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FAST TRACK BRIEF

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The IEG report "The World Bank's Country Policy and Institutional Assessment," was discussed by CODE on June 30, 2009

The World Bank's Country Policy and Institutional Assessment — an Evaluation

- **The World Bank's Country Policy and Institutional Assessment (CPIA) assesses the conduciveness of a country's policy and institutional framework to poverty reduction, sustainable growth, and the effective use of development assistance. It plays an important role in the country performance ratings that have been used for allocating resources from the International Development Association (IDA) to eligible countries since 1980.**
- **The CPIA consists of 16 criteria grouped into four clusters—economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions—weighted equally to derive the overall CPIA rating. Since the beginning of FY09, IDA has made transparent the weights of the clusters used in the IDA allocation formula—24 percent on the first three CPIA clusters combined and 68 percent on the fourth (governance) cluster (with the remaining 8 percent weighted on portfolio performance). In other words, the governance cluster has eight and a half times the weight of each of the other three clusters in the formula. This has also made transparent the weak link between the overall CPIA index and IDA allocations, with a country's governance performance (particularly relative to its performance in the other clusters) being more important in the latter.**
- **The content of the CPIA broadly reflects the determinants of growth and poverty reduction identified in the economics literature, but some criteria need to be revised and streamlined and one criterion added. The literature offers no evidence to justify any particular set of weights on the four clusters used for IDA allocation, or the way the criteria are clustered (such as having social sectors and environment in one cluster). The literature offers only mixed evidence regarding the relevance of the content of the CPIA for aid effectiveness broadly defined—that is, that it represents the policies and institutions important for aid to lead to growth. However, the CPIA is associated with aid effectiveness defined more narrowly—the better performance of Bank loans. But there is insufficient evidence to conclude that the most heavily weighted CPIA cluster associates better with loan performance than the other three clusters.**
- **The CPIA ratings are in general reliable and correlate well with similar indicators, but it is difficult to establish an empirical link between the CPIA and growth outcomes. Having Network reviewers validate ratings helps guard against potential biases in having Bank staff rate countries on which their work programs depend. The CPIA ratings correlate better with similar indicators for IBRD than for IDA countries. This could in part be because more information is available on IBRD countries, and in part because the CPIA ratings are meant to take into account the stage of**

development, which is more pertinent for IDA countries, and which means ratings for these countries are more subject to judgment than those for IBRD countries. This is exacerbated by the different practices with respect to accounting for the stage of development, as none of the Regional reviewers of the CPIA do this, while Network reviewers vary in their practices.

- **IEG makes four recommendations. First, disclose the ratings for IBRD countries in the interest of accountability and transparency. Second, remove accounting for the stage of development in the rating exercise to reduce subjectivity. Third, undertake a thorough review of the adequacy of each criterion, including a review of experience and the literature, and revise as necessary, based inter alia on the findings of this evaluation. Fourth, consider not producing an overall CPIA index while continuing to produce and publish the separate CPIA components.**

Overview

This evaluation takes the premise that beyond informing IDA allocation, the CPIA is useful as a broad indicator of development effectiveness. It reviews the appropriateness of the CPIA as an indicator that assesses the conduciveness of a country's policies and institutions to fostering poverty reduction, sustainable growth, and the effective use of development assistance. It assesses the relevance of the content of the CPIA through a review of the economics literature. It also assesses the reliability of CPIA ratings in two ways—through comparing CPIA ratings with similar indicators, and through reviewing the CPIA ratings generation process. Based on these assessments, the evaluation derives recommendations for enhancing the CPIA.

Relevance of CPIA

The contents of the CPIA are largely relevant for growth and poverty reduction. The CPIA criteria map well with the determinants—policies and institutions—of growth and poverty reduction identified in the literature, although some criteria can usefully be revised and streamlined and one can be added (see recommendations).

The evidence is mixed regarding the relevance of the content of the CPIA for aid effectiveness as defined (broadly) in the literature. The review of the literature indicates there is little consensus on the impact of aid on growth itself and on the conditions under which aid can have a positive impact on growth.

However, the CPIA is associated with aid effectiveness in a narrower sense—that is, the performance of World Bank loans. Empirical analysis finds that the overall CPIA ratings are negatively associated with the share of problem loans that in turn is correlated with loan outcomes.

Empirical analysis indicates there is insufficient evidence to conclude that the governance cluster associates better with loan performance than the other clusters. Based on this finding, as well as the lack of consensus in the literature on the conditions under which aid has an impact on growth, it can be surmised that the way the CPIA enters the formula for the allocation of IDA funds is driven much more by fiduciary and possibly other concerns of donors than by the objectives of achieving sustained growth and poverty reduction.

The CPIA strives to allow for country specificity—that different sets of policies and institutions can achieve similar outcomes—but there are some pitfalls. The CPIA instructions to staff indicate that outcomes should be taken into account when assessing policies and institutions, which helps to account for country specificity. Indeed, outcome indicators are included in the assessment of some criteria; they could also be added to other criteria, in particular trade.

The trade criterion does not adequately allow for country specificity. The specification of particular tariff rates for different ratings reflects a one-size-fit-all approach to trade liberalization that is not supported by country experience. Including export performance (an outcome indicator) in the assessment would help to allow for country specificity.

The trade criterion also does not reflect the importance of complementary institutions for successful liberalization. The two-thirds weight on trade restrictiveness and one-third weight on trade facilitation is not supported by country experience that shows that at moderate tariff levels (which practically all countries currently have), complementary factors (macroeconomic stability and trade facilitation) are more important than further tariff reduction to promote integration into the global economy.

The CPIA is missing an assessment on disadvantaged socioeconomic groups other than gender. Currently, only gender is being assessed with respect to equality, yet country evidence indicates that social exclusion of other marginalized groups could have severe poverty and growth implications.

Important linkages among certain criteria are not reflected in the CPIA. Except for the three *economic management* criteria, all the CPIA criteria are assessed independently, which could be problematic in two instances. First, the assessment of trade liberalization needs to take into

account the extent of intersectoral labor mobility because the former in the absence of the latter could exacerbate poverty. Second, fiscal policy needs to be assessed in conjunction with the quality of budgetary and financial management to ensure that the fiscal condition of the country in its entirety is realistically captured.

Reliability of CPIA Ratings

The Bank has made efforts over time to improve the definition of the CPIA rating scale to enhance the reliability of the ratings. These efforts have aimed to reduce staff discretion in providing ratings.

The CPIA ratings correlate well with similar indicators in terms of relative rankings of countries and direction of change. For each of the 16 criteria, the rank correlation coefficients of CPIA ratings with similar indicators average between 0.7 and 0.8. Other indicators correlate better with the Bank's CPIA ratings than with those of the African Development Bank and the Asian Development Bank, the closest comparators to the Bank as they use almost exactly the same CPIA guidelines.

CPIA ratings correlate better with similar indicators for IBRD than IDA countries. This could be due in part to the greater amount of information available on IBRD than IDA countries, which increases the likelihood of different institutions having similar assessments on IBRD countries. It could also be due in part to the fact that the CPIA rating exercise takes into account the stage of development (introduced since 2004). This is more pertinent for IDA countries, and hence would subject ratings of those countries to more judgment in an exercise that is already centered on staff judgment.

Accounting for the stage of development in the CPIA ratings is problematic. In addition to the judgment involved, accounting for the stage of development is also problematic because of the different practices adopted across the Bank. Regional reviewers do not take this into account, while Network reviewers vary in their practices. Further, accounting for the stage of development means that the CPIA is no longer an index in the true sense of the word.

The review process for the CPIA, which gives the Networks responsibility for validating the ratings, helps to guard against potential biases in ratings, although there are exceptions. A major advantage of the CPIA exercise is having well-informed staff's professional judgment as the central determinant of the ratings. At the same time, however, having staff rate the countries on which their work programs depend could lead to rating biases. Analysis of the 2007 review process indicates that for instances where the Networks challenged the Regions' initial proposals of a rating increase from 2006, the Networks prevailed 73 percent of the time for IDA countries (they prevailed more often—86 percent of the time—for IBRD countries). However, these instances made up only 6 percent of the ratings for IDA countries and 5 percent of the ratings for IBRD countries; hence, there does not seem to be a strong upward bias in ratings for either group of countries.

Recommendations

Based on its findings, IEG has derived recommendations to enhance the CPIA as an indicator of policies and institutions that are important for growth, poverty reduction (or welfare more broadly), and the effective use of development assistance.

Adoption of these recommendations could result in a discontinuity in the CPIA ratings, which Bank management has been trying to avoid. However, it is important that the CPIA reflect the latest thinking in development as well as lessons learned (both of which are intentions stated by the Bank). It would also provide the opportunity to address an issue that some Network reviewers have raised regarding the quality of the ratings for some criteria because of what they perceive as inflated baseline ratings from a few years ago. The recommendations are as follows.

First, disclose the ratings for IBRD countries. Disclosure is important for accountability and transparency and would further enhance the quality of the ratings.

Second, remove accounting for the stage of development from the CPIA exercise. If this cannot be done, at the very least it is important to clarify and justify in the guidelines which criteria should take into account the stage of development and how the adjustments should be made.

Third, undertake a thorough review of the CPIA and revise the criteria as necessary. It is recommended that the review entail an in-depth literature review for each criterion and reflect the latest thinking on development and lessons learned. The criteria should reflect an appropriate balance between liberalization and regulation. The review should also examine whether the clustering of criteria is appropriate. In particular, it will examine the appropriateness of clustering the social sectors together with the environment, which limits the emphasis accorded to these aspects. Guideposts for assessing the criteria need to be reviewed at the same time. It is also recommended that the following be taken into account in the review and revisions:

- Revision of the *trade* criterion to include a subcomponent on exports that evaluates performance as well as policies and institutions to reduce anti-export bias. This sub-component and those on trade restrictiveness and trade facilitation

should all get equal weights. The trade restrictiveness sub-component should be revised to reflect country experience that at moderate levels of tariffs (which almost all countries have), further reduction is less important than complementary factors for global integration.

- Dropping or reformulating the criterion on *equity of public resource use*, as much of its content is already covered by other CPIA criteria (property rights, access to education and to credit, income transfers) or information is lacking for an adequate assessment (the progressivity or regressivity of taxes).
- Addition of an assessment of other disadvantaged socioeconomic groups to the CPIA. This could either replace the criterion on *equity of public resource use* or be added to that criterion if it were to be reformulated.
- Revision of the *financial sector* criterion. This needs to entail: (a) revision of the weights for the three subcomponents—stability, depth and efficiency, and access—in light of the importance of financial stability as reflected by recent global evidence, and the mixed evidence on the importance of micro finance; (b) adding assessment of policies, regulations, and institutions for fostering an enabling environment for the financial sector taking into account lessons learned, notably from the current crisis; and (c) strengthening the assessment of financial stability.
- Combining the assessment of tax policy with fiscal policy.
- Streamlining the assessment of judicial independence and the assessment of corruption in the *public sector management and institutions* cluster, as they are currently assessed in more than one criterion in the cluster.
- Strengthening the assessment of the *environment* criterion while making the process more efficient—currently, staff need to answer 85 questions even though there is only one rating.
- Reporting only one consolidated rating for the three *economic management* criteria to avoid confusion.

Fourth, consider not producing an overall CPIA index while continuing to produce and publish the separate CPIA components. The overall CPIA index is not used as such for the allocation of IDA funds. With respect to the broader use of the CPIA as an index of policies and institutions, country specificity implies that the appropriate weights of the different clusters could be different depending on a country's initial conditions and stage of development. Producing the different components of the CPIA without assigning weights to them to arrive at an aggregate index would allow for different weights to be applied according to country contexts and use.

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