bank loan proceeds should be judged to be productive; (b) the impact of Bank-supported operations on fiscal sustainability should be assessed and judged to be acceptable; and (c) each activity financed by Bank loan proceeds should have acceptable oversight arrangements, including fiduciary oversight arrangements, to ensure that loan proceeds are used only for the purposes for which the loan is granted, with due attention to considerations of economy and efficiency. The proposed policy is consistent with the Bank’s Articles of Agreement, and with the Bank’s objectives of supporting the borrower’s own program of development expenditures, and of ensuring borrower ownership through adequate financing of the program.

11. **Operational Manual Changes.** The amended policy framework would be set out in a new operational policy (OP) statement and Bank procedure (BP)—OP/BP 6.00, *Bank Financing*—that would provide a single, unified statement of what Bank loan proceeds may be used to finance and how associated risks may be managed. In accordance with the new policy framework, the new OP/BP would supersede restrictions on eligibility of expenditures in other policy statements and guidance, which would be revised accordingly.

⁵ These changes are consistent with the Development Committee’s request (April 2001) that the development community move more rapidly on donor harmonization, while maintaining appropriate standards, and that the Bank propose specific changes to its own procedures to facilitate harmonization. In September 2003, the Development Committee noted in its communiqué, “Changes are needed in the way that aid is provided as highlighted in the Declaration of the Rome High-Level Forum on Harmonization. In addition to streamlining procedures and lowering transaction costs, assistance will have to be better aligned to country need, to country priorities and processes, to countries that demonstrate the ability to achieve measurable development results; and to support the development of countries’ capacity.... Where conditions warrant, [more aid should be provided] in ways that can finance recurrent costs.” See *Supporting Sound Policies with Adequate and Appropriate Financing* (DC2003-0016), September 13, 2003; and Chapter 11 of *2004 World Development Report: Making Services Work for Poor People* (New York: Oxford University Press for the World Bank, 2003).

⁶ See *World Bank Lending Modernization and Simplification: An Update* (CODE2003-0086), December 24, 2003.

III. BANK ELIGIBILITY POLICIES, CURRENT AND PROPOSED

12. This new approach would imply changes for a number of operational policies and processes. In the Operational Manual, eligibility would no longer be defined in a series of *ex ante* prohibitions on financing certain expenditure types, but rather in a single policy statement that sets out what Bank loan proceeds may be used to finance and how associated risks can be managed. The policy framework would thus change from one of prohibition, with provisions for exceptions, to one that sets out the conditions and criteria under which expenditure types could be financed. Guidance would be provided to staff on how to establish country financing parameters in consultation with the borrower, determine which expenditure types should be financed, disclose the justification for these determinations, and identify and mitigate risks. Changes in Bank policies and practices in each specific area are summarized below and discussed in more detail in Annex A. The Bank would retain its current policies on the financing of military expenditures, humanitarian assistance, tobacco, and pesticides and other environmentally hazardous goods.

A. Cost Sharing

13. Adequate financing of the borrower's program of development expenditures, with contributions from the borrower's own funds as well as from the Bank and other financiers, is at the core of the proposed new approach. The proposed policy on cost sharing provides the framework for the proposed changes on the policies on financing a broader range of expenditures.

14. ***Current Policy and Rationale.*** The Bank's policy on cost sharing is set out in OP 6.30, *Local Cost Financing and Cost Sharing*. It provides that the Bank set cost-sharing ceilings for all borrowing countries, with the upper limit a function of the country's ability to mobilize domestic and foreign financial resources, and thus based on its per capita income. To ensure flexibility, the country limit is applied to a rolling three-year investment lending program. For individual projects, the Bank usually expects the borrower to demonstrate commitment by making a contribution of not less than 10 percent of project cost (net of taxes and duties), although the Bank may provide a higher proportion in exceptional circumstances.⁷

15. ***Cost Sharing in Practice.*** Currently, the specific Bank policies and procedures on expenditure eligibility for different types of expenditure heavily influence the financing proportions—that is, the cost sharing—agreed with borrowers, although the two are not explicitly linked. The rolling three-year cost-sharing ceiling is not consistently applied, and cost sharing is largely determined at the project level. Problems with counterpart funding delay the implementation of otherwise satisfactory projects, a particular challenge for smaller operations in low-income countries. The problem is exacerbated by donors' pervasive practice of financing stand-alone projects outside normal country planning and budget processes. At the disbursement level, the practice of requiring two or more checks to pay for individual transactions (one for

⁷ Borrowers meet their cost shares through what are commonly referred to as "counterpart funding" contributions.

each source of finance) underscores the transactional intensity with which the policy is applied, and adds to the costs and inconvenience to borrowers, suppliers, and the Bank.

16. ***Proposed Policy Changes.*** The objective of ensuring that the borrower contributes adequately to the financing of its development program remains valid and is a centerpiece of the proposed approach to eligibility. At the country and sector levels, there is normally no problem in ensuring that cost sharing is adequate. As the Bank is estimated to finance around 1 percent (and overall overseas development assistance less than 4 percent) of the annual cost of developing countries' development programs, on average, borrowers are already financing more than 95 percent of development costs.⁸ In countries that are also adjustment borrowers, higher levels of counterpart funding for investment lending simply creates an increased financing requirement to be met by adjustment lending.⁹ This suggests that the objectives of the current policy—borrower commitment and equitable cost sharing—could be effectively met at a more aggregate level than they now are. Therefore, the Bank policy on cost sharing would be modified so that the Bank may finance activities for which the borrower has demonstrated ownership and commitment by, among other things, providing funding from its own resources. The Bank would judge the adequacy of this funding in the context of the borrower's overall development program generally and its funding for the sectors on which Bank assistance would focus in particular. This would provide the Bank with the flexibility to finance higher proportions of projects costs, in some circumstances up to 100 percent

17. ***No Changes in Aggregate Cost Sharing.*** In practice, no major change in aggregate cost sharing proportions is expected. Bank financing is leveraged, and its impact therefore enhanced, by funds provided by borrowers and other sources. There are limited financing envelopes for most borrowers—in the case of IDA, through country-specific allocations; in the case of IBRD, through exposure limits or agreed resource transfer patterns with borrowers. There is therefore a strong incentive to avoid the reduced number or smaller size of Bank-financed operations that lower borrower cost sharing would cause. Other changes in the portfolio, such as the growing interest in sectorwide approaches in which the Bank typically finances a small proportion of total costs, are likely to increase average borrower cost shares. Indications from consultations with borrowers in the preparation of this paper are that they do not wish the Bank to finance 100 percent of all project costs, but would value greatly the flexibility to do so in certain circumstances.¹⁰

⁸ These figures are based on Development Economics' estimate that aggregate annual expenditures on development programs in developing countries approximate US\$1.5 trillion.

⁹ In the period FY00 through FY02, 64 percent of aggregate IDA and 65 percent of aggregate IBRD investment lending was made to countries that had at least one adjustment loan in the same period.

¹⁰ The areas in which it is most likely that the Bank would be asked to finance higher than average cost shares include community driven development projects, where the contributions-in-kind by beneficiary communities are difficult to measure and capture in a financing plan; small, quick-to-prepare interventions, such as IDF grants and trust funds, where the recipients are often not governments, or the operation is prepared outside of the normal budget cycle; operations in countries enduring severe fiscal stress, who therefore find it difficult to make counterpart funds available; and operations whose costs are already fully integrated in country budgets.

B. Local Cost Financing

18. The IBRD Articles allow the financing of local expenditures in “exceptional circumstances.”¹¹ The IDA Articles include a similar, though more liberal, provision, allowing IDA to provide foreign exchange to finance local costs in “special cases.”¹² The Executive Directors specifically considered the limits set out by the Article provisions in 1949, 1964, and 1968,¹³ and interpreted them quite broadly, so as to permit local cost financing when the financing of foreign costs alone would not permit the Bank to assist in the financing of priority projects.¹⁴ The interpretations rendered by the Board over the years also make clear that the judgment to be made in determining whether it is appropriate to finance local costs is a qualitative rather than a quantitative one.

19. **Current Policy.** The Bank’s policy on financing local costs is set out in OP 6.30, *Local Cost Financing and Cost Sharing*, issued in September 1993. The policy limits financing of local costs to investment lending, technical assistance, and emergency recovery loans, and it provides that the Bank may finance local costs only in certain circumstances:

- (a) When indirect foreign costs can be clearly identified, the Bank may finance local expenditures up to the equivalent of such costs.

¹¹ Article IV, Section 3(c) of the IBRD Articles of Agreement states, “The Bank, if the project gives rise indirectly to an increased need for foreign exchange by the member in whose territories the project is located, may in exceptional circumstances provide the borrower as part of the loan with an appropriate amount of gold or foreign exchange not in excess of the borrower’s local expenditure in connection with the purposes of the loan.” Article IV, Section 3(b) also permits the Bank to provide the borrower with local currency to finance local costs “in exceptional circumstances, when local currency required for the purposes of the loan cannot be raised on reasonable terms.”

¹² Article V, Section 2(e) of the IDA Articles of Agreement states, “The Association, in special cases, may make foreign exchange available for local expenditures.”

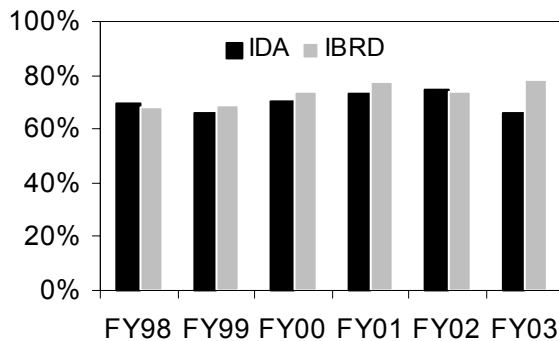
¹³ *Report of the Board Committee on Financial policy on the Question of Local Expenditures* (R221), March 31, 1949; “Minutes of Regular Meeting of the Executive Directors of the Bank, August 6, 1964” (M64-9), approved October 13, 1964; “Minutes of Joint Meeting of Executive Directors of the Bank and IDA, August 25, 1964” (SM64-19, IDA/M64-18), approved October 13, 1964; “Foreign Exchange Loans for Local Expenditures,” a memorandum for the Executive Directors from Robert S. McNamara, July 30, 1968, and “Foreign Exchange Loans for Local Expenditures,” Memorandum by the General Counsel (SecM68-436), November 29, 1968.

¹⁴ As the General Counsel stated in advising the Executive Directors when the matter was considered by the Board in 1968: “... a limitation placed on the Bank’s freedom to act under paragraph (c) phrased in non-specific terms (“exceptional circumstances”), should not be interpreted so as to prevent the Bank from achieving its purposes under the Articles. If the expectation that lending in accordance with paragraph (a) [i.e., lending foreign currency to finance foreign expenditures] will enable the Bank to achieve its purposes is not realized in any particular case, and the lending technique contemplated by paragraph (c) would be the most effective means of achieving such purposes in a manner consistent with the basic policies laid down in the Articles, lending under paragraph (c) is appropriate.” In other words, *financing of local expenditures is justified when the financing of foreign expenditures only would not enable the Bank to assist in the financing of the highest priority projects* [emphasis added]. See A. Broches, Legal Opinion, “Foreign Exchange Loans for Local Expenditures” Memorandum by the General Counsel, (SecM68-463), November 29, 1968, para. 47, and I.F. Shihata, “Financing Local Expenditures: The Bank’s Articles of Agreement As Applied in Practice,” Memorandum of the Senior Vice President and General Counsel (SecM96-366), April 9, 1996.

- (b) The Bank may finance local costs in certain high-priority projects if, after a careful appraisal of a country's overall development program, it judges that the program's financial requirements will exceed available local savings and expected foreign exchange resources. In such cases, the Bank may finance local costs: (i) if a project has too little foreign exchange cost to permit achieving the project objectives by foreign exchange financing alone; and (ii) in technical assistance (TA) projects and in TA components of investment projects, in connection with goods and services procured locally.

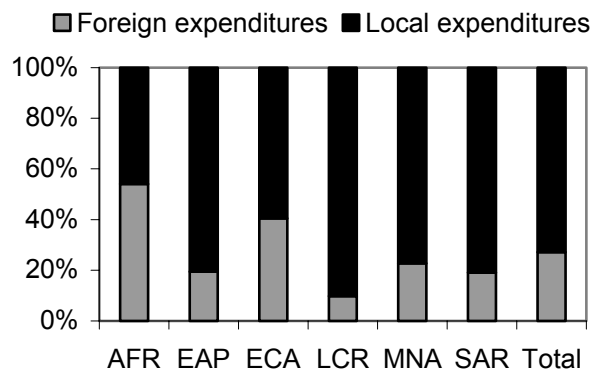
20. **Local Cost Financing in Practice.** As noted above, both the Articles of Agreement and OP 6.30 provide for local cost financing when such financing is justified in terms of needs and the country's resource mobilization effort. The Bank has applied these provisions when financing only foreign expenditures would not enable it to assist in the financing of priority projects. The proportion of Bank financing used for local currency expenditures has grown steadily, and now accounts for a substantial majority of all investment lending: in FY03, local currency expenditures accounted for 73 percent of disbursements in investment lending, up from 68 percent in FY98.¹⁵ The aggregate results were similar for IBRD and IDA borrowers (Figure 1). In four of the six Regions, local currency expenditures accounted for more than 75 percent of disbursements (Figure 2). In monetary terms, disbursements for foreign expenditures in investment lending have declined steadily, amounting to US\$2.9 billion in FY03, compared to US\$4.7 billion in FY98. This trend is also reflected in procurement indicators: the total value of prior-reviewed international competitive bidding (ICB) contracts for contractors in nonborrowing countries was US\$0.9 billion (21 percent of all prior-reviewed ICB contracts) in FY02, compared to US\$2.1 billion (29 percent) in FY98.¹⁶

Figure 1. Local Currency Expenditure Share of Investment Lending Disbursements, FY98-FY03



Source: Staff calculation based on Bank Loan Administration System.

Figure 2. Disbursement for Foreign and Local Expenditures by Region, FY03



¹⁵ In contrast, the proportion of cumulative disbursements for local currency expenditures from the creation of the Bank through FY97 was 43 percent.

¹⁶ These numbers probably underestimate the amount of supply ultimately sourced in nonborrowing countries. Liberalization of foreign exchange markets, the growth of global trade, and increased international relationships between commercial enterprises probably result in a significant proportion of what is today described as local currency expenditure being sourced in other countries.

21. ***Changing Conditions.*** Current conditions suggest the need to streamline the policy statement on local expenditures in accordance with the Board's interpretation of the Articles provisions. These conditions include (a) the evolution of global financing and foreign exchange markets, including increased convertibility of many borrowers' currencies; (b) the macroeconomic context of developing countries, with most Bank borrowers being net importers of capital and borrowing abroad to finance part of their development programs; and (c) changes in Bank-financed projects, including social sector projects with higher local cost components and, in middle-income borrowing countries, a local industrial base that can provide a substantial portion of the needs of infrastructure projects.

22. ***Proposed Policy Changes.*** The policy on financing local expenditures would continue to hinge on macroeconomic (or country) and project considerations. It would confirm that the Bank may finance local expenditures when it is satisfied that (a) financing requirements for the development program of the country would exceed the public sector's own resources (e.g., from taxation and other revenues) and expected domestic borrowing; and (b) the financing of foreign expenditures alone would not enable the Bank to assist in the financing of such projects. At this time, macroeconomic and fiscal policies in borrowing countries are such that most countries are expected to meet both criteria.

C. Taxes and Duties

23. The Bank's Articles of Agreement do not specifically address the use of the proceeds of Bank loans to finance taxes and duties, but the General Conditions Applicable to Loan and Guarantee Agreements (Section 5.08) provide that "it is the policy of the Bank that no proceeds of the Loan shall be withdrawn on account of payments for any taxes levied by, or in the territory of, the Borrower or the Guarantor on goods or services, or on the importation, manufacture, procurement or supply thereof." This policy is also articulated in OP 12.00, *Disbursement*, issued in February 1997. More recently, Management has clarified that Section 5.08 also applies to income and transaction-specific taxes levied on payments to consultant firms, individual consultants, and staff of project implementation units, whether or not such taxes are levied at source, and to social charges on salary payments that do not constitute a payment for drawdown of future benefits. To implement these requirements, country-specific standard disbursement percentages were established.¹⁷

24. ***Rationale.*** The Bank has treated taxes as an ineligible expenditure because they are considered transfer payments, representing revenues to the borrower, rather than expenditures. In addition, taxes that are imposed by the borrowing country are normally payable in local currency. Finally, there has been a concern that taxes may not be a "reasonable cost," especially in countries with excessively high taxes.

¹⁷ See the Operational Memorandum *Bank Policy on Financing Income Taxes*, June 13, 2001, and associated "Guidelines for Implementation of Bank Policy on Not Financing Local Income Taxes," issued on November 7, 2001.

25. ***Taxes and Duties in Practice.*** In practice, implementation of the policy differs significantly from case to case, and there are significant inconsistencies in the treatment of different forms of taxes. Administration of the policy has also increased the costs and complexity of project implementation, and has led to economic distortions. Because taxes payable in the territory of the borrower are not eligible for Bank financing, while there is no such restriction on taxes payable elsewhere, the disbursement treatment between foreign and local suppliers is uneven. For pragmatic considerations, application of the policy is determined largely by whether taxes are visible in supplier invoices/payments, leading to different treatment of borrowers based on how they collect, rather than the actual incidence of, taxes. Countries that implement value-added tax systems (often following the Bank's policy advice) are penalized by reference to those with other systems, as the government must finance both the full end-use tax *and* the repayments of taxes on inputs to suppliers at earlier stages of the supply chain. In a number of countries, it is the need to finance taxes that drives the government's counterpart financing contribution, rather than considerations of country commitment and the optimum financing mix. In others that are fiscally stressed, some respond by granting tax exemptions on activities financed by the Bank (and other donors), thereby causing economic distortions based on the source of financing, and undermining the integrity of fiscal and budgetary processes. The complexity of the current system has led to inconsistencies in application that cause difficulties for borrower and Bank staff alike (for example, differential practices regarding the cost base—including or excluding taxes—on which disbursement percentages are applied). With around 80 percent of all Bank investment lending in the period FY00 through FY02 to 60 countries that also had at least one adjustment loan in the same period, it can be argued that not financing taxes and duties in investment lending simply moves the financing requirement from one instrument to another.

26. ***Rationale Reconsidered.*** Taxes and duties are part of normal cost structure of economic activity; indeed, government agencies and public enterprises or organizations themselves normally pay taxes. Governments rarely exempt their purchases and imports from taxes; such a policy would be distortionary, creating an unequal and anticompetitive playing field between state-owned enterprises and the private sector. The level of transaction costs generated by the current approach, and the incentive to differential treatment and economic distortions through exemptions, can be avoided in the context of the proposed new approach to cost sharing in Bank lending.

27. ***Proposed Policy Changes.*** To eliminate these inconsistencies and distortions and reduce transaction costs in the administration of Bank-financed projects, Bank policy would be changed to provide that the Bank may finance the reasonable costs of taxes and duties associated with project expenditures.

D. Recurrent Costs

28. The Bank's policy on recurrent costs is set out in Operational Manual Statement (OMS) 1.21, *Bank Financing of Recurrent Costs*, issued in January 1985.¹⁸ The policy states that under certain circumstances the Bank may finance some "incremental" recurrent costs:¹⁹

- (a) When "the country has a serious shortage of budget resources for recurrent expenditure financing which makes it unlikely that the necessary funds for recurrent expenditures for a Bank project [will be provided]," if the Bank is satisfied that the government's economic policies are appropriate to move toward resolving the cost problem.
- (b) When "a specific recurrent expenditure plays a crucial role in the success of a project, ...to ensure that the necessary funds are available on time"; this funding, however, should provide incentives to the borrower to provide its share of the recurrent expenditures.

To encourage the borrower to gradually assume most of the recurrent expenditures of the project over time, the Bank is expected to finance a "declining percentage" of incremental recurrent expenditures. Accordingly, the proportion of recurrent expenditure covered by the loan proceeds is normally not expected to exceed 25 percent during the final year of project implementation.

29. **Rationale.** The Bank's reluctance to finance recurrent costs has been based on three premises. The first is that viable development projects should generate benefits in excess of costs (both capital and recurrent), so that, after the initial negative cash flow period, the output generated should be more than sufficient to cover the cost of operation and maintenance.²⁰ The second premise is a presumed direct link between a borrower's ability and willingness to finance at least a portion of a project's operational costs during its implementation, and the sustainability of that project. Finally, there has been a perception that recurrent costs may not be productive.

30. **Recurrent Cost Financing in Practice.** In 2000, Operations Policy and Strategy reviewed the recurrent cost financing experience of 150 projects, or one-sixth of the total projects that exited the portfolio between 1995 and 1999. More than half (54 percent) of the projects reviewed financed some recurrent costs, with proportions higher than the average in the social and rural development sectors, and in the Africa, Latin America and Caribbean, and South Asia Regions. The review revealed that (a) staff found it very difficult to calculate incremental costs at the project level; (b) few projects (less than one-quarter) complied with the required declining disbursement percentage; and (c) there was no strong relationship between

¹⁸ OMS 1.21 defines recurrent costs as "any expenditure on items that are used up in a short period which are necessary for the operation and maintenance of the project and which must be continued after the project period."

¹⁹ Incremental costs are defined as "those which are over and above the recurrent expenditures which the agency would have to meet without the project."

²⁰ See "World Bank Financing of Recurrent Costs in Investment Lending Operations," a note from Development Economics Vice President to the Operational Policy Committee, April 1998.

sustainability and financing of recurrent costs or compliance with requirements on declining disbursement percentages. Although the principle of gradually transferring responsibility for recurrent costs to the borrower is a sound one, in practice it has proven difficult for borrowers with fiscal difficulties. In addition, the timing of future economic benefits often differs from projected disbursement patterns, weakening the argument for addressing this dimension at the individual project level.

31. **Rethinking the Rationale.** The post-Monterrey focus on results requires rethinking the policy on recurrent costs. The Operations Evaluation Department's Annual Report on Development Effectiveness for 2002 noted that "achieving and sustaining the Millennium Development Goals will require significant additional recurrent financing." In the education sector, for example, recurrent costs account for about two-thirds of the financing gap associated with the "Education For All" initiative.²¹ As the Bank embraces ambitious global development goals, it needs to ensure that its financing policies are aligned with these goals, while managing associated risks. In addition, as the Bank moves beyond financing discrete projects whose costs and benefits can be easily separated out and measured to supporting broader country programs aligned with development goals, the distinction between "incremental" and "nonincremental" recurrent costs at the project level becomes less clear, and more difficult to reliably estimate and enforce.²²

32. **Distortions.** In the infrastructure sectors, the Bank's (and other donors') preference for financing capital rather than recurrent expenditures has tilted government spending toward new capital investments, even when there are insufficient resources to meet the recurrent costs of existing investments.²³ This bias can lead to incomplete and unsustainable projects, and it creates an incentive for governments to defer maintenance in order to obtain fresh capital—with the result that the capital stock is underused or eroded.²⁴ In such situations, returns to additional

²¹ See *2002 Annual Review of Development Effectiveness (ARDE)—Achieving Development Outcomes: The Millennium Challenge* (Washington, D.C.: The World Bank, 2003). The report noted further that the recurrent costs of newly created services will need to be financed, which could necessitate a review of donor policies in this area. See also Barbara Bruns, Alain Mingat, and Ramahatra Rakotomalala, "Achieving Universal Primary Education by 2015: A Chance for Every Child," World Bank, July 2003; and *Development Effectiveness and Scaling Up: Lessons and Challenges from Case Studies* (DC2002-0018), September 18, 2002.

²² Calculating incremental recurrent expenditures of a highway maintenance project, for example, requires an estimate of the level of recurrent expenditures needed for adequate maintenance of the roads included in the Bank's project compared to the actual maintenance expenditures on these roads. If the Bank's project does not include the entire road system, the OMS requires the provision of an estimate of the actual maintenance expenditure that was spent on the project roads. Similarly, if a project requires existing vehicles to be used more intensively, the OMS requires that an estimate of the additional mileage and its costs be provided. Operational staff report difficulty in calculating reliable estimates at the project level.

²³ See Ed Campos and Sanjay Pradhan, *Budgetary Institutions and Expenditure Outcomes, Binding Governments to Fiscal Performance*, Policy Research Working Paper No. 1646, The World Bank, September 1996.

²⁴ In the road sector, for example, the policy of financing maintenance projects to overcome a backlog of maintenance (on the grounds that they constitute mainly capital expenditures) is perceived to discourage timely routine and periodic maintenance, often leading to more expensive road rehabilitation projects. Similarly, in the water sector, the policy of financing deferred maintenance under rehabilitation of water works, while not financing the operation and maintenance costs of a water utility, is perceived to postpone a problem to the point of more expensive remedial action.

recurrent expenditure can far outweigh returns to additional capital expenditure.²⁵ In sectors such as education, health, and nutrition, recurrent costs can constitute a large proportion of the total project costs;²⁶ if donors cannot finance these costs, it can be difficult to achieve project objectives. Furthermore, the relevance of the traditional definitions of capital and recurrent needs to be reviewed when investments in social *capital*, mainly in the form of staff salaries, actually come from what has been traditionally defined as *recurrent* costs.

33. ***Proposed Policy Changes.*** All of this suggests a need to focus on the transparency, accountability, and effectiveness of the management of all public resources used to support country poverty reduction programs, addressing each country's recurrent cost financing as part of a broader counterpart funding strategy that is rooted in an aggregate fiscal framework, while maintaining the objective of sustainability at the relevant level (sector, subsector, or project entity). For this purpose, the Bank's policy would be changed to provide that the Bank may finance recurrent costs. In determining whether and to what extent to finance recurrent expenditures, the Bank would consider the impact on fiscal and debt sustainability (including the country's commitment and ability to provide continued financing for recurrent expenditures after Bank financing is completed) at the appropriate levels, including that of the project entity or entities.

E. Land

34. The Bank's policy on financing land is articulated in OP 12.00, *Disbursements*, paragraph 2(b), which lists "cost of land" as an expenditure not eligible for financing under a Bank loan. Historically, the Bank did not finance land for a variety of reasons, including concerns that expenditure on land did not necessarily meet the productive purposes test in the Articles of Agreement; the fact that land is always a local cost; and the problems inherent in financing what is essentially a transfer of existing ownership rights (such as the complexity of land tenure systems that make it difficult to determine a reasonable financial value of such assets, and related procurement issues).

35. ***Recent Developments.*** In March 2002, following consultation with the General Counsel, Management approved an exception to the policy prohibiting land financing so as to enhance local communities' ability to alleviate poverty by transferring assets to their members.²⁷ The exception sought to respond to a new generation of community-based land reform projects in which beneficiaries (rather than governments) acquire land on the open market, reducing concerns about corruption, efficiency, and price distortions. The exception reflected advances in

²⁵ See *World Bank Financing of Recurrent Costs in Investment Lending Operations*, op. cit.

²⁶ Depending on the type of investment, annual recurrent costs are estimated to range between 5 and 70 percent of the initial investment, with physical infrastructure requiring less recurrent spending and social infrastructure requiring more. See Peter Heller, "The Underfinancing of Recurrent Development Costs," *Finance and Development* (March 1979), pp. 38-41.

²⁷ See the memorandum "Exception to the Prohibition on Disbursement Against Land under Paragraph 2(b) of OP 12.00 on Disbursement," from Ko-Yung Tung, Vice President and General Counsel, Legal Department, and Ian Johnson, Vice President, Environmentally and Socially Sustainable Development, to Shengman Zhang, Managing Director, Operations, March 19, 2002.

land survey and titling in many parts of the world that have made reliable land transactions in selected sectors less risky than in the past, the wish to use land market reform as a force for greater competitiveness, and the experience gained by the Bank with more flexible procurement approaches in the first generation of community-driven development projects (Box 2).

Box 2. Pilot Scheme in Financing Land Acquisitions

The pilot involves screening by a Community Land Acquisitions Committee of potential projects to ensure their appropriateness for Bank financing, reviewing annually projects under implementation, an evaluation of the need to expand the pilot to resettlement and/or urban development projects, and finally, depending on the experience gained, a review of the advisability of expanding the scheme. The committee has representatives from the Environmentally and Socially Sustainable Development Network, Operations Policy and Country Services, Legal Department, and two Regions, with representatives of two other Regions as alternates. It has developed criteria for project selection that include the productivity of the land purchase, an assessment of the functioning of the land market, acceptable fiduciary arrangements, appropriate risk mitigation measures, and the need for monitoring and evaluation.

To date, two pilot projects have been approved: the Malawi Community-Based Land Development Project, which would benefit about 20,000 poor rural households by facilitating their voluntary access to otherwise neglected or underutilized land; and the Andhra Pradesh Rural Poverty Reduction Project, which will, upon community demand, purchase unused or underused land to allow tenants and landless people to move onto it. A third project, in the Philippines, is being considered.

36. **Rationale Reconsidered.** There is no economic justification for considering land a nonproductive asset; economists have long seen it as a core productive input, together with labor and capital, in the standard production function of neoclassical economic theory.²⁸ In many Bank-financed projects, land acquisition represents a necessary expenditure to meet the development objectives of the project; for example, most urban and infrastructure development projects require the acquisition of land for roads, power plants, dams, solid waste management sites, and so on; and most human development operations require land acquisition for schools, hospitals, community centers, and the like. The inability to finance land acquisition—often a costly component of such projects—can lead to long delays in project implementation when governments are unable to secure adequate financing from other sources. It also sends mixed signals as to where the Bank stands on this issue, and deprives the Bank of leverage in programs to support land reforms.

37. **Proposed Policy Changes.** OP 12.00, *Disbursements*, would be modified to eliminate the general prohibition on financing land purchases in the context of Bank-financed projects, and OP 4.12, *Involuntary Resettlement*, would be modified to remove the restriction on financing resettlement assistance in cash or the cost of the land acquisition. Management is presently

²⁸ Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), has characterized land as a productive asset. Indeed, de Soto argues that the mere possession of title to land—even idle land not associated with any project or use—has productive value. This value derives from the ability of an owner to use the title as a pledgeable financial asset. De Soto outlines the productive capacity created when the informal usufruct rights of the poor are transformed into formal titles that can serve as collateral and create further wealth, and argues that a land purchase is one of the most productive investments.

reviewing the desirability of expanding the scope beyond the current pilot scheme in the light of operational needs and experience gained. Management nevertheless intends to pursue a cautious approach with respect to financing land, and to continue to have all proposals to finance land reviewed by the Bankwide Land Committee.

F. Other Expenditures

38. The financing of several other types of expenditure (identified in Table 1) has been limited by either policy or practice. Consistent with the principle that the Bank should have the ability to finance expenditures necessary to meet the development objectives of Bank-supported operations, it is proposed to remove these blanket limitations or restrictions. Appropriate Management review processes and guidelines to staff would be put in place. Table 1 lists the affected types of expenditures, and indicates whether the content of the current policy or practice governing each would change or be clarified. In each case, a brief rationale is provided. Annex A provides a fuller description of the change proposed in each area.

39. **Special Accounts.** This paper also proposes a policy clarification in an area that is not an expenditure—special accounts. The Bank’s policy requires special accounts to be normally maintained in a fully convertible and stable currency. Although the current policy allows for special accounts to be maintained in local currency, in practice, most special accounts have been established in foreign currency. This practice may contravene country foreign exchange rules, and it is inconsistent with Bank/IMF advice that government foreign exchange should be held by central banks. To clarify that the holding of special accounts in local currency is not considered to be an exceptional choice, the proposed clarification to policy would provide that in countries with freely convertible currencies, special accounts may be held in the currency of the borrower or any freely convertible currency.

IV. DISCUSSIONS WITH EXECUTIVE DIRECTORS AND CONSULTATIONS

40. The proposed changes were discussed by the Committee on Development Effectiveness (CODE) at its meeting on November 19, 2003.²⁹ CODE welcomed the proposals, and considered that they would redress some of the imbalances between adjustment and investment lending, as well as nonfinancial costs of doing business with the Bank. It raised the following specific issues concerning implementation: (a) the need for clear guidelines to support the judgments to be made by staff, with consistent application across countries and regions, and adapted to diverse country conditions and priorities; (b) how risks to fiscal and debt sustainability of financing recurrent costs would be managed; (c) how country ownership would be demonstrated in situations where the Bank might finance 100 percent of project costs; (d) the impact on harmonization with other donors; (e) management of fiduciary risks; (f) the views of the Internal Audit Department; and (g) the impact on the Bank’s administrative budget. CODE urged that staff be provided with clear and concrete guidelines, and asked that these guidelines be shared with Executive Directors in a Technical Briefing.

²⁹ See *Report to the Board from the Committee on Development Effectiveness* (CODE2004-0001), January 9, 2004.

Table 1. Summary of Changes with Respect to Selected Other Expenditure Types

<i>Operational Manual ref.</i>	<i>Description of expenditure type</i>	<i>Change in content</i>
OP 12.00 and Op Memo June 3, 2003	Local transportation and insurance costs. Local transportation and insurance costs are a normal business cost, and are essential part of the cost of many Bank-supported projects.	Clarification
OP 12.00	Late payment penalties. These costs arise regularly in the normal course of business and, when they do, form part of project costs. The prohibition in the current policy would be lifted, and guidance on when to finance late penalties would be provided to staff.	Change
OP 12.00 and Op Memo April 5, 2002	Severance pay. The contents of the current Operational Memorandum would be reissued as guidance to staff to assist in determinations on whether, to what extent, and how to finance severance pay.	No change
OP 12.00 and Op Memo May 22, 1996	Food expenditures. The contents of the current Operational Memorandum would be reissued as guidance to staff to assist in determinations on whether, to what extent, and how to finance food expenditures.	No change
OP 4.12	Resettlement assistance (including cash compensation). The current policy prohibition on financing of resettlement assistance (including cash compensation) would be removed. Proposals to finance such expenditure would be subject to review by the Land Committee.	Change
OP 6.60	Interest during construction (IDC). IDC is a normal business cost, and necessary to the successful implementation of some Bank-supported projects. The current policy prohibition on financing non-IBRD IDC would be removed and guidance on when IDC may be financed would be provided to staff.	Change
BP 12.20	Bank charges. Bank charges, including those on special accounts, are a normal business cost.	Clarification
OP 12.10	Retroactive financing. The conditions for retroactive financing for investment and adjustment loans would be aligned in the OP.	Change
OP 11.00	Secondhand goods. The contents of the current Operational Policy would be reissued as guidance to staff to assist in determinations on whether to finance secondhand goods.	No change
-	Leased assets. Leasing is a common way to finance the acquisition of capital assets. Guidance would be issued to staff on financing of leased assets.	Change in practice

Note: BP = Bank Procedure, OP = Operational Policy, and Op Memo = Operational Memorandum.

41. **External Consultations.** At the request of CODE, a public consultation process was undertaken. The proposed changes were posted on the Bank's external website from November 21, 2003, through February 6, 2004.³⁰ Eight formal responses were received, of which two were from the contracting community and six from other donor organizations. The responses received indicate overall support for the proposed changes. They are analyzed in Annex B. Borrower governments expressed strong support in the context of work done to explore how the changes would be applied in specific countries.

42. **Internal Consultations.** Following the CODE meeting, a Bankwide group identified the issues associated with implementation, and developed a detailed implementation framework. The Regions nominated seven countries in which implementation of the proposed framework could be explored in more detail. The countries concerned were Bangladesh, Brazil, Colombia, Indonesia, Morocco, Poland, and Senegal. Advice was provided by several central units, including Controllers, Development Economics, Environmentally and Socially Sustainable Development, Internal Auditing Department, Legal Department, Operations Policy and Country Services, and Poverty Reduction and Economic Management. The implementation arrangements are discussed in more detail in the next section.

V. IMPLEMENTATION ARRANGEMENTS

43. This section outlines the implementation arrangements to apply the proposed new eligibility policy.

44. **Implementation Arrangements – A Comprehensive Package.** The policy framework for expenditure eligibility would be set out in a new operational policy statement and Bank procedures statement, OP/BP 6.00, *Bank Financing*. These would be complemented by technical guidance to staff with respect to setting country financing parameters and making decisions on financing selected expenditure types in individual projects. A series of management reviews would be put in place for both country- and project-level financing decisions, adapted to the risks of the activities concerned. These decisions would be transparent—in the case of country-level decisions, through the CAS and a website of country financing parameters maintained by OPCS; and in the case of project-level decisions, through disclosure in Project Appraisal Documents. For each of the first two fiscal years after introduction of the new policy, Management would prepare for discussion with Executive Directors a review of implementation experience, and identify any areas where changes may be needed. More detailed information on the implementation arrangements is being provided to Executive Directors separately.³¹

45. **Benefits.** The proposed changes would offer borrowers an investment lending product better aligned with country development objectives and conditions. They would further the

³⁰ See <http://www.worldbank.org/eligibility/>. The document appeared in Arabic, Chinese, English, French, Portuguese, Russian, and Spanish.

³¹ See *Eligibility of Expenditures in World Bank Lending: Implementation Arrangements* (OM2004-0012), February 23, 2004; *Eligibility of Expenditures in World Bank Lending: Implementation Arrangements – Information Note* (SecM2004-0089 and IDA/SecM2004-0132), March 9, 2004; and *Eligibility of Expenditures in World Bank Lending: Implementation Arrangements – Questions and Answers*, March 26, 2004, OPCS.

process of aligning Bank policies to support good institutional practices in borrower countries, and would facilitate harmonization with other donors. Borrower costs would be expected to decline significantly. Focusing on country conditions to guide Bank financing would reduce the transaction costs of preparing and negotiating individual projects. Project record-keeping, financial reporting, and loan withdrawals would be simplified, thus better utilizing borrower capacity. The distortionary impact of some current practices would be alleviated. Disbursement processes would be simplified for many projects, and project implementation delays would be reduced through more flexible approaches to counterpart funding arrangements.

46. **Risks.** The main implementation risks are that the greater flexibility in cost-sharing and recurrent cost financing may undermine country ownership of Bank-financed operations and fiscal and debt sustainability, and that acceptable fiduciary arrangements can be put in place to ensure that loan proceeds are used for intended purposes.

- (a) **Country ownership and fiscal sustainability.** The proposed greater flexibility, particularly regarding cost sharing and recurrent cost financing, will be applied in an environment in which countries are increasingly accounting for Bank- and other donor-financed projects as an integral part of their public sector budgets and, in many cases, within a medium-term expenditure framework. This is the case in IDA countries where poverty reduction support credits are focusing on supporting budgetary planning and implementation improvements, as well as in middle-income countries where budgetary discipline already requires donor-financed projects to be included in the budget. Thus, government ownership of its overall development program and of the individual projects that constitute it—irrespective of financing sources—is embodied in the quality of budget preparation and implementation to a much greater extent than in the specific cost-sharing arrangements for each project. These improvements, however, are not taking place in all countries at the same pace, and the Bank's determination of appropriate country financing parameters will take into account the overall quality of budget management.
- (b) Similarly, assessments of fiscal and debt sustainability at the country level will continue to influence the overall Bank lending levels to a country. When the total lending levels have been established, their distribution among projects will have an impact on sustainability at levels lower than the country. This will be addressed at the sector and subnational levels, through assessments of public expenditure allocations to the sectors and of public finance (including revenues) at the relevant subnational levels. At the project level, fiscal and debt sustainability is particularly relevant for revenue-earning agencies with independent budgets, where Bank-financed projects will continue to pay high attention to the agencies' financial projections in determining the levels of Bank financing.
- (c) **Fiduciary oversight.** The focus of fiduciary work would shift from monitoring compliance with detailed rules to ensuring that borrower systems provide reasonable assurance that expenditures financed by the Bank were appropriately

incurred for the purposes of the project. Staff would continue to assess the financial management and procurement capacity of project implementing agencies during project preparation. No change is proposed to the work done by procurement staff. There would be considerably more administrative flexibility on disbursements, without diminution in the control environment. Reviews by external auditors and Bank staff would focus more on the substantive test of *appropriateness* of expenditures financed by the Bank, rather than today's more clerical *eligibility* reviews. There would be scope for more flexibility with respect to different disbursement percentages for different types of items, differential treatment of expenditures in foreign and local currency, declining disbursement percentages, and the need to reallocate between disbursement categories. Staff would continue to carry out ex-post checks of a sample of transactions financed by the Bank.

47. **Costs.** There would be some transitional costs to the Bank, because of changes to the Bank's operational infrastructure. Several policy statements would be amended. Procedures and guidelines would need to be updated, and a program of communications and training put in place for all operational staff. A number of business processes in both the Regions and some central units would need to be adapted. In general, Management would propose to implement these changes within the overall planned budget envelopes for the affected units. In practice, some reallocations are likely to be needed as roles and responsibilities are refined. In the aggregate, Management does not foresee significant administrative cost savings in the short-run, as the resources freed up by simplification will be re-directed to deal with country parameters, and ensuring appropriate oversight in an environment of greater flexibility. The potential for cost savings in the future would be examined as part of the proposed annual reviews of the first two years' operations.

48. **Implementation Timing.** Once the Bank establishes a given country's financing parameters (relating to cost sharing, recurrent cost financing, local cost financing, and taxes and duties)—that is, the Regional Vice President has approved them and notified the Executive Directors—the policy will apply to all projects appraised in that country. The policy may then be applied to other projects under preparation or implementation in that country, if (a) the borrower so requests, and (b) the Bank considers the proposed change to be justified in terms of meeting the objectives of the projects, and the benefits exceed the costs of changing such projects.

49. **Practices of Other Multilateral Development Banks.** Annex C sets out a comparative table comparing Bank policies and practices to those of three other multilateral development banks (MDBs). Practices vary, but in general the frameworks of the other MDBs appear to be more liberal than the Bank's, in particular in the areas of local currency expenditure and recurrent cost financing.

VI. SUMMARY AND RECOMMENDATIONS

50. This paper proposes a new framework to govern the expenditures that are eligible for Bank financing. The proposed framework rests on three guiding principles: (a) the expenditures financed from the Bank loan proceeds are productive; (b) the impact of the operations financed under such loans on the borrowing country's fiscal sustainability is acceptable; and (c) acceptable oversight arrangements, including fiduciary oversight arrangements, are in place to ensure that such loan proceeds are used only for the purposes for which the loan is granted, with due attention to considerations of economy and efficiency. Consistent with these principles, Executive Directors are requested to approve changes to the Bank's policy on eligibility of expenditures and to the General Conditions Applicable to Loan and Guarantee Agreements as described in this paper and summarized below.

51. **Bank Financing.** Bank loan proceeds finance expenditures necessary to meet the development objectives of operations supported by the loans. In determining which activities to finance, the Bank considers whether the proposed expenditures are justified by reference to the project's development objectives, and reviews the arrangements to ensure that the loan proceeds will be used for their intended purposes. The Bank will retain its current policies related to the financing of military expenditures, humanitarian assistance, tobacco, pesticides and other environmentally hazardous goods. The policy would provide for the following:

- (a) **Cost sharing.** The Bank may finance activities for which the borrower has demonstrated ownership and commitment by, among other things, providing funding from its own resources. The Bank judges the adequacy of this funding in the context of the borrower's overall development program, and of its funding for the sectors on which Bank assistance would focus in particular, and determines the limit on the proportion of individual project costs that may be financed by the Bank in the country. The actual proportion to be financed by the Bank in each project, within the limit for the country, may vary depending on project-specific and other considerations.
- (b) **Recurrent cost financing.** Country development programs typically require both capital investment outlays and recurrent costs, such as expenditures on salaries and operating costs. The Bank may finance recurrent expenditures. In determining whether and to what extent to finance these expenditures, the Bank considers the project's impact on fiscal and debt sustainability (including the country's commitment and ability to provide continued financing for recurrent expenditures after Bank financing is completed) at the appropriate levels, including that of the project entity or entities.
- (c) **Local cost financing.** The Bank may finance local expenditures when it is satisfied that (i) financing requirements for the development program of the country would exceed the public sector's own resources (e.g., from taxation and other revenues) and expected domestic borrowing; and (ii) the financing of

foreign expenditures alone would not enable the Bank to assist in the financing of individual projects.

- (d) **Taxes and duties.** The Bank may finance the reasonable costs of taxes and duties associated with project expenditures.
- (e) **Retroactive financing.** The Bank may finance payments made by a borrower out of its own resources before the date of the Loan Agreement under certain conditions.³²

52. **Other Types of Expenditure.** In appropriate circumstances, the Bank may finance the following types of expenditure, which are now prohibited or restricted as a matter of either policy or practice: (a) leased assets; (b) local transportation and insurance; (c) interest during construction, in addition to that payable on IBRD loans; (d) land; (e) late payment penalties; (f) charges associated with bank accounts maintained in connection with the project; (g) cash compensation and other resettlement compensation paid in cash; (h) severance pay; (i) food; and (j) secondhand goods.

53. **Special Accounts.** In countries with freely convertible currencies, the Bank may allow borrowers to open special accounts in the currency of the borrower or any freely convertible currency.

54. **Amendment to the General Conditions Applicable to Loan and Guarantee Agreements.** Section 5.08 of the General Conditions is amended to read as follows:

Except as otherwise provided in the Loan Agreement, the proceeds of the Loan may be withdrawn to pay for taxes levied by, or in the territory of, the Borrower or the Guarantor on the goods or services to be financed under the Loan, or on their importation, manufacture, procurement or supply. Financing of such taxes is subject to the Bank's policy of requiring economy and efficiency in the use of the proceeds of its loans. To that end, if the Bank shall at any time determine that the amount of any taxes levied on or in respect of any item to be financed out of the proceeds of the Loan is excessive or otherwise unreasonable, the Bank may, by notice to the Borrower, adjust the percentage for withdrawal set forth or referred to in respect of such item in the Loan Agreement as required to be consistent with such policy of the Bank.

³² The conditions under which retroactive financing is permitted would be: (a) the activities financed are included in the project description; (b) the payments are for items procured in accordance with applicable Bank procurement procedures; (c) such payments do not exceed 20 percent of the loan amount; and (d) the payments were made by the borrower not more than 12 months before the expected date of Loan Agreement signing. The date after which payments may be made is agreed at appraisal, confirmed during negotiations, and recorded in the loan agreement. In extraordinary circumstances, such as in response to emergency conditions, exceptions to these limits may be approved by the Regional Vice President in consultation with the Vice President, Operations Policy and Country Services. Proposals for retroactive financing, including any exceptions to normal limits for such financing, would be spelled out in the Project Appraisal Document (PAD).

55. ***Policy Statement and Guidance.*** If the Executive Directors approve these recommendations, Management will replace the current policy framework with a new policy to be reflected in a new operational policy statement and Bank procedures statement—OP/BP 6.00, Bank Financing—that will set out a single, unified statement of what Bank loan proceeds may be used to finance; and it will amend other sections of the Operational Manual, as appropriate. Management will put in place review processes appropriate to the risks associated with the different forms of expenditure. Management will also issue guidelines to assist staff in determining whether, to what extent, and how to finance the expenditure types addressed in this paper. Once the Bank establishes a given country's financing parameters (relating to cost sharing, recurrent cost financing, local cost financing, and taxes and duties)—that is, the Regional Vice President has approved them and notified the Executive Directors—the policy will apply to all projects appraised in that country. The policy may then be applied to other projects under preparation or implementation in that country, if the borrower so requests and the Bank agrees.

**EXPENDITURE ELIGIBILITY IN INVESTMENT LENDING:
SUMMARY OF PROPOSED CHANGES TO BANK POLICY/PRACTICE**

<i>Item and reference</i>	<i>Current policy</i>	<i>Issues</i>	<i>Proposed change in policy/practice</i>
<p>1. Cost sharing OP 6.30</p>	<p>The Bank sets cost-sharing ceilings for each borrowing country, applied to the Bank's rolling three-year investment lending program in that country. The ceiling is a function of the country's ability to mobilize domestic and foreign financial resources, and thus is based on its per capita income. For individual projects, the Bank normally expects the borrower to demonstrate commitment to the project by making a 10 percent minimum contribution to project cost net of taxes and duties (with some exceptions, such as when government finances are seriously strained).</p>	<p>In practice, the rolling three-year cost-sharing ceiling is not consistently applied, and cost sharing is largely determined at the project level.</p> <p>Counterpart funding problems delay the implementation of otherwise satisfactory projects. This is exacerbated by donors' practice of funding stand-alone projects outside country planning and budget systems.</p> <p>Bank financing levels are normally a small fraction of the country's development budget, suggesting that the country is already demonstrating commitment by bearing the great majority of its development costs.</p> <p>The objectives of securing borrower commitment and equitable cost sharing can be met at a more aggregated level.</p>	<p>The Bank supports activities for which the borrower has demonstrated ownership and commitment by, among other things, providing funding from its own resources. The Bank judges the adequacy of this funding in the context of the borrower's overall development program and its funding for the sectors on which Bank assistance would focus in particular, and determines the limit on the proportion of individual project costs that may be financed by the Bank in the country. The actual proportion to be financed by the Bank in each project, within the limit for the country, may vary depending on project-specific and other considerations.</p> <p>Staff would receive guidance in determining country and project cost-sharing arrangements.</p>
<p>2. Local cost financing OP 6.30</p>	<p>The Bank's Articles of Agreement provide that the Bank normally lends only for foreign exchange costs. The Articles allow financing of local costs in the following exceptional circumstances: (a) when the project gives rise indirectly to an increased need for foreign exchange, and (b) when the borrower cannot raise the local currency required for the purposes of the loan on reasonable terms. The Executive Directors specifically considered the limits set out by the Article provisions in 1949, 1964, and 1968, and interpreted them broadly, to permit local cost financing when the financing of foreign costs alone would not permit the Bank to assist in the financing of priority projects. OP 6.30 lists some other specific cases for local cost financing.</p>	<p>Changed conditions suggest the need to reflect the Executive Directors' interpretation in policy statement on local expenditures: (a) the evolution of global financing and foreign exchange markets, including increased convertibility of many borrowers' currencies; (b) the macroeconomic context of developing countries, with most Bank borrowers being net importers of capital and borrowing abroad to finance part of their development programs, and (c) the changes in Bank-financed projects, including social sector projects with higher local cost components and, in middle income borrowing countries, a local industrial base that can provide a substantial portion of the needs of infrastructure projects.</p> <p>Bank financing for local costs now accounts for a substantial majority of all investment lending (more than 70 percent in FY03), and policy should be adapted to reflect this reality.</p> <p>The procedures for financing local currency expenditures add administrative costs to borrowers and the Bank.</p> <p>Other MDBs have more liberal policies in this area than the Bank.</p>	<p>The Bank may finance local expenditures when it is satisfied that (a) financing requirements for the development program of the country would exceed the public sector's own resources (e.g., from taxation and other revenues) and expected domestic borrowing; and (b) the financing of foreign expenditures alone would not enable the Bank to assist in the financing of such projects.</p>

<i>Item and reference</i>	<i>Current policy</i>	<i>Issues</i>	<i>Proposed change in policy/practice</i>
<p>3. Taxes and duties</p> <p>OP 12.00 and Operational Memorandum dated June 13, 2001</p>	<p>General Conditions Applicable to Loan and Guarantee Agreements (Section 5.08) provide that the Bank does not finance customs duties or taxes imposed by the borrower (the only exception is taxes associated with consultants' fees and PIU staff salaries financed by trust funds for which the donors have agreed to finance taxes).</p>	<p>Implementation of the policy differs significantly from case to case, leading to inconsistencies in the treatment of taxes. Implementation of the policy has led to significant economic distortions and has increased the costs and complexity of project administration substantially.</p> <p>Taxes and duties are part of the normal cost structure of economic activity and of Bank-financed projects</p> <p>Borrower cost-sharing arrangements are often determined by estimated levels of taxes and duties for Bank-financed activities, rather than considerations of borrower ownership and the optimum mix of debt and government financing.</p> <p>With around 80 percent of all Bank investment lending in the period FY00 through FY02 to 60 countries that also had at least one adjustment loan in the same period, it can be argued that not financing taxes and duties in investment lending simply moves the financing requirement from one instrument to another.</p>	<p>The Bank may finance the reasonable costs of taxes and duties associated with project expenditures.</p> <p>Staff would receive guidance on determining reasonable costs of taxes and duties.</p>
<p>4. Recurrent costs</p> <p>OMS 1.21</p>	<p>Recurrent costs are eligible for financing if (a) the country has serious shortage of budget resources that makes it unlikely to be able to finance recurrent expenditures for the project; and (b) a specific recurrent expenditure is crucial to the success of the project, and Bank financing is desirable to ensure timely availability of funds. Recurrent costs are normally financed on a declining basis, and Bank financing should not exceed 25% in the final year.</p>	<p>Recurrent costs, in themselves, are not nonproductive.</p> <p>The policy bias in favor of financing capital expenditures distorts government spending toward new capital investments.</p> <p>Both infrastructure sectors and social sectors such as health and education, which are important for global development goals, have large recurrent costs. OED has noted that the financing needs of "Education for All" may require a review of donor financing policies.</p> <p>Financing of recurrent costs on a declining basis is administratively cumbersome, and it poses problems for borrowers with fiscal difficulties, especially where the timing of future economic benefits differs from projected disbursement patterns.</p> <p>Other MDBs have more liberal policies in this area than the Bank.</p>	<p>The Bank may finance recurrent expenditures. In determining whether and to what extent to finance recurrent expenditures, the Bank will consider the impact on fiscal and debt sustainability (including the country's commitment and ability to provide continued financing for recurrent expenditures after Bank financing is completed) at the appropriate levels, including that of the project entity or entities.</p> <p>Staff would receive guidance on how to take into account the impact on fiscal and debt sustainability at the appropriate levels.</p>

<i>Item and reference</i>	<i>Current policy</i>	<i>Issues</i>	<i>Proposed change in policy/practice</i>
<p>5. Land</p> <p>OP 12.00 and OP 4.12</p>	<p>OP 12.00 states that the cost of land is not eligible for Bank financing. OP 4.12 states that the Bank does not disburse against the cost of land (including compensation for land acquisition)</p>	<p>The inability to finance land acquisition can lead to long delays in project implementation and deprive the Bank of leverage in programs to support land reforms.</p> <p>Because the acquisition of land is not in itself an unproductive use of the Bank's funds, and in light of the Bank's greater engagement in the area of land reform, a pilot is currently under implementation under which the Bank may finance land in the context of community-based land reform projects.</p>	<p>Remove from OP 12.00 and OP 4.12 the policy prohibitions on financing land and cash compensation under resettlement plans.</p> <p>Staff would receive guidance on determining whether and to what extent the Bank may finance land. Management is presently reviewing the desirability of expanding the scope beyond the current pilot scheme in the light of operational needs and experience gained. Management intends to pursue a cautious approach with respect to financing land, and to continue to have all proposals to finance land reviewed by the Bankwide Land Committee.</p>
<p>6. Local transportation and insurance</p> <p>OP 12.00 and Operational Memorandum dated June 3, 2003</p>	<p>Local transportation and insurance costs are not eligible for Bank financing (except as part of foreign shipments), unless the project legal documents provide for the financing of local costs. These costs may, however, be financed when a supplier includes them in its bid for goods or works.</p>	<p>Local transportation and insurance costs are an essential part of the cost of many Bank-supported projects.</p>	<p>Clarify that financing local transportation and insurance costs is not intended to be restricted, and such costs are eligible for Bank financing.</p>
<p>7. Late payment penalties</p> <p>OP 12.00</p>	<p>Late payment penalties imposed by suppliers (unless incurred in connection with a disputed payment that has been arbitrated) are not eligible for Bank financing.</p>	<p>These costs arise regularly in the normal course of business and, when they do, they form part of project costs.</p>	<p>Remove the prohibition on financing late payment penalties imposed by suppliers.</p> <p>Staff would receive guidance on circumstances in which these costs could be financed.</p>
<p>8. Severance pay</p> <p>OP 12.00 and Operational Memorandum dated April 5, 2002</p>	<p>The Bank may finance severance pay in public enterprise reform operations that are expected to result in an increase in productivity after restructuring, with the assessment of impact on productivity set out in the project documentation. The Operational Memorandum provides guidance on carrying out economic analysis and assessing social impact, as well as on addressing risks specific to financing severance payments, such as adverse selection, overpayment, and moral hazard.</p>		<p>Severance pay would remain eligible for Bank financing. The contents of the current Operational Memorandum would be reissued as guidance to staff to assist in determining whether, to what extent, and how to finance severance pay.</p>

<i>Item and reference</i>	<i>Current policy</i>	<i>Issues</i>	<i>Proposed change in policy/practice</i>
9. Food OP 12.00 and Operational Memorandum dated May 22, 1996	Food for human consumption is not eligible for Bank financing, except under some circumstances set out in the Operational Memorandum. Bank financing is provided on declining basis.		The contents of the current Operational Memorandum would be reissued as guidance to staff to assist in determining whether, to what extent, and how to finance food expenditures. The requirement for declining disbursements would be removed in the context of agreed cost sharing arrangements at the country level.
10. Interest during construction (IDC) OP 6.60	The Bank does not finance IDC on or in connection with IDA credits or any loan made by another lender. The Bank may finance IDC from the proceeds of an IBRD loan if the beneficiary is a financially autonomous entity whose cash flow requires such financing.	IDC is necessary in some Bank-supported projects to allow a new or rehabilitated asset to be brought into productive use. The normal accounting treatment is that IDC be capitalized into the final cost of the asset to be depreciated over the asset's useful life.	Remove the policy restriction on financing IDC. Staff would receive guidance on determining whether and to what extent the Bank may finance these costs.
11. Bank charges BP 12.20	Operating charges on special accounts are eligible for Bank financing only if they are provided in the definition of incremental operating costs in the project legal agreements.	Bank charges are part of normal project costs. Bank charges associated with special accounts are, by definition, incremental, as the special account is created solely for the purpose of implementing Bank-financed projects.	Clarify that financing of charges associated with bank accounts maintained in connection with the project is not intended to be restricted, and such charges are eligible for Bank financing.
12. Retroactive financing OP 12.10	In exceptional circumstances, to facilitate the prompt execution of Bank-financed operations, the Bank allows retroactive financing of payments that do not exceed 10 percent for investment loans (20 percent for adjustment loans) of the loan amount, and made after project identification begins and within 12 months (4 months) before the expected date of loan signing.	The policy could be simplified by aligning the conditions for retroactive financing for investment and adjustment loans.	Amend policy to allow the Bank to finance payments made before the date of the Loan Agreement that do not exceed 20 percent of the loan amount, when such payments were (a) incurred in connection with activities included in the project description and associated with items procured in accordance with applicable Bank procurement procedures; and (b) made not more than 12 months before the expected date of signing of the Loan Agreement. In extraordinary circumstances, such as in response to emergency conditions, exceptions to these limits may be approved by Management. Proposals for retroactive financing, including any exceptions to normal limits for such financing, would be spelled out in the Project Appraisal Document (PAD).

<i>Item and reference</i>	<i>Current policy</i>	<i>Issues</i>	<i>Proposed change in policy/practice</i>
13. Secondhand goods OP 11.00	Procurement of secondhand goods is eligible for Bank financing only under the following circumstances: (a) there is a surplus (in suitable quantity and quality) of the type of goods required from enough sources to ensure competitive bidding, and (b) the procurement of new goods would result in excessive costs due to lack of economies of scale.		The contents of the current Operational Policy would be reissued as guidance to staff to assist in determining whether to finance secondhand goods.
14. Leased assets	There is currently no Bank policy statement on financing leased assets.	In practice, the Bank has tended to avoid financing lease payments. When it has done so, they have been treated as operating or recurrent costs, and thus financed on a declining basis.	Since leasing is a common way to finance the acquisition of capital assets, it is proposed to clarify that these costs are eligible for Bank financing. Staff would receive guidance.
15. Resettlement assistance (including cash compensation) OP 4.12	The Bank does not disburse against cash compensation and other resettlement assistance paid in cash.	Resettlement assistance (including cash compensation) is a necessary cost of projects that involve resettlement. The Bank's policy on involuntary resettlement requires that displaced persons should be provided prompt and effective compensation. The policy also indicates circumstances in which payment of cash compensation for lost assets may be appropriate.	Remove the prohibition on financing cash compensation and other resettlement assistance paid in cash.
16 Special accounts OP 12.20	Special accounts are normally maintained in a fully convertible and stable currency. The Bank may agree to a local currency special account when the country's currency is stable and fully convertible or when (a) the country's currency (even if not freely convertible) is stable, (b) the expenditures to be financed are primarily in local currency and measures satisfactory to the Bank have been taken for meeting foreign currency expenditures, and (c) the government has stated its intention of amending financial regulations or obtaining waivers that would permit future establishment of convertible accounts for Bank-financed special accounts.	The Bank's normal practice is to require that special accounts be held in foreign currency. It is estimated that over 85 percent of payments from special accounts are used to meet local currency expenditures. Holding of foreign currency accounts contravenes foreign exchange rules in several countries, and is inconsistent with Bank/IMF advice that government foreign exchange should be held by central banks. On the other hand, most central banks are rarely organized to be able to provide the retail banking services needed by implementing entities. Some countries respond by holding special accounts offshore, further undermining country foreign exchange management, and making it more difficult to ensure that the related transactions are appropriately reflected in government accounts.	In countries with freely convertible currencies, special accounts may be held in the currency of the borrower or any freely convertible currency.

EXTERNAL CONSULTATIONS

1. At the request of the Committee on Development Effectiveness, an external consultation process took place. The proposals were placed on the Bank's external website from November 21, 2003, through February 6, 2004.¹ Comments were invited from the public through a return e-mail address. The World Bank also directly invited selected organizations to provide comments, including:

- (a) Multilateral development banks (MDBs) including African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank, International Monetary Fund, and Islamic Development Bank;
- (b) Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD-DAC);
- (c) International Fund for Agricultural Development (IFAD) and the United Nations Development Program (UNDP); and
- (d) Global contractors' and consultants' federation organizations, namely the Confederation of International Contractors' Associations (CICA) and the International Federation of Consulting Engineers (FIDIC).²

2. **Summary.** Seven formal responses were received, of which two were from the contracting community and five were from donor organizations. In the aggregate, the responses indicated that contracting community is strongly supportive of the proposed changes. The donor community also expressed support and highlighted its relevance in the context of ongoing harmonization efforts. Donors highlighted the need to adequately address issues relating to implementation, including management of risks. Most of the responses also commended the World Bank for engaging in consultations.

3. **Individual Responses.** A summary of the individual responses received is provided below:

- (a) The CICA described the proposed changes as excellent. It commented that the changes were timely, well conceived, and would be welcomed by developing countries. It requested clarification that the proposed policy would allow for Bank financing of local taxes on works, bank/financial institutions' fees or charges for issuing bonds and guarantees, and late payment penalties relating to works. It highlighted the important need for financing of recurrent costs of investment projects, particularly in the context of the Bank's Infrastructure Action Plan.

¹ See <http://www.worldbank.org/eligibility/>. The document appeared in Arabic, Chinese, English, French, Portuguese, Russian, and Spanish.

² CICA represents 5 regional federations of contractor associations that represent 77 countries. FIDIC represents 65 member associations of engineering-based consulting companies that represent about 560,000 professionals.

- (b) European International Contractors (EIC) highlighted the need for Bank financing of recurrent costs in physical infrastructure projects, in support of infrastructure development using a spectrum of public-private partnerships and output-based aid.³
- (c) The Asian Development Bank commented that the paper was well argued. It supported the concept of reducing transaction costs to borrowers, and the proposed policy's relevance to harmonization. It noted the need for appropriate management of risks, particularly the maintenance of appropriate controls and assessment of fiscal sustainability. It requested clarification on some specific aspects of the proposed policy (e.g., on judging commitment on the basis of borrower funding of the country's overall development program, on the appropriateness of financing of leased assets, and on the need to consider impact on debt sustainability in the financing of local expenditure).
- (d) The EBRD noted that the proposals did not significantly vary from its current approach. EBRD's policies and practices appear to be more liberal than those of the World Bank in some of the areas covered in the paper (e.g., EBRD does not have policy restrictions on financing local expenditures or on financing of land). It however noted that EBRD focused substantially on specific projects that rely on project revenues for loan repayment; and that its sovereign operations were highly discrete, project-finance oriented, usually with high levels of capital expenditure. Due to the project-specific nature of EBRD's operations, it considered the proposed changes or the issues underlying these changes to be less relevant to EBRD in some areas. These areas include, for example, considering fiscal sustainability issues in making financing decisions; judging appropriate cost-sharing arrangements in the context of borrower funding of the country's overall development programs (rather than of individual projects); addressing the inconsistencies in the treatment of financing of taxes and duties among different instruments (since EBRD does not provide adjustment lending); and financing of recurrent costs (since EBRD is not involved in social sector projects).
- (e) The Inter-American Development Bank indicated that it was very supportive of the proposed changes, and that the World Bank's proposal had close relationship and similarity to its proposed new lending instruments and policy revisions.
- (f) The Islamic Development Bank welcomed the proposed changes in the World Bank's financing policies.
- (g) The International Fund for Agricultural Development noted the relevance of the proposed changes to the overall harmonization agenda. It agreed that there was a disconnect between expenditures that are appropriate for borrowers to incur and those that are eligible for World Bank financing. It noted the need for elaboration of operational guidance to implement the policy and to address risk identification and mitigation. It indicated the need to ensure that project ownership, borrower

³ EIC is an industry association that represents construction industry federations from 15 European countries. The revenue of international business (excluding revenue from inside the European Union) of contractors affiliated to EIC members amounts to about 45 billion Euro annually.

commitment, and sustainability are taken into account in determining expenditures eligibility (particularly on cost sharing and recurrent cost financing). It recognized the difficulties involved in administering the current policy on financing of taxes and duties and noted that financing of land could be useful in some circumstances. It highlighted the need to also consider Bank financing of equity capital.

- (h) OECD-DAC welcomed the direction of change, particularly in the context of the principles agreed at the Rome High-Level Forum on Harmonization in February 2003. It supported the greater flexibility implied in the proposals and noted the significance of these changes for the donor community more widely and for the Bank's ability to work more closely with other donors. It noted the need to factor in the risks that the changes potentially involve. It also highlighted the need for the World Bank to take further actions to fully meet the objectives of helping borrowers meet the Millennium Development Goals, and to harmonize the Bank's procedures and those of other donors to better support country capacity and reduce transaction costs.

**ELIGIBLE EXPENDITURES IN INVESTMENT LENDING:
COMPARATIVE POLICIES AND PRACTICES OF MULTILATERAL DEVELOPMENT BANKS**

<i>Item</i>	<i>World Bank</i>	<i>Asian Development Bank (AsDB)</i>	<i>African Development Bank (AfDB)</i>	<i>Inter-American Development Bank (IADB)</i>
Local currency costs	<p>The Bank normally lends only for foreign exchange costs. Financing of local costs is allowed in the following exceptional circumstances: (a) for local costs that represent indirect foreign costs that are clearly identifiable; (b) if a specific project has too little foreign exchange cost to permit achievement of project objectives by the Bank's foreign exchange financing alone; and (c) for technical assistance projects or components and local costs of goods and services procured locally.</p> <p>The following local costs are also eligible for financing: (a) ex-factory cost of items procured from local suppliers on ICB or international shopping procedures; and (b) costs of local consultants selected through a competitive procedures involving local and foreign firms.</p>	<p>AsDB primarily finances the direct and indirect foreign exchange costs of projects. Local cost financing is based on three conditions: (a) a recognition that the low levels of per capita income seriously constrains capacity to generate the domestic savings needed for development; (b) to ease balance of payments strains, by providing a portion of the external capital needed to finance the excess of domestic investment over domestic savings, and indirectly, by providing foreign exchange to meet part of the demand for imports that may be generated by the project; and (c) to achieve the Bank's strategic objectives and increase the effectiveness of the Bank's assistance by bearing a reasonable part of the cost of a project that is of a high priority on strategy considerations but has a low foreign exchange content in its cost.</p> <p>The following local costs relating to contracts procured on the basis of ICB or international shopping procedures are also eligible for financing: (a) ex-factory cost of items procured from local suppliers; and (b) the percentage of civil works contracts procured from domestic suppliers that represents direct and indirect foreign exchange costs if the contract were awarded to a foreign contractor.</p>	<p>No policy restriction on financing local currency costs. However, in practice, local currency costs are expected to be financed by the borrower's counterpart contribution, and AfDB's financing percentage for the project is determined taking this into consideration.</p>	<p>No restrictions on financing local currency costs (IADB provides financing in foreign exchange to finance a pre-established percentage of the total estimated project cost; in addition, it provides financing for local costs in local currency).</p>

<i>Item</i>	<i>World Bank</i>	<i>Asian Development Bank (AsDB)</i>	<i>African Development Bank (AfDB)</i>	<i>Inter-American Development Bank (IADB)</i>
Recurrent costs	<p>Recurrent cost financing is eligible for financing if (a) the country has serious shortage of budget resources that makes it unlikely that it can finance recurrent expenditures for the project; or (b) a specific recurrent expenditure plays a crucial role for the success of the project, and the Bank's financing is desirable to ensure timely availability of funds.</p> <p>Recurrent costs are normally financed on a declining basis, and the Bank's financing should not exceed 25% in the final year.</p>	Eligible for financing.	Same as for local currency costs.	Recurrent costs can be financed, but need to be considered on a case-by-case basis (approved by the Board). Recurrent costs are always financed on a declining schedule.
Land	Not eligible for financing.	Costs of land and rights-of-way are not eligible for financing.	Same as for local currency and recurrent costs.	Not eligible for financing.
Duties and taxes levied by borrowing country	Not eligible for financing (except for taxes associated with consultants' fees and PIU staff salaries financed by trust funds for which the donors have agreed to finance taxes).	Not eligible for financing.	Not eligible for financing.	Not eligible for financing.
Other ineligible costs	<p>Local expenditure for transportation and insurance (except as part of foreign shipments), unless the project legal documents provide for the financing of local costs. These costs may, however, be financed when a supplier includes them in its bid for goods or works.</p> <p>Late payment penalties imposed by suppliers (with some exceptions).</p> <p>Food for human consumption (with some exceptions).</p> <p>Interest during construction other than on IBRD loans in some circumstances.</p> <p>Items not required for the project.</p>	<p>Working capital other than incremental and initial working capital.</p> <p>Interest and financial charges other than those on AsDB loans.</p> <p>Expenditures not directly attributable to the project.</p>	Expenditures relating to items such as the following: alcoholic beverages; tobacco; radioactive materials; platinum, pearls, gemstones, gold, and related products; nuclear reactors and related products; arms, ammunition and other goods intended for military and/or paramilitary purposes or for luxury consumption; expenditures for environmentally hazardous goods.	Arms and military spending.

