

# »»» Materials on Development Finance

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Author: Stefanie Peters / Editors: Friederike Bauer, Thomas Pummer

## Policy-based financing – results of an interim evaluation

**The PBF promotional approach repeatedly draws criticism: too little control, too little influence, too high a risk. Wrongly, as a recent interim evaluation from Tunisia also shows.**

Policy-based financing (PBF) (or in the case of lending also policy-based lending (PBL)) is still a relatively new promotional approach in German development cooperation. The intention is to promote (sector) policy reforms that improve the framework conditions for sustainable development in partner countries.

The recent interim evaluation of this kind of PBF for the water sector in Tunisia also indicates just how effective this approach can be. It has shown that the promotional approach can support important reforms in a sector, provided that specific conditions are met. If this is the case, PBF is an effective and lean means of initiating lasting changes in partner countries. In this sense, PBL has proven to be an effective instrument in Tunisia.

### The difference compared to other instruments

In an international context, roughly speaking, we can draw a distinction between three essential development financing categories:

- **Project or investment finance:** These are used to produce or purchase specific items or services. These could be power plants, hospitals, or vaccination campaigns.
- **Result-based financing:** This is not used for direct financing of

expenses, but instead a “price” is paid only for achieved results, for example a certain amount for each kilometre of completed road or for one kilowatt hour of electricity from sustainable energy production.

- **Policy-based financing:** Here, payments are not linked to specific goods, services or results, but to the development and implementation of (sector) policy reforms, such as for the national energy transition or changes in the water sector.

Policy-based financing is used by many multilateral and some large bilateral development banks — in German development cooperation at KfW.

The key elements of PBL projects are (sectoral) policy reform programmes, which are launched by the partner governments and carried out with donor support. The aim is to promote sustainable development in the partner country by reducing or eliminating structural barriers to development. The initial reform idea is developed in close dialogue between partner and donor countries and is generally implemented in several phases.

The partner country always takes the lead. The donors provide support with content-related input and financing. The most important reform steps and their implementation schedules are recorded in a policy matrix with their own clearly defined indicators and milestones.

In essence, PBF projects therefore consist of the following elements:

- policy dialogue on equal terms;

- technical support in the design and implementation of reforms;
- provision of funding to implement these reforms.

### Scepticism towards PBF

Policy-based financing sometimes faces scepticism because funds flow directly into the partner country's budget. Some consider them to be susceptible to misuse and insufficiently effective with respect to the objective to be achieved. Critics say that donors have no control over the use of their funds, and money flows into a large pot without ultimately clearly identifying how it is or was used.

The example of Tunisia shows that this blanket criticism is unjustified. Rather, it depends on how the relevant policy-based financing is designed. In this case, it consisted of a promotional loan for reforming the water sector over three phases, two of which have already been completed – which is why it is currently only an interim evaluation. This specifically examined the extent to which the promotional loan for reform influenced the Tunisian water sector and supported public institutions. General conclusions for the instrument can also be derived from this with appropriate caution.

### Political background

Tunisia is a strategic partner for the German Federal Government in Africa, both in terms of stronger economic cooperation and with regard to securing peace and stability in the North African region. The movement known as the Arab Spring began in Tunisia in

2011/2012. Hopes for a process of liberalisation and democratisation were high, but have not yet been fully met. The country is at a crossroads due to internal power struggles and a slackening economy, not least owing to the coronavirus pandemic and the Ukraine conflict. This makes it all the more important from a German perspective to drive forward economic development and strengthen democratic forces.

### Importance of the sector

The water sector is extremely important for stabilising the country: Tunisia is one of the most arid countries in the world. At the same time, it is highly economically dependent on agriculture and therefore also on secure irrigation options.

When the project for the promotional loan for reform was appraised in 2017, Tunisia's water sector was in a critical phase with regard to the administration and management of water resources. Reforms were necessary and overdue.

The programme, for which a loan agreement was signed in the second half of 2017, was intended to promote corresponding changes in the water sector in order to ensure or establish security of supply in the country. Secondly, its intent was to contribute to stabilising public finances and overcoming a short-term liquidity shortage. The loan was designed as a programme with three phases and a total volume of EUR 300 million (market funds provided by KfW at favourable conditions). Phase one and two with EUR 100 million each were disbursed in 2018 and 2020. Phase three is still pending.

### Project design

For each phase, reform matrices with agreed measures were developed together with relevant stakeholders in the dialogue on policy, the implementation of which was then jointly monitored. Funds were only disbursed once the reform objectives and indicators agreed for each phase had been achieved (if the milestones were not met, the transfers would not have been made).

In phase one, the matrix included ten key reform and modernisation measures, two in the macroeconomic context, eight in the water sector. These included, for example, a decree for a new waste water standard and for higher waste water fees as well as the further training of those responsible for the water programme.



Sidi Saad dam in Tunisia. Photo: KfW image archive / Jonas Wresch.

Phase two included 13 reform measures, all of which concerned the water sector. These included the increase in drinking water fees, a study on the water situation in Tunisia in 2050, the introduction of a new water code in parliament and the creation of promotional districts for special-purpose hydropower associations. On the one hand, the agreed measures were tailored to the needs of the partner country and, on the other hand, to the portfolio of German development cooperation.

### Evaluation in detail

With regard to the OECD-DAC criteria, the interim evaluation concluded that:

**Relevance:** The instrument of policy-based financing is particularly well suited to addressing major development bottlenecks. In the case of Tunisia, reforms to manage the extremely scarce water resources more efficiently are undoubtedly of paramount importance for the country's further development.

**Coherence:** Supported political reform programmes must fit in well with the overarching development strategies of the partner countries, but also with German and

international development cooperation. This has been very successful in Tunisia thanks to the intensive policy dialogue with many stakeholders in the partner country (and also in the donor group).

**Effectiveness:** This has to do with the question of how consistently the reforms developed in the policy dialogue are also implemented in practice. For Tunisia, it can be stated that the reforms developed in phases one and two were implemented as planned and are having sector-wide effects, among other things, not least as a result of the tariff increases achieved.

**Efficiency:** PBF's efficiency is based on its systemic approach. The policy dialogue was streamlined, the technical support was needs-oriented and the provision of financing was appropriate. It was possible to implement the policy reform measures in Tunisia as part of the PBF within a short time window (within the context of local political conditions) of less than three years.

**Impact:** The crucial aspect is ultimately whether the reforms will also lead to actual tangible improvements for the population. As the reform programme in Tunisia has not yet been completed, no definitive statements can yet be made in this regard, but the available evidence indicates that the verdict may be positive in the end.

**Sustainability:** The same applies to reform programmes and investments: the expected impacts should be "sustainable" if possible, i.e. not simply be a "flash in the pan", and they should not be reversed under the next government. Although the broad stakeholder consultations have contributed to safeguarding the reforms politically, no final verdict is possible here either due to the current political volatility in Tunisia.



Olive cultivation in Tunisia, which depends on appropriate irrigation. Photo: KfW image archive / Jonas Wresch

### Overall rating

The overall assessment of the promotional loan for reforms is positive. The rationale states: “The water sector is of great social and strategic importance for Tunisia. The Tunisian government’s assumption of ownership of reform and financial needs served as the basis for the promotional loan for reforms. All milestones, i.e. the reform steps to be achieved as a prerequisite for disbursement and the outputs, were met or achieved and are rated positively.”

In addition, the evaluation came to conclusions that are of general importance for the handling and success of PBF:

- Programme objectives and measures must work together systematically and the policy matrix must be adapted accordingly.
- Policy dialogue is promoted when a PBF is based on national development plans and strategies.
- A PBF can fulfil its purpose, particularly if it encounters a partner willing to reform (and a solvent partner when granting loans).
- A PBF can generate appeal: in Tunisia, the loan in the water sector was a forerunner for further reform financing from other donors.

### Role of PBF in the context of development policy

The PBF instrument is highly politically relevant because work on reforms targets the core of development. It addresses structural causes instead of combating symptoms. Accordingly, the PBF promotional approach represents an

important expansion of the support offered by Germany.

The central (broad-based) impact of reform financing is not primarily due to the use of the funds provided, but rather to the improvement in key framework conditions for sustainable sector development resulting from the reforms (which are often difficult to influence via individual projects).

As a rule, PBF is used where there is long-standing sectoral expertise on the donor side. PBF thus enables important synergies in conjunction with the respective bilateral investment portfolio. PBF is thus usefully supplementing German involvement in individual projects and better safeguarding its sustainability. This also applies to the water sector in Tunisia as a whole, in which KfW has traditionally been involved for many years.

### Conclusion

The example of Tunisia shows that PBF is a useful part of German development cooperation’s toolbox when it comes to reforms and structural changes in a sector and country. In addition to the fundamental willingness on the partner side to undertake reforms, clearly defined reforms and objectives, as well as concrete measures and indicators thereunder (i.e. a solid policy matrix), are decisive for its effectiveness. In this respect, reform financing in the Tunisian water sector can certainly be regarded as “good practice”.

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#### KfW Group

Palmengartenstrasse 5–9  
60325 Frankfurt am Main, Germany

Tel. +49 69 7431-9906  
[Stefanie.Peters@kfw.de](mailto:Stefanie.Peters@kfw.de)  
[www.kfw.de](http://www.kfw.de)