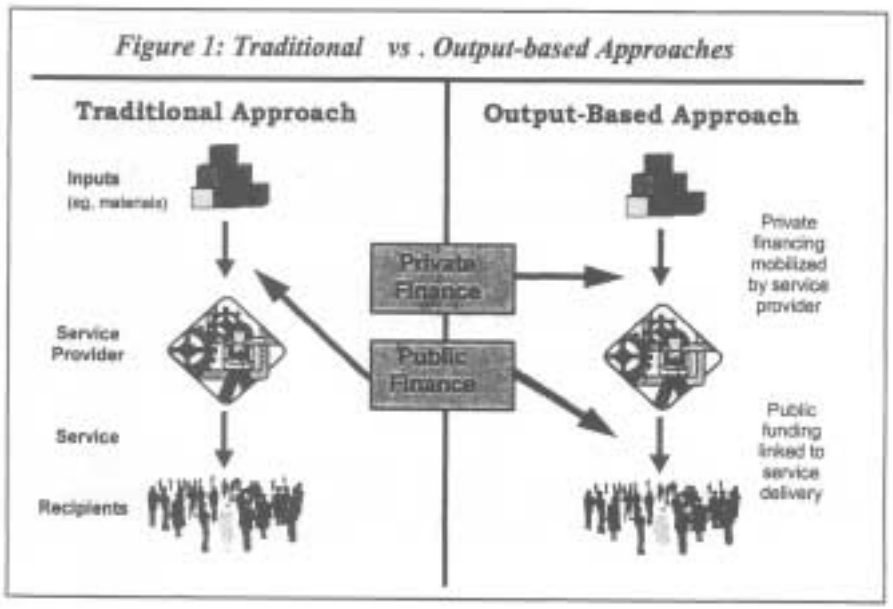
Annex IV

OUTPUT-BASED AID

Traditional approaches to providing health, education, infiastructure, and other public services channel public funding (whether sourced from domestic taxpayers or international development assistance) to the labor, materials, and other inputs consumed by state-owned monopolies, with at best indirect links between funding and the delivery of services. In the developing world especially, results have often been disappointing. Incentives for efficiency and innovation have been weak. Accountability for performance has been dismal. And opportunities for leveraging scarce public resources through private financing have been limited.

Output-based aid seeks to address these weaknesses by delegating service delivery to a third party under contracts that link payment to the outputs or results delivered (see Figure 1). It thus has the potential to improve incentives and accountability while also expanding opportunities for mobilizing private financing. The focus shifts not only from inputs to outputs, but also toward development outcomes.



Approaches of this kind have been applied to improve the delivery of a broad range of basic services in developing countries, ranging from rural telecommunications services in Peru and road maintenance in Argentina to health services in Haiti and Nicaragua and education services in Chile and Colombia. While each of these schemes reflects a common strategy, there are no standard models or blue prints and approaches need to be adapted to particular sectors and implementation environments.

Design Issues and Options

Some of the key issues that need to be addressed in designing any output-based aid scheme include:

- *What services should attract public funding or subsidies?* This requires consideration of matters such as the rationale for public financing, budget constraints and sustainability issues. In some cases, subsidies might be more appropriately directed to household connections to basic services, rather than ongoing consumption.

- *Who will be eligible to receive services that attract public funding, and how will they be targeted?* Approaches range from means-testing of individual households to reliance on proxies such as area of residence or level of usage.

- *Who will be eligible to provide the services?* This requires consideration of matters such as minimal technical qualifications. Potential providers might include the local or international private sector as well as NGOs.

- *Will services be provided in a competitive or monopolistic market?* In some cases, it may be feasible [to use voucher-type approaches] to allow eligible recipients to choose from a number of potential suppliers, while in other cases monopoly provision may be justified and the benefits of competition are tapped primarily by bidding for the right to serve the market.

- *How will key performance standards be defined?* There are many dimensions to this question, including the extent to which the standards focus on ultimate outcomes, the nature and quality of inputs utilized, or variations on these.

- *How will payment be tied to performance and structured?* Particularly when new assets to be financed to enable service delivery, an important issue will be the extent to which some proportion of the total payment may need to be paid up-front, in anticipation of delivery.

- *How should the scheme's administrative arrangements be structured?* Issues to be considered include the scope of the scheme in terms of sectors, service areas, and funding sources, as well as the allocation of various functions, including service monitoring.

While some of these issues can be complex, insights can contract award and be gained from the handling of similar issues in the context of more traditional private infrastructure arrangements.

Assessing Approaches

The design of output-based aid schemes will typically involve tradeoffs between competing objectives. Progress in applying the key principles can be measured at the level of individual schemes against several criteria:

- Targeting of development outcomes—reflected in the approach to designating eligible recipients and in the role of outcome-related performance measures.
- Accountability for results—reflected in the extent to which payment depends on achievement of the specified results.
- Incentives for efficiency-reflected in the form and extent of competition and of contract-based incentives.
- Opportunities for innovation—reflected in the balance between input-, output-, and outcome-related performance measures.
- Mobilization of private financing—reflected in the amount of private financing leveraged by the public resources.

Cost-effectiveness

Pilot schemes usually have relatively high design and implementation costs, reflecting the additional costs associated with pioneering new approaches and the small number of service recipients over which costs are nominally allocated. Follow-on or expanded schemes usually show improved cost-effectiveness by drawing on the lessons of pilots and allocating costs over a larger pool of recipients. Efforts to launch pilots and identify and disseminate lessons of experience across regions and sectors can thus yield significant benefits.

Annex V

COMMERCIAL DISCIPLINES FOR DEVELOPMENT INSTITUTIONS PROVIDING DIRECT FINANCIAL SUPPORT TO THE PRIVATE SECTOR

When a sound investment climate exists private investors will take care of the good deals that exist. Bad deals should in any case not be pursued by anybody. In such an environment there is no role for development institutions investing in projects or supporting the private sector directly. Yet, wherever the investment climate remains to be improved, it is often argued that policy measures alone will not be sufficient to elicit supply response from private firms. In addition, it is argued there may be a role for development institutions in supporting a vigorous supply response.

The risk-mitigating ability ofthe WBG

Development institutions such as the World Bank Group (WBG) may have special relationships with governments. This may allow them to reduce political risks (mainly expropriation risks including currency transfer and breach of contract) associated with investing in a country – given a particular policy environment. Private Co-financiersmay benefit from such risk mitigation ability of development institutions. De facto, such risk reduction functions help extend the rule of law and security of contracts and property rights in the world.

The special relationship between, say the WBG and a government, may not only help reduce risks of some form of expropriation, it may also help improve the policy environment itself. The government may trust the WBG and be willing to adjust policies and regulations that expand the scope for sensible private investment. In particular, the government may be willing to adjust policies, when the WBG is involved as an investor or Co-investor in a particular project. In this case policy reform can be shown to translate immediately into additional investments. Private parties would benefit from the risk mitigation role of the WBG in the project at hand, if they still fear some form of expropriation risk. The government can use this approach to enhance the credibility of its policy announcements. Such projects are typically called demonstration projects.

The lower cost of capital for the WBG

In both cases, good projects are made possible by reducing political risk. The WBG is able to reduce the political risk thanks to its special relationship. In other words it has a lower risk-adjusted cost of capital than private firms that cannot reduce such risks. But there is no argument to say that the WBG should earn less than the full cost of capital of such a project. The full cost of capital includes both the cost of borrowing and the cost of equity capital which are applied to the project.

Consider the case of IFC, the arm of the WBG that fulfills the functions outlined above. If the IFC were to invest well it would earn its own risk-adjusted cost of capital. Yet, it would only pay out returns to creditors. The shareholders of IFC, the countries that own the IFC, are willing to leave the return on equity inside the corporation as retained earnings. In fact, they provide in this way a subsidy to IFC. Yet, IFC should not use this subsidy to support projects of the type mentioned above, because these should earn their full cost of capital. Otherwise they should not have been undertaken.

The risk adjusted cost of capital of IFC is not easily determined. There are no simple market comparators that would reveal the number. Essentially, there are two ways of assessing the cost of capital for IFC. First, one can use financial theory and the closest existing market parameters to estimate the likely cost of capital. The Board of Directors of IFC would then need to decide on a number that becomes a binding return target for IFC. Alternatively, one could sell some of IFC's shares and let the market decide which return is satisfactory compensation for IFC's risks. In the latter case the governance structure of IFC could be affected significantly as private owner representatives might become Board members and the relationship between IFC and its shareholders might be affected, thus potentially undermining the trust that provides IFC with risk reduction possibilities.'

Unbundling subsidies

By ensuring that typical development projects of IFC earn their full cost of capital, the subsidy provided by the shareholders is effectively unbundled. If one wants to make the subsidy transparent it should be placed into a special grant window and be allocated to purposes that clearly deserve a subsidy.

To be able to do so IFC would need a form of internal accounting separation that separates its "cost of capital earning business" – in short its "commercial" business – from its "subsidy business". It would then need guidelines on what purposes are deserving of a subsidy. In principles subsidies might support three types of purposes. They might be used to deal with so-called externalities such as environmental or social goals. They might be used to fund public goods, such as institution-building and policy reform or they might be directed at helping the poor to deal with affordability concerns.

In any one of these cases a decision is required whether the client country itself should fund the subsidy for deserving purposes or whether IFC is justified in doing so on behalf of the taxpayers in its member countries.

Such a separation or unbundling of the subsidy from the commercial business holds potential to resolve the following issues, Some critics of IFC accuse it of providing unjustified subsidies to private firms – so-called corporate welfare, Unbundling of the subsidy can prevent such corporate welfare. IFC might also be tempted to invest systematically in substandard projects earning less than the full cost of capital. This

1 Another option would be to issue quasi-equity instruments that would allow investors to participate in IFC's profits without giving the voting rights.

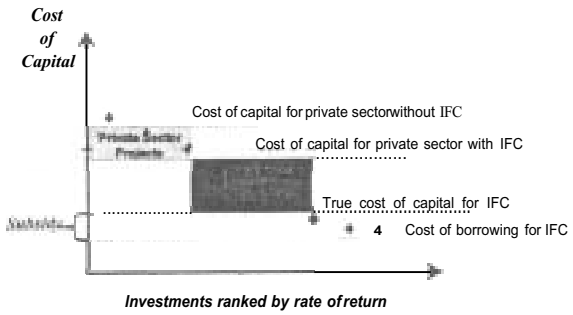
again can be prevented by imposing a meaningful target rate of return on IFC that reflects its cost of capital. Finally, the shareholders of IFC have been asking it to invest more in low income countries, so that the special subsidy embedded in IFC products benefits the poorest countries and does not substitute for government funding in middle income countries. By unbundling the subsidy it is possible to focus it on low income countries, while still providing the benefits of risk reduction and demonstration projects to middle income countries.

Imposing rate of return targets on IFC investments

Based on the foregoing reasoning IFC should be subject to a rate of return target. Such a target would help unbundle the subsidy and focus the developmental role of IFC. As in the past IFC projects should not crowd out private projects and should provide additionality, e.g. meet special environmental and social safeguards or corporate governance standards and earn a positive economic rate of return. Additionality may be supported with grant funding under an unbundled scheme if there are true reasons for subsidies and there is no normal business case for meeting special standards.

The general logic of this is summarized in Figure 1. The figure shows in simplified fashion the impact of an IFC-type organization. Without IFC there would be a high risk adjusted cost of capital for the private sector. In the figure only one project by private investors would happen, where the rate of return exceeds the cost of capital. When IFC and development institutions more broadly improve the investment climate, the risk adjusted rate of return of the private sector drops and private investors can carry out more projects by themselves. Yet, there are also some special demonstration projects, where IFC can still reduce the cost of capital below that of the private sector and these could then be partially supported by IFC without crowding out the private sector. However, no "commercial" project that earns less than the risk-adjusted cost of capital of IFC should be supported by it.

Figure 1: The cost of capital and the role of direct financial support to private firms by the IFC



Annex VI

TOOLKITS AND PRACTICAL GUIDES FOR POLICY DESIGN AND IMPLEMENTATION

A. Investment Climate Policy

A.1 Investment Promotion

MIGA Investment Promotion Toolkit: A Comprehensive Guide to FDI Promotion
Multilateral Investment Guarantee Agency
Multilateral Investment Guarantee Agency, Washington, D.C. February **2001. ISBN 0–8213-4933-3**

This toolkit offers a comprehensive compilation of international best practices in investment promotion, with the objective national and local investment intermediaries to attract and retain foreign direct investment.

Marketing a Country: Promotion as a Tool for Attracting Foreign Investment
Louis T. Wells and Alvin G. Wint
FIAS Occasional Paper No. 13. International Finance Corporation, Washington, D.C., April **2000**

This paper provides guidance on the promotional techniques and structures that countries can employ in their competition to attract foreign direct investment.

A.2 Corporate Governance

ROSC - Corporate Governance and the International Financial Architecture
http://www.worldbank.org/ifa/rosc_cg.html

The web site of the ROSC initiative (Reports on the Observance of Standards and Codes) provides updates on best practices in corporate governance, and a template which is being used as the diagnostic for corporate governance regimes in client countries.

A.3 Governance and Anti-Corruption

Step-by-step Guide to the Implementation of the New Empirical Tools for Anti-Corruption and Institutional Reform
Website of World Bank Institute's Anti-Corruption and Governance
http://www.worldbank.org/wbi/governance/guide.htm

This guide describes with concrete examples the characteristics and implementation procedures of WBI's governance and diagnostic tools.

A.4 Small and Medium Enterprise Development

SME Country Maps
SME Department
International Finance Corporation, Washington D.C.
http://www.ifc.org/sme/cm/

Drawing heavily on the operational work and knowledge of the WBG and others, the SME Department is developing SME country maps which are designed to bring together essential information about priority needs of SMEs that must be addressed in the client countries. ***They*** *highlight the four principal areas of focus of the World Bank Group's SME strategy: the business environment, access to capital, access to business development services and access to information and technology. The maps are used as a diagnosis tool, a knowledge management tool and a programming tool for policy interventions.*

A.5 *Microfinance*

Microfinance Handbook: An Institutional and Financial Perspective
Ledgerwood, J.
World Bank, Washington D.C., 1998, ISBN 0-8213-4306-8

A technical manual aimed at assisting microfinance practitioners in the design and implementation of their activities. It covers issues in microfiance provision, in designing and monitoring financial products and services, and in measuring performance and managing viability.

The website of CGAP (Consultative Group to Assist the Poorest) also provides a number of background papers on the role of the financial regulators in supporting the development of microfinance.
http://www.cgap.org/

A.6 Enterprise Surveys

The following are a series of papers and presentations that provide guidance on when and where to use an enterprise survey, how to design and implement the survey, and how to use the findings of the survey:

Business-Government Consultative Mechanisms for Market-Oriented Reform (presentation)
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/documents/consmech.ppt

FAQ On Enterprise Surveys
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/resources/faq-bea.htm

Listening to Firms: Assessing Constraints to Private Sector Development through Firm-Level Surveys
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/resources/documents/Listen_firm.pdf

Regulatory Impact Assessment With "How to" and Examples From Canada and Mexico (presentation)
Andrew Stone
Washington D.C., World Bank.

Using Firm-Level Surveys in Private Sector Assessments (presentation)
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/resources/documents/Survey_PSA.pdf

B. Contracting for Service Provision

B.1 General Guides to Contract Design and Implementation

The Case-by-Case Approach to Privatization: Techniques and Examples
Dick Welch and Olivier Frémond
World Bank Technical Paper No. 403. World Bank, Washington, D.C., March 1998.

This paper identifies the key steps for privatization, describes sale options and the processes for carrying them out, and examines special conditions. It outlines how governments should undertake case-by-case privatization by identifying basic principles and common challenges, describes various

methodsfor valuing state enterprises, and explains the role offinancial advisors.

Concessions for Infrastructure: A Guide to Their Design and Award
CelineLevesque, Michel Kerf, David Gary, Timothy Irwin & Robert Taylor
World Bank Technical Paper 399. World Bank, Washington, D.C., March 1998, ISBN 0-8213-4165-0.

This book covers key issues in the designing, awarding, implementing and monitoring of infrastructuresector concessions.

Designing Output-Based Aid Schemes: A Checklist
Warrick Smith
In, Contracting for Public Services: Output-based Aid and its Applications; edited by Penelope Brook and Suzanne Smith. World Bank, Washington, D.C., forthcoming October2001

A detailed checklist for the design and implementation of output-based aid schemes.

A Guide for Hiring and Managing Advisors for Private Participation in Infrastructure
PPIAF / World Bank, Washington, D.C., 2001

This toolkit seeks to assist governments in hiring and managing economic consultants,financial advisors and legal experts, as well as other specialist expertise needed to design and implementprivate infiastructure reforms.

Bidding for Concessions
Michael Klein
Policy Research Working Paper 1957. World Bank, Washington, D.C., August 1998

A guide to key issues in the design of bidding and rebidding processes.

Labor Redundancy, Retraining and Outplacement During Privatization
Antonio Estache, Jose Antonio Schmitt de Azevedo and Evelyn Sydenstricker
PolicyResearch Working Paper 2460. World Bank Institute, Washington, D.C., October 2000

A guide to the design of labor redundancy programs based on experience with railway privatization in Brazil.

B.2 Sector Specific Toolkits and Guidelines

Toolkits for Private Sector Participation in Water and Sanitation
Transport, Water and Urban Department, World Bank
World Bank, Washington, D.C., 1997

A set of toolkits intended to assist governments in designing and implementing private sector contracts in the water and sanitation sector. The toolkits look at how to choose a privatization option, how to hire advisers and design a transaction process, and what to look for in management, concession and BOT contracts.

Private sector participation in municipal solid waste management: Guidance Pack
Sandra Cointreau, Prasad Gopalan and Adrian Coad
SKAT, St. Gallen, Switzerland, 2000 (in collaboration with the World Bank)

A toolkit designed to assist solid waste managers and key decision makers in municipalities of low- and middle income countries to decide whether to involve private sector participation and ifso, how to do it and is based on a wide range of case studies and extensive international experience.

Port Reform Toolkit
World Bank
World Bank, Washington, D.C., 2001

The Port Reform toolkit is designed to lower the learning curve for institutional renewal by providing background information, concrete examples, specific tools and methods which policy makers and reformers require to proceed with port reforms.

Best Methods of Railway Restructuring and Privatization
Ron Kopicki and Louis S. Thompson
CFS Discussion Paper Series #111. World Bank, Washington, D.C., August 1995

A practical reference work for policy makers on the restructuring and privatization of railways – including rail enterprise reform, and the design of institutions to carry out restructuring and privatization.

Privatization and Regulation of Transport Infrastructure: Guidelines for Policymakers & Regulators
Antonio Estache and Gines de Rus (eds.)
World Bank, Washington, D.C., June 2000. ISBN 0-8213-4721-7

Covering airports, seaports, railways and toll roads, and drawing on the experience of almost two decades of restructuring and private participation in these sectors, this book provides lessons and guidance on the design of privatization reforms, and ongoing sector regulation.

A toolkit is also near completion on private participation in toll roads.

Private Sector Participation in Health Handbook
April L. Harding and Alexander S. Preker (editors)
Health, Nutrition and Population Department, The World Bank, Washington D.C.
Forthcoming in October 2001.

The handbook provides a comprehensive guide for policy-makers and health sector analysts on policies for enhancing the contributions of private health care providers, both for profit and non-profit, to health sector objectives.

C. Regulation

C.1 Regulatory System Design

Utility Regulators—Decision Making Structures, Resources, and Start-up Strategy
Warrick Smith
Viewpoint 129. World Bank, Washington, D.C., October 1997

This paper provides guidance on three issues in the design of a regulatory agency.. decision-making structures (including the number of decision makers, the basis for selecting them, the role played by stakeholders, and the regulatory and appeals processes) resources (including human resources, funding), and start-up strategy.

Utility Regulators—The Independence Debate
Warrick Smith
Viewpoint 127. World Bank, Washington, D.C., September 1997

This paper explains the requirements for establishing independent regulatory agencies, including formal safeguards, and suggests possible paths of transition for setting up such agencies.

Utility Regulators-Roles and Responsibilities
Warrick Smith
Viewpoint 128. World Bank, Washington, D.C., September 1997

This paper sets out three main issues in defining a utility regulator's role: the scope of its coverage, its role in relation to ministers, and its role in relation to other regulatory entities such as the competition agency or agencies dealing with environment or health and safety.

Regulating Utilities—Thinking About Location Questions
Warrick Smith
World Bank Summer Workshop on Market Institutions. Mimeo, World Bank, Washington, D.C., July 2000

This paper covers issues relating to the location of regulatory authorities within a country's institutional framework. Specifically the author addresses two questions: (i) which tier of government should have responsibility for regulating utilities (ii) should regulatory agencies be created on an industry-specific or broader basis.

C.2 Regulatory Rules and Their Implementation

Resetting Price Controls for Privatized Utilities: A Manual for Regulators
Richard Green and Martin Rodriguez-Pardina
World Bank, Washington D.C., March 1999. ISBN 0-8213-4338-6

This manual describes the task that an economic regulator should undertake when revising price control for a regulated company, and provides practical guidance for new regulators on the implementation of these tasks.

Telecommunications Regulation Handbook
Hank Intven, Jeremy Oliver, Edgardo Sepulveda
InfoDev. World Bank, Washington, D.C., November 2000

The authors describe major regulatory practices in telecommunications sectors around the world. The focus of the Handbook is on practices that promote the efficient supply of telecommunications services in a competitive marketplace.

Information, Accounting, and the Regulation of Concessioned Infrastructure Monopolies
Phil Bums and Antonio Estache
Policy Research Working Paper 2034. World Bank Institute, Washington, D.C., December 1998

Information that private operators of infiastructure monopolies provide regulators can and should be used to address technical issues and monitor performance. The authors examine the ways such information can and should be generated, especially through the accounting requirements a regulator can impose on private operators of infrastructure concessions.

D. Service Access for the Poor

Energy and Development Report 2000: Energy Services for the World's Poor
ESMAP, World Bank
World Bank, Washington, D.C., 2000

This report focuses on energy and poverty alleviation. The report considers the challenge of expanding access for low-income households and communities in developing countries, and looks at how to use market structure and regulatory reform to facilitate technological and commercial innovations in serving the poor.

Extending Telecommunications Beyond the Market: Toward Universal Service in Competitive Environments
Bjorn Wellenius
Viewpoint 206. World Bank, Washington, D.C., March 2000

Competitive markets go a long way toward making telecommunications services available throughout the population. But governments often seek to extend access to services beyond what the private sector will provide on its own. This paper outlines options and best practices for service expansion policies in developing countries.

Designing Output-Based Aid Schemes: A Checklist
Warrick Smith
In, Contracting for Public Services: Output-based Aid and its Applications; edited by Penelope Brook and Suzanne Smith. World Bank, Washington, D.C., forthcoming October 2001

A detailed checklist for the design and implementation of output-based aid schemes.

Infrastructure for Development: Private Solutions and the Poor
http://www.ppiaf.org/conference/presentations.html

This web site gathers papers and presentations from a PPIAF/DfID/World Bank funded conference held in May/June 2000, focusing on policy and practical issues in expanding services to the poor through private sector participation in infrastructure.

Papers include:

Impact of Market Structure on Service Options for the Poor
David Ehrhardt

Improving choice is key to improving services. This paper looks at how pro-competitive reform of existing networks and liberalization of entry by new service providers can improve the services available to low-income households.

Regulating Infrastructure for the Poor: Perspectives on Regulatory System Design
WarrickSmith

The design of regulatory systems in developing countries draws heavily on developed country models and experience. This paper looks at how regulatory rules, agencies and processes might need to be designed to address the needs of the poor in developing countries.

Measuring the Impact of Energy Intervention on the Poor - an Illustration from Guatemala
Vivien Foster

To date, very few infrastructure reforms have included systematic efforts to assess the impact of reform on access to services by the poor. This paper looks at options for building impact indicators into reform projects at an early stage, using sample indicators from the energy sector in Guatemala.

Utility Privatization and the Needs of Poor in Latin America: Have We Learned Enough to Get it Right
Antonio Estache, Andrés Gomez-Lobo & Danny Leipziger

Efforts to reform utilities can affect poor households in varied, often complex, ways. This paper looks at how governments can improve the chances that poor households will benefit from reform – in particular by promoting competition, and adopting responsible redistribution policies.

Annex VII

ENVIRONMENTAL AND SOCIAL SAFEGUARD POLICIES OF THE WORLD BANK GROUP

Environmental Assessment, OP4.01, January 1999

Natural Habitats, OP4.04, June 2001

Pest Management, OP4.09, December 1998

Forestry, OP4.36, September 1993

Safety of Dams, OP4.37, September 1996

International Waterways, OP7.50, June 2001

Indigenous Peoples, OD4.20, September 1991

Involuntary Settlement, OD4.30, June 1990

Cultural Property, OP4.11, August 1999

Projects in Disputed Areas, OP7.60, June 2001

Child and Forced Labor, Policy Statement, March 1998