

ASIAN DEVELOPMENT BANK

**REVIEW OF THE ASIAN DEVELOPMENT BANK'S POLICY ON THE
PERFORMANCE-BASED ALLOCATION OF ASIAN DEVELOPMENT FUND
RESOURCES**

November 2004

ABBREVIATIONS

ADB	—	Asian Development Bank
ADF	—	Asian Development Fund
AfDF	—	African Development Fund
ARPP	—	<i>Annual Review of Portfolio Performance</i>
CPA	—	country performance assessment
CPIA	—	country policy and institutional assessment
CSPU	—	country strategy and program update
DMC	—	developing member country
IDA	—	International Development Association
PBA	—	performance-based allocation
PDMC	—	Pacific developing member country
SPD	—	Strategy and Policy Department

CONTENTS

	Page
EXECUTIVE SUMMARY	i
I. INTRODUCTION	1
II. THE PERFORMANCE-BASED ALLOCATION POLICY	1
A. Objectives, Principles, and Scope of the Policy	1
B. Policy Impact	5
C. Uses of Asian Development Fund VIII Resources	11
D. Implementation	13
III. LESSONS, ISSUES, AND DIRECTIONS	14
A. Measuring Country Performance	14
B. Balancing Objectives	18
C. Implementing the Policy	21
IV. ENHANCEMENTS TO THE POLICY	22
A. Principles to Guide Revisions	22
B. Country Performance Criteria	22
C. Country Ratings	24
D. Proposed Allocation Formula	25
E. Extra-Formula Allocations	26
F. Disclosure	29
G. Monitoring the Policy	30
H. Summary	30
V. IMPLEMENTATION	31
A. PBA Focal Point	31
B. Country Performance Assessments	32
C. The Allocation Process	33
D. Interim Arrangements	34
RECOMMENDATION	37
APPENDIXES	
1 Asian Development Fund Approvals Prior to Performance-Based Allocation	38
2 The Revised Country Performance Assessment System and Allocation Formula	40
3 The International Development Association's Approach to Allocating Resources to Postconflict Countries	43

EXECUTIVE SUMMARY

In a context where the link between Asian Development Fund (ADF) allocations and performance had not been transparent or concerted, in March 2001, the Asian Development Bank's (ADB's) Board approved the Policy for the Performance-Based Allocation of ADF Resources. The new approach explicitly recognized that in seeking to reduce poverty, ADF concessionary resources would be best directed to good performers. In doing so, the policy sought to create incentives for improved performance. Beyond the performance measurement and allocation framework, the policy provided management with an important tool to strengthen development effectiveness through more focused policy dialogue, better country planning processes, and improved operations.

The review of the policy and the associated proposals are based on extensive discussions with donor shareholders' and borrowers' representatives that took place during the ADF IX replenishment process. The review also draws on parallel developments in other multilateral development banks, particularly the International Development Association (IDA).

The policy has led to more resources being allocated to better performing countries. Even though the link between performance and allocation is not as strong as the policy anticipated (and is less evident for Pacific developing member countries), no link was discernable before the policy was introduced. However, for given performance, PBA outcomes have not favored lower-income countries as they should have. While less populous countries have received larger per capita allocations than more populous countries, compared with historical allocations, the share of larger countries in ADF has increased.

Adjustments to formula allocations intended to attenuate "abrupt" or "sharp" changes in lending volumes have had an important influence on outcomes. Although these adjustments have been consistent with the provisions of the policy, they have created entitlements based on historical allocations and, as such, detract from the performance characteristics of the system.

Resources allocated outside the formula have been sizable, ranging from 15% to 25% of total ADF resources. These "set-asides" have been dominated by allocations to support postconflict reconstruction and peace in Afghanistan and, to a lesser extent, selected projects in Indonesia. About 5% of ADF resources have also been earmarked to support subregional projects. Although the ADF VIII Donors' Report endorses support for subregional projects, the policy provides no guidance on project eligibility.

Assessments of country-specific performance criteria ("triggers") have had only a modest impact on allocations, but borrowers and ADB have incurred significant costs in implementing them. Triggers have also presented funding challenges. On balance, assessments have favored higher lending scenarios. As no additional resources have been available to fund higher lending volumes, reduced allocations for countries that met baseline requirements were required to remain within the ADF resource envelope.

Operations departments have been responsible for country performance assessments and for allocation decisions. Although a good deal has been achieved, there have been a variety of implementation challenges. In particular, PBA activities have not always dovetailed well with country programming.

A number of factors have complicated communication with country authorities. Most important, demands that were unanticipated at the time of the ADF VIII replenishment have

squeezed resources available for other country programs. Consequently, strong and improved performance has not always attracted more resources.

Enhancements proposed by the review reflect stakeholders' interests in a strengthened policy and both reflect and contribute to an emerging international consensus on ways to promote and invest in better performance in low-income countries and strengthen accountability for the use of scarce concessional resources. Enhancements seek to (i) improve country performance assessments, (ii) elevate the role of governance, (iii) strengthen the link between performance and allocation, (iv) sharpen ADF's focus on small countries, (v) clarify criteria for extra-formula allocations, (vi) deepen client involvement, (vii) improve transparency and accountability, and (viii) reduce costs.

To help improve the quality of country performance assessments, the review proposes alignment with World Bank performance criteria and use of World Bank performance assessment guidelines. The advantages of alignment outweigh any benefits of customization. The credibility of PBA and of ADB's engagement with ADF clients will, however, continue to depend on the independence and full ownership of ratings by ADB. Strengthened processes for client consultation, ratings review, and accreditation are proposed. Public disclosure of numerical ratings from 2005 will also enhance transparency.

The review proposes that the weight of governance in the measurement of country performance be raised from 30% to 50%. This will give governance a more central role in the allocation process. However, the review concludes that the application of IDA's governance factor would be highly nontransparent, and proposes an alternative allocation model.

To strengthen the link between performance and allocation and incentives for better performance, the review proposes that the allocation formula be recalibrated so that changes in performance exercise a more powerful impact on allocations. For the largest ADF borrower, a 10% improvement in performance would attract a 13% increase in allocation under the current policy. For an identical improvement, the smallest borrower would be rewarded with about an 18% increase in allocation. For a 10% improvement in performance, the allocation formula proposed by the review would increase allocations for the largest ADF borrower by 30% and for the smallest borrower by nearly 45%.

Although small countries have performed broadly on a par with larger countries, their shares in ADF have declined during the ADF VIII period. Less populous countries have been losing resources because the policy's small country bias is not as pronounced as the bias in historical allocations. The review proposes recalibrating the population weight to arrest the drift of resources to larger countries. The strengthened performance characteristics of the allocation model will ensure that allocations are increased only for small countries that are performing satisfactorily.

Determining allocations for special needs is not possible on a formula basis. Such decisions are best made case-by-case. Even so, the policy must provide clear guidance on circumstances that would warrant ADF support and provide criteria for determining suitable allocations. Proposed revisions to the policy provide eligibility and allocation criteria for subregional projects and reiterate the commitment made in the Disaster and Emergency Assistance Policy to adopt the IDA 13 framework to guide postconflict allocations. The policy recognizes that even though allocations to weakly performing countries should be limited, the need for close engagement will remain.

The review advocates deeper client involvement in PBA. The review proposes closer consultations on country performance ratings during the rating exercise and then focused dialogue that draws on the ratings during country programming. Although country teams will be required to share their preliminary assessments with country authorities, it is equally important that ratings are not negotiated with borrowers. Senior operations staff should explain ratings outcomes and explore possible strategic responses with country authorities. ADB will arrange regional training workshops on PBA methods in 2005.

The proposed public disclosure of numerical ratings, beginning with the 2005 country performance assessment, will be an important step toward improved transparency and strengthened accountability for the policy. Country authorities would be invited to comment on ratings and their views would be published with ratings. Public disclosure of ratings should help improve their quality and strengthen the compact with clients.

The review proposes that responsibility for ADF allocations be moved from the operations sphere to a PBA Focal Point in the Office of the Director General, Strategy and Policy Department. The director general of the Strategy and Policy Department, who reports directly to the President, will be accountable for matters related to implementation of the policy. The PBA Focal Point will also be responsible for coordinating country performance assessments. With full numerical disclosure of ratings, mechanisms intended to ensure full operational and corporate ownership of ratings are proposed. The Vice Presidents of Operations Groups and Knowledge Management and Sustainable Development will be responsible for ratings accreditation.

Allocations under the proposed revisions will be made on a biennial rather than on an annual cycle. This will provide greater operational flexibility in the use of allocations and help ease the bunching of loan approvals. The use of the “collar” will be discontinued. Given the need to closely monitor the circumstances of postconflict and weakly performing countries, their allocations will continue to be determined annually. To ensure that information is current, country performance assessments will continue on an annual cycle and numerical ratings will be disclosed each year.

In summary, the proposed revisions to the PBA elevate the performance characteristics of the system. They also limit and provide more explicit guidance on extra-formula allocations. Clients should benefit from reduced transaction costs, closer engagement, and greater transparency. Incentives for improved performance, particularly in relation to governance, have been accentuated. Contingent on their performance, ADF’s smaller clients will continue to attract larger per capita allocations.

I. INTRODUCTION

1. Before the Policy on Performance-Based Allocation for Asian Development Fund Resources¹ was approved in March 2001, Asian Development Fund (ADF) allocation decisions were based largely on country-specific considerations. Although performance played a role in decisions, its influence on allocations was not concerted or transparent. Following adoption of the Asian Development Bank's (ADB's) Poverty Reduction Strategy² and evidence that aid had been most effective in accelerating poverty reduction in countries whose policy and institutional performance was strong,³ the need to strengthen the link between country performance and resource allocation became apparent.

2. In this context, the performance-based allocation (PBA) policy marked an important departure from earlier practices. The new approach explicitly recognized that in seeking to reduce poverty, ADF resources would be best directed to good performers. In doing so, the policy sought to create incentives for improved performance. In addition to the performance measurement and allocation framework, the policy provided management with an important tool for strengthening development effectiveness through more focused policy dialogue, better country planning processes, and improved operations.

3. This review represents the culmination of an extended examination of the efficacy of the PBA policy and of ways to improve and strengthen it. Starting with the ADF VIII Midterm Review⁴ and moving through the ADF IX negotiation period,⁵ extensive discussion has taken place among ADF donor shareholders, borrowers' representatives, colleagues in the International Development Association (IDA) and the African Development Fund (AfDF), and ADB staff. The review is an integral part of a much broader assessment by the international community of PBA methods across multilateral concessional funds and developing regions. The review both contributes to and reflects an emerging international consensus on ways to promote and invest in better performance in low-income countries and to strengthen accountability for the allocation and use of scarce resources that have significant opportunity costs for both contributors and low-income countries.

II. THE PERFORMANCE-BASED ALLOCATION POLICY

A. Objectives, Principles, and Scope of the Policy

4. Aid has not always supported growth, improved social outcomes, strengthened governance, and reduced poverty. Differences in country policies and institutions go some way toward explaining the mixed record. Usually, benefits are muted in countries where policies are poor and institutions are weak, and aid is most effective where policy and institutional

¹ ADB. 2001. *Policy on Performance-Based Allocation for Asian Development Fund Resources*. Manila.

² ADB. 1999. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy*. Manila.

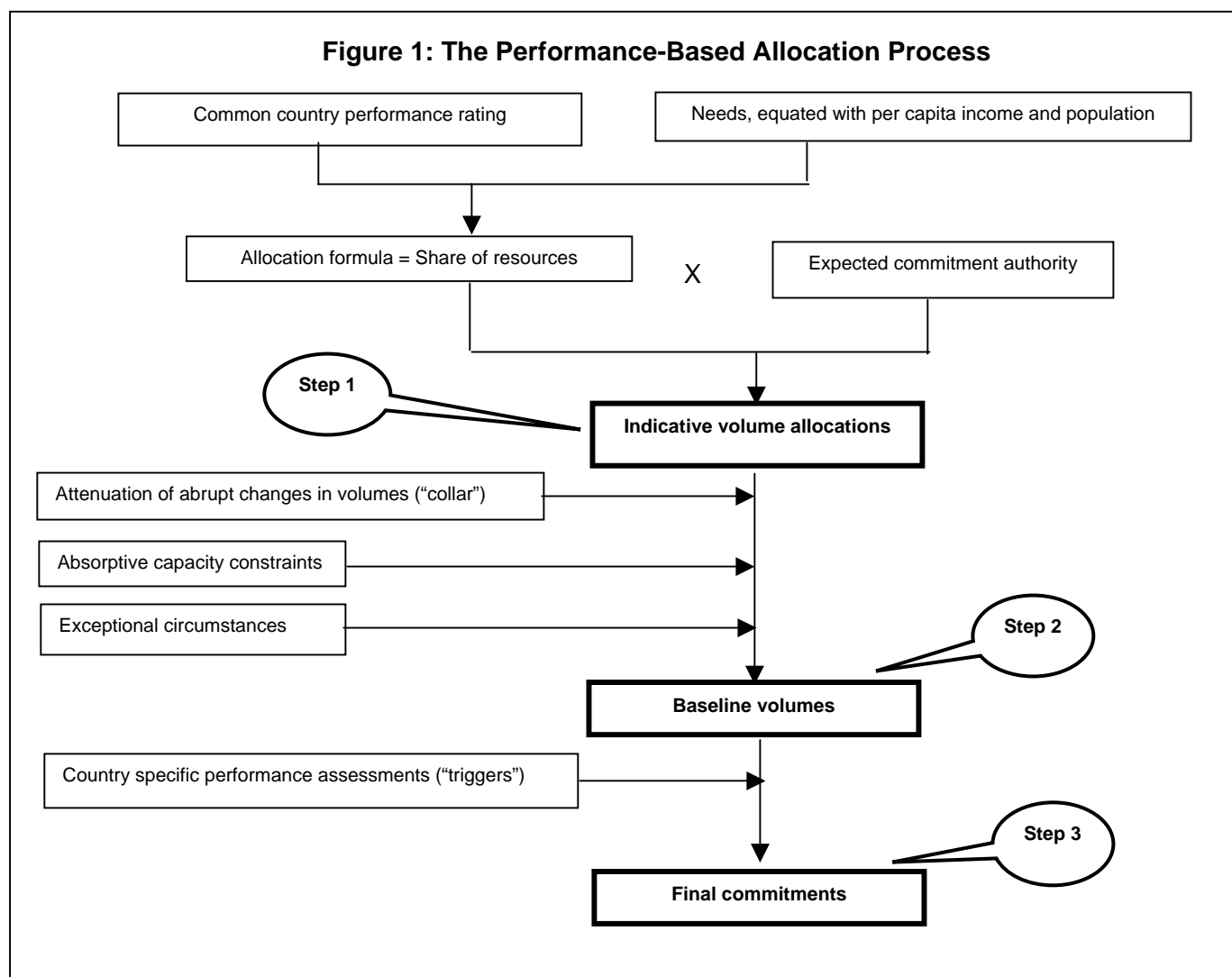
³ World Bank. 1998. *Assessing Aid: What Works, What Doesn't, and Why*. Washington, DC.

⁴ ADB. 2003. A Review of the Initial Testing and Application of a Performance-Based Allocation System for ADF Resources. Discussion paper presented at the ADF VIII Midterm Review Meeting, in Washington, DC.

⁵ Donor shareholders and borrowers' representatives discussed PBA issues at each of the ADF IX replenishment meetings. The following papers were prepared to support the ADF IX discussions: ADB. 2003. Performance-Based Allocation at ADB: Strengthening the Policy and its Implementation. Discussion paper presented at the ADF IX Donors' Meeting, Tokyo; ADB. 2004. Performance-Based Allocation at ADB: Proposed Enhancements. Discussion paper presented at the 2004 ADF IX Donors' Meeting, Lisbon; ADB. 2004. Increasing the Weight of Governance in the Revised PBA System. Information paper presented at the 2004 ADF IX Donors' Meeting, in Seoul. All papers are posted on <http://www.adb.org/ADF/meetings.asp> and were made available for interdepartmental review and public comment.

performance is strong.⁶ To serve better poverty reduction objectives, the PBA policy brings country performance to the fore in allocating ADF resources. But the policy also allows for the influence of other factors. Country needs, absorptive capacities, and special circumstances may modify allocations based on performance considerations. The policy also recognizes the special challenges that small countries face.

5. ADB's graduation policy⁷ determines eligibility for ADF resources. The PBA policy earmarks separate pools of resources for eligible Pacific developing member countries (PDMCs) and other countries with access to ADF. Within each pool, the PBA policy sets out a three-step allocation process, shown schematically in Figure 1.



⁶ Development practitioners generally agree that policy matters. Microeconomic evidence drawn from postevaluation studies certainly suggests that project success is a function of the policy environment. However, macroeconomic evidence, usually based on cross-country panel data, appears sensitive to specification choices and has been interpreted in different ways by different commentators.

⁷ ADB. 1998. *A Graduation Policy for the Bank's DMCs*. Manila.

6. In the first step, indicative country shares of ADF are generated by an allocation formula (Box 1). Larger country shares accrue to better performers and to countries with greater needs, as approximated by their per capita incomes and populations (Box 2). The formula's parameters mean that changes in performance have about seven times (1.8/0.25) the power of changes in per capita income in influencing allocations. Because the weight on population is less than one, other things being equal, less populous countries attract more resources in per capita terms. This small country bias derives from an institutional concern about small and often structurally vulnerable countries.⁸

Box 1: The Allocation Formula

The allocation formula is explained in Appendix 4 of the policy. The allocation share for country i is

Share of country i = scaling factor x country performance rating $_i^{1.8}$ x per capita income $_i^{-0.25}$ x population $_i^{0.75}$

and

Scaling factor = $1 \div \sum_i [\text{country performance rating } _i^{1.8} \times \text{per capita income } _i^{-0.25} \times \text{population } _i^{0.75}]$

IDA and AfDF employ similar formulas but with different exponential weights on the country performance rating per capita income and population terms. IDA and AfDF apply a weight of 2 to their performance ratings, -0.125 to per capita income and 1 to population. The derivation of the country performance rating is also different. The Inter-American Development Bank uses a linear allocation formula.

Source: ADB. 2001. *Policy on Performance Based Allocation for Asian Development Fund Resources*. Manila.

7. In the second step, formula outcomes are modified to attenuate abrupt changes in allocations,⁹ to accommodate absorption capacity constraints, and to provide for "exceptional country circumstances." Exceptional circumstances are defined as postconflict situations, natural catastrophes, and countries undertaking far-reaching reforms. The baseline volumes that emerge after incorporating these adjustments form the basis for operational planning and dialogue with countries.

8. In the third and last step, allocations may be revised by assessments of performance objectives tailored to each country. These objectives and associated performance indicators are intended to capture achievements that common country performance criteria might miss. Depending on these achievements, which are measured against indicators and targets agreed on with country authorities, the country strategy and program update (CSPU) may provide for increases or reductions over baseline volumes.

⁸ ADB. 1966. *ADB Charter*. Manila. The Charter requires that ADB give "special regard to the needs of the smaller or less developed member countries in the region."

⁹ The policy does not spell out why abrupt changes in lending volumes should be avoided, nor does it specify numerically what is meant by abrupt. Presumably, abrupt changes in volumes could be costly and disruptive from an operations perspective or create difficulties for borrowers' budgetary processes. However, a potential difficulty with this provision is that it refers to lending volumes, whereas the PBA formula determines only shares in ADF lending. If available ADF resources happen to diverge significantly from historical lending, abrupt changes would actually be unavoidable.

Box 2: The Framework for Country Performance Assessments

The policy identifies 20 separate performance criteria, of which 19 pertain to policy and institutional dimensions of performance and the 20th is a measure of portfolio performance. The inclusion of a measure of portfolio performance is intended to provide a more institutionally relevant indicator of potential effectiveness. Portfolio performance is measured using the project-at-risk method. As outcomes can be influenced by such extraneous factors as terms of trade or other shocks, the policy equates performance with actions rather than with results.

Performance criteria are listed below. The numbers in parentheses are aggregation weights used to achieve an overall rating. The minimum rating on any indicator is 1 and the maximum rating is 6.

- A. Sustainable Economic Growth (25%)
 - 1. Macroeconomic Management (10%)
 - Fiscal Policy (3.33%)
 - Monetary Policy (3.33%)
 - External Financing Policies (3.33%)
 - 2. Structural Policies (10%)
 - Trade Policy and Foreign Exchange Regime (2.5%)
 - Financial Sector Efficiency and Soundness (2.5%)
 - Factor and Product Markets and Prices (2.5%)
 - Enabling Environment for Private Sector Development (2.5%)
 - 3. Environmental Protection (5%)
 - Environmental Laws and Institutions (2.5%)
 - Environmentally Damaging Subsidies (2.5%)
- B. Socially Inclusive Development (30%)
 - 1. Framework for Poverty Monitoring and Policy Formulation (6%)
 - 2. Enhancing the Economic Capital of the Poor (6%)
 - 3. Developing the Human Capital of the Poor (6%)
 - 4. Equity and Social Safety Nets (6%)
 - 5. Empowerment and Participation (6%)
- C. Governance and Public Sector Management (30%)
 - 1. Rule of Law (6%)
 - 2. Anticorruption and Accountability Institutions (6%)
 - 3. Civil Service (6%)
 - 4. Revenue Mobilization and Budget Management (6%)
 - 5. Management and Efficiency of Public Expenditures (6%)
- D. Portfolio Performance (15%)

Source: ADB. 2001. *Policy on Performance Based Allocation for Asian Development Fund Resources*. Manila.

9. The policy stresses that PBA is a management tool and that implementation should not be unduly rigid or mechanical. However, the policy also states “what is critical is that, even with this flexibility, the system will retain the basic robust relationship between performance and allocations” (footnote 1, p12).

B. Policy Impact

1. Performance, Population, and Income Impacts

10. ADF allocations for 2002–2004 have been approved under the policy. To see how the policy has influenced ADF resource allocation, allocations under ADF VIII can be compared with pre-PBA allocations under ADF VII (Appendix 1). This can be done using the statistical technique of multiple regression analysis.

11. Table 1, which presents the results of the multiple regression analysis, shows underlying empirical regularities. Results refer to allocations within a pool of Group A and B1 countries that excludes Afghanistan, PDMCs and Indonesia (a Group B2 country).¹⁰ The empirical weights that best characterize underlying regularities can be compared with the policy's formula weights (shown in the second row of the table). Approximately, they measure the proportional change in a country's ADF share induced by a 1 percent increase in its measures of performance, population, and per capita income.¹¹

Table 1: Empirical Allocation Weights for Group A and B1 Countries, ADF VII and ADF VIII

Period	ADF Shares	Performance	Population	Per Capita Income	Goodness of Fit, R ²	Number of Observations
ADF VII	Historical approvals	—	0.58 ***	—	0.81	41
ADF VIII (PBA Period 2002– 2004)	Formula (step 1)	1.80	0.75	-0.25	Deterministic	Not applicable
	Collar-adjusted	1.55 ***	0.65 ***	-0.17 *	0.95	39
	Baseline (step 2)	1.18 ***	0.65 ***	—	0.94	39
	Final (step 3) ^a	1.34 ***	0.64 ***	—	0.93	39

*** = Statistical significance at the 99% confidence limit; ** = significance at the 90% confidence limit, — not significantly different from zero.

ADF = Asian Development Fund, R² = 1 - [sum of squared residuals/ total sum of squares]

^a In 2003, adjustments were made to final allocations to compensate for overprogramming and underprogramming in 2002. These adjustments have been netted out.

12. During the ADF VII period, a small country bias can be detected in allocations for Group A and B1 countries. Less populous countries systematically got larger per capita allocations. On average, 1.00% more population attracted only 0.58% more resources. However, no link can be detected between ADF VII allocations and either country performance or per capita income.

¹⁰ In this review, Group A and B1 countries consist of Azerbaijan, Bangladesh, Bhutan, Cambodia, Kyrgyz Republic, Lao People's Democratic Republic, Maldives, Mongolia, Nepal, Pakistan, Sri Lanka, Tajikistan, and Viet Nam. Uzbekistan was reclassified as a Group B2 country in 2004, but has yet to receive an allocation of ADF resources. The PDMCs are Cook Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Under ADF IX, Timor Leste, a PDMC, will receive ADF allocations, but did not access resources during ADF VIII. Because allocations for Afghanistan (Group A) and Indonesia (Group B2) are determined through set-asides, they are discussed separately.

¹¹ Strictly speaking, formula weights set an upper bound on response elasticities, the exact values of which also depend on initial country shares. For countries with small ADF shares, the approximation is close. For larger countries, where shares may be about 20% of ADF resources, response elasticities are about 80% of the value of the formula weights. See Annex B of ADB. 2003. Performance-Based Allocation at ADB: Strengthening the Policy and its Implementation. Discussion paper presented at the ADF IX Donors' Meeting, Tokyo.

Measurement bias might be one reason for this.¹² Also, during ADF VII several structural factors were important, including sanctions on lending to Pakistan in 1998 and 1999; postconflict concerns in Cambodia; and demands by new borrowers, such as Tajikistan.

13. For the PBA period, the weights in the second row of Table 1 describe the characteristics of the formula allocations for Group A and B1 countries (Figure 1, step 1).¹³ The weights in the third row characterize empirical links after the “collar” is applied to formula allocations to attenuate abrupt changes in lending (Box 3). In the fourth row, the estimated weights describe baseline allocations incorporating adjustments for the collar and special circumstances (Figure 1, step 2). In the last row, the reported weights describe final allocations after adjustments based on “trigger” assessments of country-specific performance objectives (Figure 1, step 3).

Box 3: The Collar

During 2002–2004, upper and lower bounds (or a collar) were set on performance-based allocation (PBA) lending volumes based on countries’ historical lending averages. These constraints are not explicitly defined by the policy, but have evolved during the course of implementation.

In 2002 and 2003, the collar constrained PBA lending volumes to a range of 85% to 115% of a country’s 5-years historical lending average. In 2004, the range was widened to 75% to 125% of a 3-years historical average. Where the allocation generated by the formula fell outside the prescribed range, it was re-set at the nearest boundary value. For example, if the historical lending volume was \$100 and the formula allocated only \$50, the volume would have been re-set to \$85 in 2002 and 2003 and \$75 in 2004. As large differences have emerged between performance-based formula allocations and historical lending volumes, the collar has been widely applied. Indeed, differences are so large for some countries that for collar-adjusted allocations to converge on the formula might take 10 years.

During Asian Development Fund VIII, the volume of resources available to support programs for Group A and B1 countries shrank and fell below historical lending volumes. Consequently, after the application of the collar, allocations exceeded the supply of ADF resources. Country allocations were then scaled down, on a proportional basis, to match the supply of resources. A 2% reduction was required in 2003 and a 12% reduction in 2004. Therefore maximum reductions in volumes over the respective historical averages were 16.7%, not 15.0%, in 2003, and 34.0%, not 25.0%, in 2004.

14. In contrast to the ADF VII period, PBA allocations for Group A and B1 countries are systematically linked to country performance. A robust statistical link between allocations and performance suggests that a basic commitment of the policy has been met. But the empirical link is smaller than the policy weight. Extra-formula adjustments have detracted from the influence of performance. A small country bias is also present. Although more accentuated than in the formula, the bias is less pronounced than in ADF VII. Once adjustments are factored in for special country circumstances and trigger evaluations, allocations show no link to per capita income levels.

¹² Measurement biases may have obscured links, because this result depends on the use of 2001 CPA data. No contemporaneous CPA data are available before 2001.

¹³ The formula allocations are deterministic, and thus policy weights describe fully their characteristics.

15. For PDMCs, links between allocations and performance and income cannot be easily identified. Usable information is limited by infrequent loans, often three or more years apart. A small country bias is, however, also present in PDMC allocations.

2. Group and Country Impacts

16. Table 2 compares ADF shares across periods. The policy has been associated with a reduction in ADF shares for Group A countries other than the PDMCs. Unadjusted application of formula shares would have led to even larger reductions. The main reason for the reduction in Group A's formula allocation is that the small country bias in historical allocations is diluted by the formula and most Group A countries are small. Collar adjustments have shored up allocations for Group A countries and held allocations for Group B1 countries in check. Differences between allocations and approvals during the ADF VIII period are explained largely by shortfalls in approvals for PDMCs. Differences in performance ratings for Group A and B1 countries were small, with ratings for PDMCs trailing both.¹⁴

Table 2: Average Shares of the Asian Development Fund by Country Group
(%)

Group	Approvals		Allocations		PBA-Formula Shares (2002–2004)
	ADF VII	ADF VIII ^a	ADF VII	ADF VIII	
PDMCs	4.3	1.4	3.9	4.5	4.3
Group A	28.1	24.8	25.8	24.9	20.6
Group B1	67.7	73.8	70.3	70.6	75.1
Group A and B1	95.8	98.6	96.1	95.5	95.7
Total	100.0	100.0	100.0	100.0	100.0

ADF = Asian Development Fund, PBA = performance-based allocation, PDMC = Pacific developing member country.

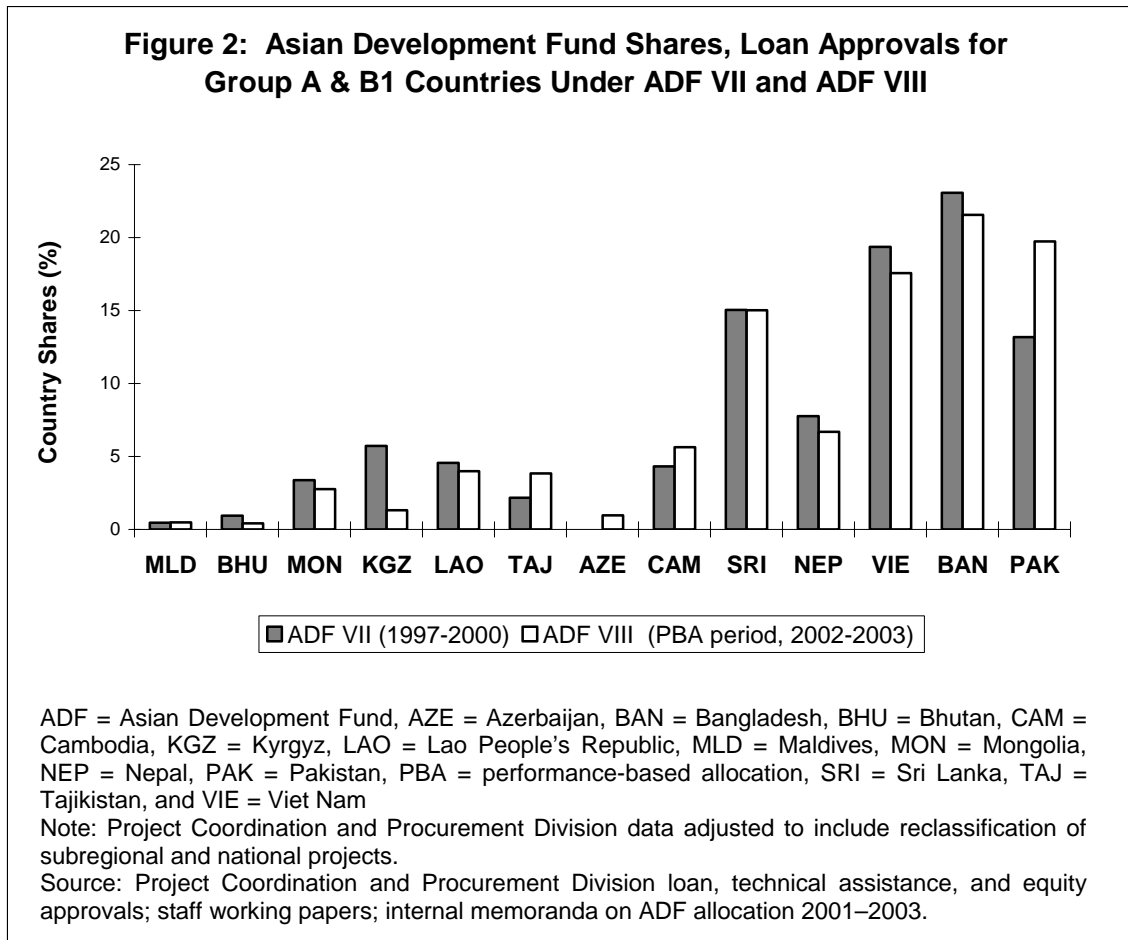
Note: ADF VII: pre-PBA period, 1997–2000; ADF VIII: PBA period, 2002–2004. Afghanistan and Indonesia not included. Totals may not add up due to rounding.

^a 2004 approvals not yet completed and data are for 2002–2003, which include adjustments in Project Coordination and Procurement Division data on reclassification of subregional projects and national projects.

Source: Project Coordination and Procurement Division loan, technical assistance, and equity approvals; staff working papers; internal memoranda on ADF allocations.

17. Figure 2 shows changes in ADF approval shares at a country level. Countries are ranked by population size on the horizontal axis. Increased approvals for Group B1 countries are largely accounted for by Pakistan. During the ADF VII period, Pakistan's share of approvals was depressed by sanctions. The pronounced drop in approvals for the Kyrgyz Republic, a Group A country, during ADF VIII followed a decision to limit program size based on external debt considerations.

¹⁴ Unweighted country performance ratings for 2001–2003 for PDMCs, Group A, and Group B1 countries were 3.2, 3.6, and 3.5, respectively. Population-weighted ratings averages are 2.7, 3.3, and 3.4, respectively.



3. Impact of the Collar and Provisions for Exceptional Circumstances

18. Table 3 summarizes the impact of the collar measured by the difference between allocations after application of the collar and formula volume allocations (Box 3). Differences between collar-adjusted and formula allocations are sizable for many countries. For PDMCs, large percentage differences mask differences between small volume allocations. For most PDMCs, the comparison is also distorted by irregular lending. But for Group A and B1 countries, where lending volumes are usually much larger, differences are also large and did not narrow with the passage of time. The main reason for this is that the resources available to Group A and B1 countries contracted and dictated PBA volume allocations that, on average, were less than historical volumes (Box 3).

19. Table 4 summarizes adjustments for special country circumstances. Allocations to Afghanistan, which were provided through a set-aside, were substantial. Cambodia, Sri Lanka, and Tajikistan also obtained sizable adjustments to their volume allocations to meet postconflict needs.

Table 3: Impact of the Collar, 2002–2004

Group and Country	Difference Between Formula Allocations and Collar-Adjusted Allocations (%)		
	2002	2003	2004
Pacific Developing Member Countries			
Cook Islands	(59)	123	42
Federated States of Micronesia	196	152	313
Kiribati	0	16	18
Papua New Guinea	(44)	(40)	(45)
Republic of Marshall Islands	604	435	561
Samoa	(15)	12	18
Solomon Islands	349	450	124
Tonga	0	82	20
Tuvalu	11	23	41
Vanuatu	79	25	18
Group A			
Bhutan	0	(2) ^a	(12) ^a
Cambodia	9	12	22
Kyrgyz Republic	109	105	51
Lao People's Democratic Republic	65	111	77
Maldives	100	124	132
Mongolia	76	70	74
Nepal	0	(2) ^a	(0.3)
Tajikistan	26	(2) ^a	11
Group B1			
Azerbaijan	0	(2) ^a	(12) ^a
Bangladesh	0	(15)	(12) ^a
Pakistan	0	(20)	(12) ^a
Sri Lanka	74	40	58
Viet Nam	0	(2) ^a	(12) ^a

Note: Computed as [(collar allocation – formula allocation)/formula allocation] x 100.

^a Denotes no collar adjustment, but formula allocations had to be reduced to provide resources to finance collars in other countries (Box 3).

Source: Performance-Based Allocation Working Group working papers, 2002–2004.

Table 4: Special Country Circumstances

Country	Special Circumstances
Afghanistan	\$150 million in 2003 and \$135 million in 2004 because of postconflict considerations.
Bangladesh	\$30 million reduction in 2002 to correct population bias in PBA formula. The Validation Group questioned this adjustment and it was not repeated.
Cambodia	\$20 million increase in 2002 because of postconflict considerations.
Indonesia	\$150.0 million, \$103.2 million, and \$60.0 million in 2002, 2003, and 2004. Indonesia is on the watch list for graduation from ADF.
Kyrgyz Republic	Absorptive capacity constraints. Allocation set by formula; collar adjustments, which would have increased the allocations, were not applied in 2002 and 2003.
Mongolia	\$5 million increase in 2002 due to 3 consecutive harsh winters.
Pakistan	\$10 million reduction in 2002 to “correct” population bias in PBA formula. The Validation Group questioned the basis for this adjustment and it was not repeated.
Papua New Guinea	In 2002 and 2003, the allocation was reduced because of absorption constraints.
Sri Lanka	\$53 million increase in 2003 because of postconflict considerations.
Tajikistan	\$24 million and \$13 million in 2002 and 2003 because of postconflict considerations.

ADF = Asian Development Fund.

Sources: internal memoranda on ADF Allocation, 2001–2003.

4. Impact of Country-Specific Performance Assessments (Triggers)

20. Baseline allocations emerge after collar and other adjustments for special country circumstances (Figure 1, step 2). Final allocations may deviate from baseline allocations by as much as plus or minus 20% depending on assessments of country-specific performance objectives. These objectives are intended to capture facets of performance not measured in the country performance assessment (CPA). Three assessments of country-specific performance objectives have been completed, although the first (carried out in 2001 for 2002 allocations) was of an interim nature.¹⁵

Table 5: Country-Specific Performance Assessments (Triggers), 2002–2004

Group and Country	PBA 2002		PBA 2003		PBA 2004	
	Induced Changes in Share(%)	Trigger	Induced Changes in Share(%)	Trigger	Induced Changes in Share(%)	Trigger
Pacific Group						
Cook Islands	(2.0)	Base	0.0	Base	0.0	Base
Federated States of Micronesia	(7.1)	Base	(0.1)	Base	(0.2)	Base
Kiribati	(6.1)	Base	0.4	High bias	(0.1)	Base
Papua New Guinea	2.3	Base	(0.6)	Base	(0.7)	Base
Republic of Marshall Islands	2.0	Base	0.6	High bias	1.0	High bias
Samoa	0.0	Base	0.9	High bias	1.1	High bias
Solomon Islands ^a	1.0	Base	(0.2)		(0.1)	
Tonga	8.1	Base	(0.1)	Base	(0.1)	Base
Tuvalu	1.0	Base	(0.1)	Low bias	(0.1)	Low bias
Vanuatu	1.0	Base	(0.7)	Low bias	(0.7)	Low bias
Group A						
Bhutan	(0.8) ^b	Base	0.0	Base	0.0	Base
Cambodia	(0.2)	Base	(0.1)	Base	(0.2)	Base
Kyrgyz Republic	(0.1)	Base	0.0	Base	(0.1)	Base
Lao PDR	(0.1)	Base	(0.1)	Base	(0.2)	Base
Maldives	0.1	High	0.0	High bias	0.0	Base
Mongolia	0.8	High	0.2	High bias	0.4	High
Nepal	(0.3)	Base	(0.2)	Base	(0.3)	Base
Tajikistan	(0.2)	Base	(0.1)	Base	(0.1)	Base
Group B1						
Azerbaijan	(0.1)	Base	0.0	Base	(0.1)	Base
Bangladesh	(0.8)	Base	(0.4)	Base	(1.0)	Base
Pakistan	2.9	High	1.5	High bias	1.2	High bias
Sri Lanka	(0.5)	Base	(0.3)	Base	(0.4)	Base
Viet Nam	(0.8)	Base	(0.4)	Base	0.9	High bias

Notes: An assessment of “high” attracted 20% more resources and “high bias” attracted 10% more resources. An assessment of “low” led to a 20% reduction in volume and “low bias” led to a 10% reduction. No volume adjustments, other than those needed to satisfy the resource constraint, occurred in “base” cases.

^a Operations for 2003 and 2004 assessments were temporarily suspended because of the security situation.

^b As there were no projects in Bhutan’s pipeline in 2002, no PBA allocation was made.

Source: PBA Working Group working papers and internal memoranda on country performance assessment of triggers, 2001–2003.

¹⁵ The first set of country-specific performance triggers was agreed on in 2001 and was subsequently evaluated twice, after 6 months and after 18 months. This was an interim arrangement because no triggers had been in place prior to the approval of the policy.

21. Table 5 summarizes the impact of country-specific performance assessments on allocation shares. Out of 67 assessments, performance has fallen short of baseline requirements in only 4 cases, each of which incurred a 10% volume reduction in allocations.¹⁶ In 49 assessments, baseline volumes have been confirmed. In 10 cases, volume increases of 10% have been approved based on achievements that exceeded the baseline targets, but did not fully satisfy the requirements of the high case. The conditions required for the high case (+20%) have been met in four cases.

22. In net terms, assessments have favored higher lending scenarios. As resources released from low lending scenarios were insufficient to fund increases required by high lending scenarios, reductions in allocations for countries that met baseline requirements were then imposed. Even though triggers are country specific and are calibrated on absolute standards, it is performance relative to that in other countries that matters for allocations.

C. Uses of Asian Development Fund VIII Resources

23. A breakdown of ADF allocations during 2002–2004 is presented in Table 6. These are the final allocations generated in step 3 of Figure 1. Allocations that have been managed outside the formula include those for postconflict needs, allocations to Indonesia, and those for other special circumstances. The policy does not provide detailed guidance on how allocations should proceed in postconflict or in other special circumstances; neither does it specify eligibility criteria for funding subregional projects.¹⁷ In practice, subregional projects have been financed through an administered set-aside that has supported the project pipeline.

Table 6: Asian Development Fund Allocations After Triggers, 2002–2004

Program	2002 Allocations		2003 Allocations		2004 Allocations	
	\$ million	% Share	\$ million	% Share	\$ million	% Share
PDMCs	66.0	4.2	44.1	2.8	50.0	3.8
Indonesia	150.0	9.6	103.2	6.7	60.0	4.6
Group A	331.0	21.1	305.4	19.7	255.2	19.6
Group B1	922.0	58.8	862.3	55.6	744.8	57.3
Group A + Group B1	1,253.0	79.9	1,167.8	75.3	1,000.0	76.9
Of Which						
Other Special Circumstances	5.0	0.3	0.0	0.0	0.0	0.0
Postconflict ^a	44.0	2.8	66.0	4.3	0.0	0.0
Afghanistan ^b	0.0	0.0	150	9.7	135.0	10.4
Subregional Cooperation	100.0	6.4	85.0	5.5	55.0	4.2
Total	1,569.0	100.0	1,550.0	100.0	1,300.0	100.0

PDMC = Pacific developing member country.

Note: These shares differ from those in Table 2 because of the presence of set-asides in the denominator. Set-asides are excluded from the denominator in Table 2. Totals may not add up due to rounding.

^a \$20 million to Cambodia (Group A) and \$24 million to Tajikistan (Group A) in 2002, \$53 million to Sri Lanka (Group B1) \$13 million to Tajikistan in 2003

^b Set-asides for Afghanistan are based on postconflict considerations.

Source: Asian Development Bank internal memoranda on Asian Development Fund allocation, 2001–2003; Performance-Based Allocation Working Group working papers, 2001–2003.

¹⁶ In each case, the assessment deemed that some of the baseline conditions had been satisfied.

¹⁷ ADB. 2000. *Seventh Replenishment of the Asian Development Fund*, Manila approves the use of ADF resources to support subregional projects; however, the PBA policy does not provide further guidance on the matter.

24. The size of set-asides has been based largely on strategic and operational considerations. The allocation for Indonesia, a Group B2 country that has been on a watch list for graduation from ADF since 1998, has also been set administratively, but draws on CPA ratings and operational judgments about projects' suitability for concessional financing. Set-asides have been substantial in some years. Allocations for subregional projects peaked in 2002 at 6.4% of ADF resources. In 2003, support for peace, security, and postconflict needs consumed 14% of ADF commitments. Set-asides were smaller in 2004.

Table 7: Allocations and Approvals, 2002–2003
(\$ million)

Group and Country	Allocations		Approvals ^a	
	2002	2003	2002	2003
PDMCs	66.0	44.1	24.6	8.0
Group A				
Bhutan	0.0	9.4	0.0	9.4
Cambodia	75.0	54.4	75.9	54.0
Kyrgyz Republic	20.0	24.9	15.0	15.5
Lao People's Democratic Republic	45.0	42.3	46.0	46.0
Maldives	6.0	6.0	5.0	6.0
Mongolia	50.0	29.5	34.1	29.5
Nepal	83.0	103.6	60.0	94.0
Tajikistan	52.0	35.4	50.3	38.0
Group B1				
Azerbaijan	23.0	22.1	0.0	22.0
Bangladesh	263.0	226.2	269.6	226.0
Pakistan	270.0	230.2	276.0	178.0
Sri Lanka	146.0	185.0	160.3	185.3
Viet Nam	220.0	198.9	225.0	179.0
Group A and B1	1253.0	1167.9	1217.2	1082.6
Afghanistan		150.0	167.2	150.0
Indonesia	150.0	103.2	131.2	74.2
Subregional Cooperation	100.0	85.0	110.0	64.3

PDMC = Pacific Developing Member Country

^a Include adjustments in Project Coordination and Procurement Division data reclassifying subregional projects to national projects and vice versa.

Source: Project Coordination and Procurement Division loan, technical assistance, and equity approvals; staff working papers; internal memoranda on Asian Development Fund allocation 2001–2003.

25. PDMCs compete for resources separately from Group A and B1 countries. The policy stipulates that the share of PDMCs in ADF VIII should equal their share in ADF VII. Allocations for PDMCs have averaged 3.6% of total ADF resources during 2002–2004 or 4.5% of country programs (excluding Afghanistan and Indonesia). ADF commitment authority, net of allocations for PDMCs and other set-asides, has determined the volume of resources available to Group A and B1 countries outside the Pacific.

26. Annual lending approvals have tracked PBA allocations closely (Table 7). Where overprogramming has occurred, it has been to accommodate lumpy, discrete projects, and has been funded through a reduction in the following year's ADF allocation to the borrower. When

approvals have fallen short of allocations, resources have reverted to the general pool except where the shortfall in borrowing has been beyond the country's control.

D. Implementation

27. Table 8 summarizes arrangements for implementing PBA, identifying the main PBA activities and nodes of responsibility. Although the policy refers to a 3-years rolling allocation process, in practice, PBA activities and allocations have been managed within a fixed-period, annual cycle.

Table 8: Implementation of the Policy

Activities	Outputs	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
CPAs on Common Criteria	Initial CPA ratings	■	■											■	■	
PBA Working Group Review and Finalization of Ratings	Final CPA ratings			■												■
Determination of Country and Other Special Allocations by Regional Departments	Proposed baseline allocations for following year			■												■
Validation Group Review and Management Approval	Approved allocations (Figure 1, step 2)				■											
Country Programming Mission (Country Teams) Involving - programming based on baseline allocation for the following year, - consultation on performance, - formulation of country-specific performance objectives and indicators (triggers) to be assessed in the following year	CSPUs				■	■	■	■	■							
Country Program Confirmation Mission (Country Teams) Involving - assessment against country-specific performance objectives set 18 months previously, - recommended lending scenario	Recommended lending scenario							■	■	■	■					
PBA Working Group Review and Finalization of Country-Specific Performance Assessments and Recommended Lending Scenarios	Proposed allocations after triggers											■	■			
Validation Group Review and Management Approval of Lending Scenarios	Approved PBA allocations (Figure 1, step 3)													■		
Planning Directions Confirm Lending Based on Expected Commitment Authority	Bank-wide planning directions															■

28. Regional departments have led implementation. They have conducted CPAs and assigned country ratings. Regional Departments have also had primary responsibility for determining allocations. The PBA Working Group has coordinated activities, ensured consistency, carried out quality checks of performance assessments, and estimated preliminary allocations. Management decisions about baseline (Figure 1, step 2) and final (Figure 1, step 3) ADF allocations have rested on recommendations endorsed by regional department directors general and operational Vice Presidents. For each round of allocations, the Validation Group, drawn from nonoperations departments, has reviewed the process and advised on policy compliance and implementation.

29. PBA allocations are reported in CSPUs. The CSPUs provide the link between country performance assessments and the country planning process. Country performance ratings have been treated as confidential and are not disclosed in CSPUs, which are approved by country authorities and are public documents. Quintile rankings¹⁸ of country performance ratings have been provided to the Board on a confidential basis.

30. There have been 69 CPAs and 67 assessments on country-specific objectives. Each has entailed extensive review by the Working Group and Validation Group evaluation of the process. Each year, staff from operations spends about 80 working weeks on PBA activities, not including the time of the Validation Group, nonoperational staff, and senior management. ADF borrowing countries have also incurred costs in negotiating and agreeing on country-specific performance objectives and in furnishing the information needed for assessments.

31. Although much has been achieved, some difficulties have been experienced. The complexity and rigor of country performance assessments has delayed their completion in some cases. Uncertainties about the available pool of ADF resources have caused slippages in the determination of volume allocations and synchronization with country programming missions. In particular, large demands, emanating from postconflict needs in Afghanistan, unanticipated at the time of ADF VIII, required midstream adjustments in 2002 and squeezed the resources available for other countries in 2003 and 2004. Reaching consensus among regional departments about set-asides and other allocations has been lengthy. The phasing of country programming and country program confirmation missions has also been problematic, as they have preceded confirmation of lending scenarios based on “trigger” assessments. In discussing these assessments, the Board has called for greater cross-country consistency in the performance tests applied.

32. PBA has resulted in less predictability about allocations. This is inherent in any system that rewards performance, especially where relative rather than absolute performance is what matters. But for reasons that are extraneous to the policy,¹⁹ revisions to baseline allocations were necessary in 2003 and 2004. This has blurred the link between performance and volume allocations. As the resources available to support country programs for Group A and Group B1 countries have shrunk, strong or improved performance in some countries has been associated with reduced allocations. Finally, ADB has been unable to deliver fully on agreed lending scenarios, because low lending cases have not released sufficient resources to fund high lending cases within a fixed resource envelope.

III. LESSONS, ISSUES, AND DIRECTIONS

33. Reflections on lessons learned and the experiences of other multilateral institutions are useful in three broad areas: (i) the assessment and measurement of country performance; (ii) the balancing of different objectives; and (iii) policy implementation.

A. Measuring Country Performance

1. Policy and Institutional Performance

34. ADB uses 19 separate criteria for assessing countries’ policy and institutional performance (Box 2). AfDF and IDA use 20 criteria. The policy notes that differences in criteria

¹⁸ That is in groups of five arranged in order of the top 20% of performers, the next best 20%, and so on.

¹⁹ Principally postconflict needs in Afghanistan and revisions to estimates of the commitment authority.

across institutions are more of degree than of kind. The Inter-American Development Bank has the most parsimonious framework for assessing country performance, using only 10 criteria.

35. In considering the structure of CPAs, issues arise about: the relevance of criteria, the possibility of overlap among them, the weights that are used to aggregate over different dimensions of performance, and transparency. These issues are not unique to ADB and have been under active review in other institutions.

Table 9: World Bank Country Policy and Institutional Assessment Criteria

2003	Expert Panel Proposals
A. Economic Management	A. Economic Management
1. Management of Inflation and Macroeconomic Imbalances	1. Monetary and Exchange Rate Policy
2. Fiscal Policy	2. Fiscal and Debt Policy
3. Management of Public Debt (External and Domestic)	
4. Management and Sustainability of the Development Program	
B. Structural Policies	B. Structural Policies
5. Trade Policy and Foreign Exchange Regime	3. Trade
6. Financial Stability	4. Financial Sector
7. Financial Sector Depth, Efficiency, and Resource Mobilization	5. Business Environment
8. Competitive Environment for the Private Sector	
9. Goods and Factor Markets	
10. Policies and Institutions for Environmental Sustainability	
C. Policies for Social Inclusion/Equity	C. Policies for Social Inclusion
11. Gender	6. Gender
12. Equity of Public Resource Use	7. Equity of Public Resource Use
13. Building Human Resources	8. Building Human Resources
14. Social Protection and Labor	9. Social Protection and Labor
15. Monitoring and Analysis of Poverty Outcomes and Impacts	10. Policies and Institutions for Environmental Sustainability
D. Public Sector Management and Institutions	D. Public Sector Management and Institutions
16. Property Rights and Rules-Based Governance	11. Property Rights and Rules-Based Governance
17. Quality of Budgetary and Financial Management	12. Quality of Budgetary and Financial Management
18. Efficiency of Revenue Mobilization	13. Efficiency and Equity of Revenue Mobilization
19. Quality of Public Expenditures	14. Quality of Public Administration
20. Transparency, Accountability, and Corruption in the Public Sector	15. Transparency, Accountability, and Corruption in the Public Sector

Sources: World Bank. 2003. *CPIA Questionnaire*. Available: <http://www.worldbank.org>; World Bank. 2004. World Bank. 2004. *Country Policy and Institutional Assessment: An External Panel Review*. Washington, DC.

36. An independent expert panel reviewed the World Bank's framework for country policy and institutional assessments (CPIAs) in March 2004.²⁰ The panel concluded that even though the criteria focused on the right areas, there were too many. The panel recommended a simplified structure for the CPIA (Table 9). The streamlined framework reduces overlap by folding debt management and development expenditure considerations into fiscal and debt policy, by combining criteria on the financial sector, and by bringing goods and factor market dimensions of performance together under the rubric of the business environment. The panel

²⁰ World Bank. 2004. *Country Policy and Institutional Assessment: An External Panel Review*. Washington, DC.

concluded that a separate rating for poverty monitoring served no useful purpose as it was adequately captured by other criteria. These changes would reduce CPIA criteria from 20 to 15.

37. In considering performance aggregation weights, the expert panel on the World Bank's CPIA observed that evidence linking performance to growth and poverty reduction could not support a precise calibration of weights. They called for more research. In practice, the impact of aggregation weights on country ratings depends on how ratings on different criteria vary across countries. If weights are reassigned among criteria that have similar ratings, aggregate ratings are unlikely to change much. Because, in practice, countries that do well or poorly on one criterion tend to do well or poorly on others, the choice of weights might reasonably be guided by practical considerations, such as transparency, until clearer evidence emerges.²¹

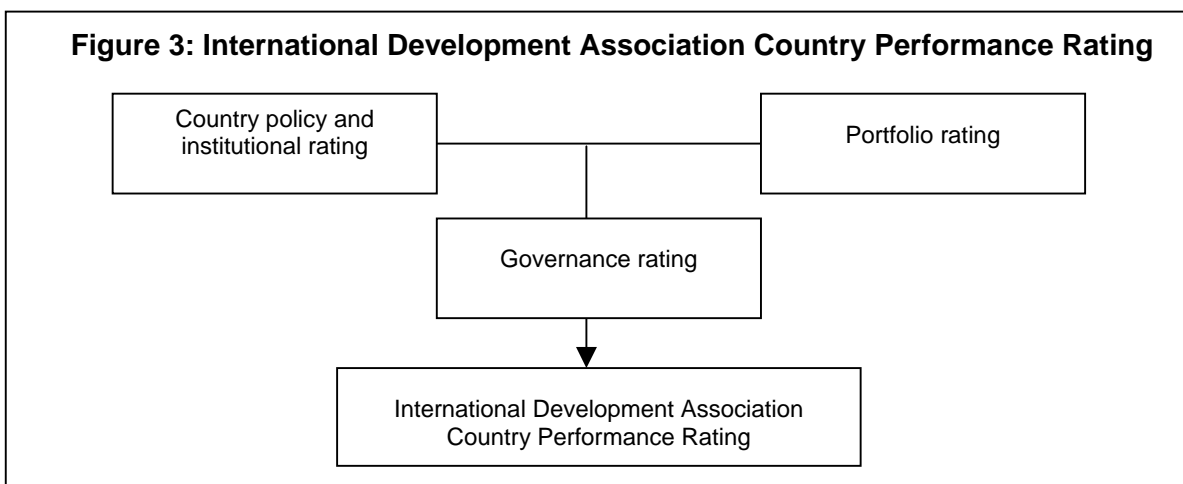
38. Appendix 2 of the policy (footnote 1) identifies the scope of each performance criterion and the characteristics of poor, average, and strong performance. The World Bank's assessment questionnaire for the CPIAs also provides detailed advice on ratings, identifying statistical and other guideposts. For each ADB CPA criterion, ratings may be assigned in a continuous range from 1 through 6. Until recently, the World Bank rated only in a range of 2 to 5 and in discrete half-point intervals. A rating of 1 was reserved for unsatisfactory performance for a period of 3 or more years and a rating of 6 for good performance sustained for 3 or more years. An advantage of scoring in discrete half-point intervals is that it guards against spurious differentiation among countries whose performance characteristics are substantially similar. A drawback is that it might accentuate differences in performance and allocations at the boundaries of ratings. The expert panel broadly endorsed the World Bank's approach to rating, but recommended that CPIA ratings of 1 and 1.5 and 5.5 and 6 be assigned to exceptionally weak and exceptionally strong performers in a manner consistent with the broader scoring guidelines.

39. Performance ratings are only as reliable as the judgment of the raters. To mitigate subjectivity, ratings could be based on quantifiable indicators that are easily verified. The Millennium Challenge Corporation rates countries' performance using only published, quantifiable indicators.²² But a purely quantitative approach to performance measurement has its own problems. For some aspects of performance, relevant and reliable indicators might not exist. The expert panel concluded that using "outside data" as a check on staff's professional judgment was probably better than relying solely on data-based indicators.

40. The CPIA is one of three parts of the country rating used for IDA allocation purposes. To capture country portfolio considerations, portfolio ratings are derived from the World Bank's *Annual Review of Portfolio Performance* (ARPP) and combined with the CPIA rating. In the last step, the combined policy and portfolio rating is modified by a "governance factor" to determine the overall IDA country performance rating. Figure 3 shows the structure of the IDA country performance rating (equivalent to the CPA, Box 2). The measurement of portfolio performance and the use of a governance factor are discussed later.

²¹ Cross-correlations are reported in ADB. 2003. Performance-Based Allocation at ADB: Strengthening the Policy and its Implementation, Annex D. Discussion paper presented at the ADF IX Donors' Meeting, Tokyo. The World Bank arrived at this conclusion after conducting principal component and factor analyses on its CPIA ratings.

²² Millennium Challenge Corporation, Washington, DC. Available: <http://www.mcc.gov/countries/selection/index.shtml>.



2. Portfolio Performance

41. The past performance of projects in a country is thought to be a good indicator of the likely effectiveness of new projects. ADB, like other multilateral development banks, measures the quality of its portfolio using the so-called project-at-risk approach. Although the project-at-risk system captures a large range of information about ongoing projects, this approach has well-known problems. In particular, assessing the performance of new borrowers or borrowers that have only a few active or no projects is difficult. Moreover, if only current projects are assessed, canceling a weak project might result in an improved rating. In addition, the question of whose performance is being measured needs to be resolved. For example, a borrower might fail to meet ADB's implementation targets, but those targets might sometimes be unrealistic. Evidence also suggests that in some multilateral development banks, project supervisors have rated too optimistically, giving an upward bias to ratings.

42. These difficulties have no easy solutions and they are not unique to the ADF portfolio. Alternative approaches have their own limitations. For example, independent postevaluation data are selective and only available with long lags. Although self-evaluation data are more comprehensive and timely, they are more likely to be prone to bias. Data on disbursement performance provide yet another source of information, but their comparability across countries is complicated by, among other things, different mixes of project and program finance.

3. The Governance Factor

43. IDA's use of a governance factor increases the effective weight of governance in the country performance rating (Box 4). Its application gives an effective weight of about 68% to governance criteria in IDA's country ratings (Box 4). This compares with a nominal weight of about 24% in the combined CPIA and portfolio rating. In AfDF, the nominal weight of governance is 25% and it has an effective weight of 60%, after the application of a governance factor with an exponential weight of 1. As ADF does not apply a governance factor, the effective weight of governance is equal to its nominal weight in the CPA, i.e., 30%.

44. The application of the governance factor not only changes the relative weights of the underlying performance criteria, it stretches the scale on which country performance is rated (Box 4). As governance ratings are usually positively correlated with other policy and institutional performance ratings, application of the governance factor tends to clip ratings on

underlying performance criteria for countries that are poor performers and boost underlying ratings for countries that are good performers. In response, at each point on the performance scale, resources move toward better performers. For example, using IDA’s formula weights and suppressing the governance factor, a country with a performance rating of 4 would be allocated 4 times the resources of a country with a rating of 2. But once the governance factor is applied, this ratio rises to 32.²³ Agreeing that good governance is critical for successful development outcomes, the expert panel nevertheless concluded that its impact on IDA ratings was possibly disproportionate and that the governance factor was highly nontransparent.²⁴

Box 4: The International Development Association’s Governance Factor

The International Development Association’s (IDA’s) governance factor is equal to the average rating on preselected governance criteria, drawn from the country policy and institutional assessment (CPIA) and the *Annual Review of Portfolio Performance* (ARPP), divided by 3.5 and weighted by an exponent of 1.5. That is:

$$\text{Governance factor} = (\text{governance rating} \div 3.5)^{1.5}.$$

The IDA country performance rating, used for IDA allocations, is then defined as:

$$\text{Country performance rating} = \text{Governance factor} \times (0.8 \times \text{CPIA rating} + 0.2 \times \text{ARPP rating}).$$

Because all criteria are measured in a range of 1 to 6, the minimum value of the governance factor is $(1 \div 3.5)^{1.5} = 0.153$ and the maximum value is $(6 \div 3.5)^{1.5} = 2.240$. Therefore, the minimum possible IDA country performance rating is $0.153 \times 1 = 0.153$ and the maximum rating value is $2.24 \times 6 = 13.460$. In practice, the observed range is narrower because actual ratings do not span theoretical maximum and minimum values.

The nominal weight of governance is the sum of the weights assigned to governance criteria in the CPIA, plus the nominal weight of the procurement flag in the ARPP. After application of the governance factor, it can be shown that the “effective” weight of governance equals:

$$\frac{[\text{governance exponent} \times (0.8 \times \text{CPIA rating} + 0.2 \times \text{ARPP rating}) \div \text{governance rating} + 0.8 \times \text{nominal governance weight}]}{[\text{governance exponent} \times (0.8 \times \text{CPIA rating} + 0.2 \times \text{ARPP rating}) \div \text{governance rating} + 1]}$$

This expression is the ratio of the partial derivative of the IDA country performance rating with respect to a change in the governance rating divided by the sum of all partial derivatives. Because the effective weight depends on actual ratings, its value may vary by country and over time. The numbers reported in the text refer to averages. It is not difficult to show that for any given set of ratings, a smaller value for the exponent will reduce the effective weight of governance.

The African Development Fund also applies a governance factor with an exponential weight of 1.0.

B. Balancing Objectives

45. Although the PBA policy gives primacy to country performance in allocating ADF resources, it admits a role for other factors, including needs, absorptive capacity, and special country circumstances. Through a set-aside for PDMCs and the small country bias embedded in the formula, the policy also recognizes the special challenges that small countries face. Catering

²³ This assumes respective governance ratings of 4 and 2.

²⁴ IDA. 2004. IDA’s Performance-Based Allocation System: Update on Outstanding issues. Discussion paper presented at the IDA 14 Replenishment Meeting, Paris.

to these objectives with finite resources entails trade-offs and requires clarity in articulating priorities.

1. Poverty

46. Because eligibility for ADF resources is restricted to poor countries, a strong poverty focus is implicit in PBA and ADF (footnote 7). The poverty focus is accentuated through the formula, which, other things equal, allocates larger ADF shares to countries with lower per capita incomes. For two otherwise identical countries, but one with half the per capita income of the other, ADB's formula would allocate 19% more to the lower-income country. In IDA (and the AfDF), the allocation would be 9% more.

47. In practice, however, the intended link between ADF allocations and per capita income has not materialized (Section II.B). The collar and provisions for special country circumstances have nullified it. An increase in the absolute size of the formula weight on per capita income would help ensure more favorable treatment for lower-income countries, but could also risk weakening the performance characteristics of the system. Empirical evidence shows that the poorest countries often face acute absorption constraints.²⁵

48. Better measurement of needs might also help sharpen the focus on poverty. The use of per capita income and population data tend to underestimate needs in countries where income inequality is most pronounced. Ideally, country needs should be captured by measures of the number of poor and the severity of their poverty. At this time, however, no internationally comparable poverty data are available that have the coverage and reliability of national income and population statistics. Alternative approaches to measuring needs based on indicators of human development also have their limitations.²⁶

2. Performance

49. The policy weights imply that, at the margin, differences in performance exert considerably more pull on allocations than differences in needs. Other things being equal, a country that outperforms another by a factor of 2 attracts 3.5 times more resources.

50. Although experience shows that the policy has led to more resources being allocated to better performing DMCs, the pull of performance on allocations has fallen short of policy expectations (Table 1). The link between performance and allocation is also considerably weaker than in IDA's system.²⁷ Three reasons account for this. First, and most important, there is no governance factor accentuating differences in ratings on underlying criteria. Second, the formula weight on the country performance rating is larger in IDA. Third, the collar creates an entitlement that detracts from the impact of performance in ADF. Closer alignment with IDA and AfDF would require increasing the leverage of performance on allocations.

²⁵ Such evidence has indicated that an "efficient" allocation of official development assistance would restrict per capita allocations at lower income levels because of absorptive constraints. Allocations would then rise with per capita income as absorption constraints were eased, but would then taper off at higher income levels as needs declined. See, for example, IDA. 2004. *IDA's Performance-Based Allocations System: An Update on Outstanding Issues*. Washington DC. Available: <http://siteresources.worldbank.org/IDA/Resources/PBAIDA14.pdf>.

²⁶ ADB. 2003. *Performance-Based Allocation at ADB: Strengthening the Policy and its Implementation*. Discussion Paper presented at the ADF IX Donors' Meeting, Tokyo, pp19–20.

²⁷ For identical ratings, use of the IDA rating and formula generates a ratio of more than 14:1 in allocations between the best and worst performers. The corresponding ratio using the ADF rating and formula is about 2.6:1. See, ADB. 2004. *A Comparison of Performance-Based Allocation Methods*. Note presented to ADF donor shareholders, Lisbon. Available <http://www.adb.org/ADF/meetings.asp>.

3. Small Countries

51. IDA and AfDF per capita formula allocations are independent of population size.²⁸ But ADF's formula allocates more resources on a per capita basis to less populous (small) countries. This bias favoring small countries is intended to address their greater vulnerability and structural disadvantages, and facilitates operations at a minimum efficient scale across DMCs of diverse size. PDMCs, whose allocations are funded out of a separate pool, also receive more resources on a per capita basis than other countries.

52. ADB's Charter mandates a special focus on small countries; however, there is no scientific way to determine how large the small country bias should be. Clearly, the bias should not be so large as to generate allocations that would present absorption difficulties or heighten risks of debt distress, and neither should the bias take precedence over performance considerations. But during 2002–2004, small countries, which have been performing broadly on a par with larger ones, have seen their ADF shares decline. Reversing the drift of ADF resources from small to large countries might require a more concentrated small country bias. But consideration would also need to be given to possible tensions this could create with the performance characteristics of the system.

4. Postconflict, Disaster, and Emergency Needs

53. The PBA policy provides for special allocations to meet postconflict needs, disasters and emergencies. During 2002–2004, the bulk of special provisions have covered postconflict needs, with most being directed to reconstruction efforts in Afghanistan. Decisions on these allocations have been anchored in needs assessments that have been undertaken jointly with development partners. Board approval of the policy on disaster and emergency assistance²⁹ in May 2004 commits ADB to using the current IDA postconflict framework (IDA 13), including IDA monitoring and evaluation indicators. PBA allocations for disasters and emergencies should also be consistent with the new policy.

5. Subregional Allocations

54. During the ADF VIII period, \$240 million was allocated to support subregional projects. Even though the ADF VIII Donors' Report and Board of Governors' Resolution mandates support for subregional projects, the policy provides no guidance about subregional allocations. In practice, subregional projects have been funded through an administratively determined set-aside.

55. Clearly, measuring performance at a subregional level entails conceptual and practical challenges. Recognizing these problems, IDA and AfDF allocate resources to support subregional cooperation on a project rather than on a program basis. Funding decisions rest on criteria that include agreements on cost sharing with participating countries and the demonstration of spillover benefits. IDA and AfDF fix the volume of support for subregional projects through a predetermined set-aside.

²⁸ Although not part of the allocation formula, a small country bias can also be detected in IDA. First, all countries receive a minimum fixed monetary allocation, which benefits small countries more than large countries. Second, because access to IDA is capped for IDA blends (those with access to IDA and IBRD resources), which are large countries, this also favors small countries.

²⁹ ADB. 2004. *Disaster and Emergency Assistance Policy*. Manila.

56. Support for subregional cooperation is an important ADB mandate, and ADF is the main instrument for carrying it forward in poor countries. To ensure that funding for subregional projects is better aligned with the performance principles that guide national allocations, the policy needs to provide clearer guidance on eligibility and allocation criteria.

6. Weakly Performing Countries

57. In weakly performing countries, supporting normal operations within the framework of ADB's policies is difficult and, consequently, weak performers should attract only limited ADF resources. But weak performance must not lead to disengagement or to erosion in the quality of support. Indeed, weak performers need special attention and tailored assistance efforts. Only where a country is unwilling to engage with the international community on constructive terms might assistance programs be suspended and activities limited to monitoring and surveillance.

58. The origins of weak performance vary. As national coordinating capacities are likely to be limited in countries whose performance is extremely weak, the importance of close partnership among donors is paramount in such situations. Shared assessments and the judgments based on them will provide an important foundation for an engagement strategy and an assignment of roles. Decisions on the nature and volume of financial assistance consistent with the engagement strategy should also be taken in close partnership. To support and accommodate this approach, the policy should accommodate limited ADF allocations for weakly performing countries judged on a case-by-case basis.

7. Countries on Graduation Watch List

59. It is anticipated that as a country's income level rises and its access to non-concessional sources of finance improves, it will eventually graduate from ADF assistance. The graduation policy (footnote 7) sets out the framework and criteria for classifying DMCs. For countries that are on the watch list for ADF graduation, access to ADF resources may need to be capped to encourage the use of ordinary capital resources.

C. Implementing the Policy

1. Resource Allocation and Operational Functions

60. Other multilateral development banks separate responsibilities for resource allocation and operations, whereas ADB operations groups are responsible for allocations. Even though a substantial proportion of allocations are rules based, and the fixed size of the resource envelope provides an important check on the process, operations departments also allocate resources to support postconflict, other special needs, and subregional projects. The basis for these allocations has not always been transparent. A separation of operations and resource allocation roles would strengthen the system's checks and balances and provide for clearer accountability.

2. Operational and Implementation Challenges

61. Matching country programs and projects to PBA allocations within a fixed annual cycle has been challenging, delaying some projects and requiring changes in the scope of others. Such changes can jeopardize program coherence and affect project quality. Implementation difficulties have also been experienced. A recent review of ADB's new business processes has observed that PBA implementation delays have created difficulties for country programming.

There is a need to consider how implementation could be improved to reduce costs, support project and program quality, and better serve ADF borrowers' requirements.

3. Reporting and Disclosure

62. Quintile rankings of country performance ratings have been provided to the Board. Beyond this, country performance ratings have been treated as confidential. Concerns about the ratings' possible impact on investor sentiment and public confidence as well as limited institutional experience with the CPAs have influenced decisions on disclosure. Disclosure practices vary in other multilateral development banks. The Inter-American Development Bank discloses numerical ratings to its board. IDA has publicly disclosed information about quintile rankings of CPIA components since fiscal year 2000, but has stopped short of full public disclosure of numerical ratings.

63. The independent expert panel on the World Bank's CPIAs concluded that public disclosure of numerical ratings would be beneficial for developing countries, the World Bank, and the development community more broadly. The panel noted that the quality of the performance assessments would benefit from outside scrutiny and information sharing and that disclosure would enrich country dialogue and strengthen operations. But in moving toward numerical disclosure it would be important to deepen engagement with clients and ensure that their concerns about the robustness of ratings and their potential misinterpretation and misuse are addressed.

IV. ENHANCEMENTS TO THE POLICY

A. Principles to Guide Revisions

64. The policy covers the allocation of both ADF loans and grants across countries. A separate framework guides eligibility for grants.³⁰ Proposed revisions to the policy are guided by a number of principles. These seek to (i) improve CPAs; (ii) give increased weight to governance; (iii) strengthen the link between performance and allocation; (iv) sharpen ADF's focus on small countries; (v) clarify and refine criteria to guide allocations to support special needs, subregional projects, and weakly performing countries; (vi) deepen client involvement in and understanding of PBA; (vii) improve transparency and accountability; and (viii) reduce transaction costs and streamline implementation. These enhancements are in the interests of ADF donor shareholders and borrowers. Revisions to the policy should also contribute to institutional efforts to manage better for development results.

B. Country Performance Criteria

65. CPAs are the bedrock of PBA. The current CPA framework is already substantively similar to IDA's CPIA (with an added ARPP rating). For operations in the poorest countries of developing Asia, institutional mandates and client groups are insufficiently distinctive to warrant differences between them. With the prospect of increased public disclosure of CPAs, the advantages of aligning country performance criteria outweigh any benefits from customization. The use of common criteria would help reduce clients' costs, support improved performance assessments, and, by extension, lead to more effective use of scarce ADF resources.

³⁰ ADB. 2004. *Eighth Replenishment of the Asian Development Fund and Third Regularized Replenishment of the Technical Assistance Special Fund*, R111-04. Manila.

66. This review proposes that beginning in 2005, the CPA framework be modified to accommodate the main recommendations of the independent expert panel and, thereby, that it be aligned with the World Bank's CPIA. The criteria set out in Table 10 would form the basis for the 2005 CPAs. The World Bank's CPIA exercise for 2004 will use identical performance criteria (1–16), plus its ARPP rating. ADB will use the World Bank's rating guidelines and detailed rating guidelines will be publicly disseminated. The new CPA has 17 criteria compared with 20 in the old CPA.³¹ Continued alignment of performance criteria might require future adjustments.³² Management would report subsequent revisions, if any, to the Board.

Table 10: Current and Proposed Performance Criteria, 2005

Current Framework	Proposed Framework 2005
I. Sustainable Economic Growth	A. Economic Management
a. Macroeconomic Management	
1. Fiscal Policy	1. Macroeconomic Management
2. External Financing Policies	2. Fiscal Policy
3. Monetary Policy	3. Debt Policy
b. Structural Policies	B. Structural Policies
4. Trade Policy and Foreign Exchange Regime	4. Trade
5. Financial Sector Efficiency and Soundness	5. Financial Sector
6. Factor and Product Markets and Prices	6. Business Environment
7. Enabling Environment for the Private Sector	
c. Environmental Protection	
8. Environmental Laws and Institutions	C. Policies for Social Inclusion/ Equity
9. Environmentally Damaging Subsidies	
II. Socially Inclusive Development	
10. Framework for Poverty Monitoring and Policy Formulation	
11. Enhancing the Economic Capital of the Poor	7. Building Human Resources
12. Developing the Human Capital of the Poor	
13. Equity and Social Safety Nets	8. Social Protection and Labor
	9. Equity of Public Resource Use
14. Empowerment and Participation	10. Gender
	11. Policies and Institutions for Environmental Sustainability
III. Governance and Public Sector Management	D. Public Sector Management and Institutions
15. Rule of Law	12. Property Rights and Rules-Based Governance
16. Anticorruption and Accountability Institutions	13. Transparency, Accountability, and Corruption in the Public Sector
17. Civil Service	14. Quality of Public Administration
18. Revenue Mobilization and Budget Management	15. Quality of Budgetary and Financial Management
19. Management and Efficiency of Public Expenditures	16. Efficiency of Revenue Mobilization
IV. Portfolio Performance	E. Portfolio Performance
20. Portfolio Performance	17. Portfolio Performance

Sources: ADB. 2001. Policy on Performance-Based Allocation For Asian Development Fund Resources; External Panel Review of Country Policy and Institutional Assessments. Discussion paper. Washington, DC.

³¹ An external debt management criterion has been retained and has not been amalgamated with fiscal policy, as recommended by the expert panel. The World Bank argues that amalgamation would overburden the fiscal policy criterion. A compelling reason to retain a separate performance criterion is that external debt sustainability and the risks of debt distress will play an increasingly important role in decisions about concessional financing and country programming.

³² The World Bank's CPIA is not circumscribed by a policy, and World Bank's management reviews decisions on criteria and criteria weights annually. Over time, CPIAs have been changed to accommodate shifts in policy emphasis, improved knowledge, and new data. The World Bank is planning another independent review in 3 to 5 years.

67. Standardizing performance criteria will reduce transaction costs for clients and help improve their understanding of ratings and the rating process. However, the integrity of the policy and of the allocation process will require that ADB carry out independent assessments and determine its own ratings. Accountability for the use of ADF resources would also be compromised by the adoption of third-party ratings. Accordingly, full institutional ownership of country ratings at both the operational and corporate levels will be crucial. At the same time, independent performance assessments that are broadly congruent should help buttress the credibility of ratings and may increase their currency with country authorities. If ratings diverge, deeper analysis and more intensive dialogue with country authorities will be needed. Although the possibility of divergent assessments may risk undermining the credibility of ratings, outside scrutiny should eventually help to reconcile any differences. In the context of the broader harmonization agenda, the possibility of joint CPAs could be considered in terms of initiatives to more closely coordinate business processes and analytical work to support country strategies. The PBA policy supports joint assessments for postconflict and weakly performing countries and would not preclude joint performance assessments in other countries provided that these do not impair ownership of and accountability for ratings.

C. Country Ratings

68. From 2004, the World Bank's CPIA ratings will be an unweighted average of cluster ratings A–D (Table 10). The IDA country performance rating, on which IDA allocations depend, will remain a hybrid combining the CPIA, the ARPP ratings, and the governance factor (Figure 3).

69. This review proposes a different approach to using country performance ratings for allocation purposes. Rather than amalgamating policy and institutional performance, portfolio performance, and governance, it proposes that the allocation framework accommodate these components of performance separately. This proposal responds to concerns that IDA's governance factor is not particularly transparent and may inadvertently demote other important components of performance.

70. In aggregating across individual ratings, this review proposes that, as in IDA, cluster-rating values be calculated as the simple average of indicator ratings in that cluster. The more criteria a cluster has, the less weight each carries. In aggregating across clusters to obtain a policy and institutional rating, equal cluster weights would be applied. However, to avoid double counting governance in the allocation process, it is proposed that the policy and institutional rating be defined as the average rating value of the economic management, structural policies, and policies for social inclusion/equity clusters. A separate governance rating would be equated with the cluster rating value for public sector management and institutions (cluster D).³³ Finally, the portfolio rating would remain based on the projects-at-risk scoring scheme, modified by expert assessments by ADB's portfolio specialists. Interagency efforts to improve the use of projects-at-risk data for portfolio assessments are under active consideration.³⁴ Box 5 summarizes the proposed rating framework.

³³ In the calculation of its governance factor, IDA includes a procurement performance rating from its ARPP rating.

³⁴ An interagency technical workshop on PBA methods is planned for 24–25 January 2005. Measuring portfolio performance is one agenda item.

Box 5: Proposed Component Performance Ratings

Policy and institutional rating =
(economic management rating + structural policies rating + social/equity and inclusion rating) ÷ 3

where

Cluster rating = \sum_i criteria rating value $_i$ ÷ n

and n is the number of criteria in the cluster and i indexes criteria.

Governance rating = cluster rating for public sector management and institutions.

The portfolio performance rating would be derived as before.

71. Policy and institutional, governance, and portfolio ratings can be combined in a variety of ways for reporting purposes. An unweighted average of the policy and institutional rating and the governance rating equates with the World Bank's CPIA. Multiplying a weighted average of the derived CPIA and portfolio ratings by an exponentially weighted governance rating would generate IDA's country performance rating.³⁵ Appendix 2 explains how the proposed component ratings could be combined in an overall country performance rating, consistent with the allocation model proposed below.

D. Proposed Allocation Formula

72. The proposed allocation formula is shown in Box 6. The formula implies an effective weight of governance of about 50%, compared with 30% in the present policy.³⁶ Policy and institutional performance would account for about 35% of performance related allocations and portfolio considerations for 15%.³⁷ Revisions to IDA's PBA will reduce the effective weight of governance in its country performance rating from 68% to 66%.³⁸

73. In the proposed formula, performance exercises a much more powerful influence on allocations than before. Performance would have a combined exponential weight of 4,

³⁵ The exponential weight on the governance factor would be 1.5 and policy and institutional and portfolio ratings would be combined with linear weights of 0.8 and 0.2, respectively. The only difference between this derived rating and IDA's country performance rating would be the absence of an ARPP component in the governance rating. Also all ratings would be larger than IDAs by a common scale factor of 3.5^{1.5}.

³⁶ Because performance is condensed into three separate components each with its own formula weight, the effective weight of governance is measured in relation to its contribution to performance-related allocations. An expression for the effective weight of governance is

$$[\text{GIR exponent} * (1 \div \text{GIR})] \div [\text{GIR exponent} * (1 \div \text{GIR}) + \text{PIR exponent} * (1 \div \text{PIR}) + \text{PR exponent} * (1 \div \text{PR})],$$

where GIR is the governance rating, PIR is policy and institutional rating, and PR is portfolio rating. The effective weight of governance in this model therefore depends on the underlying cluster rating values. If they are equal, the weight is 50%. To the extent that rating values vary, the effective weight may deviate from 50%.

³⁷ This is the sum of the exponential weights on performance elements of the formula. In IDA, the corresponding weight is 5. The implied weight is obtained by adding the governance factor weight (1.5) to the weight on the combined CPIA and ARPP ratings (1) and then multiplying by the formula weight on the IDA country performance rating (2).

³⁸ IDA. 2004. IDA's Performance-Based Allocation System: IDA Rating Disclosure and Fine-tuning the Governance Factor. Paper presented to IDA Deputies. Washington DC, October 4–6, 2004. IDA Deputies have endorsed these proposals and asked IDA to re-examine the issue at the IDA14 mid-term review.

compared to 1.8 in the existing policy.³⁹ Under the current policy, if the performance of the borrower with the largest ADF share were to improve by 10% it would attract about a 13% increase in its allocation. For an identical improvement, the smallest borrower would get about 18% more.⁴⁰ These premiums increase sharply with the new allocation formula: the largest ADF borrowers' allocation would increase by about 30%, and that of the smallest borrower by close to 45 percent.⁴¹ A 10% improvement in the governance rating alone would increase the largest borrower's allocation by about 14.5% and that of the smallest borrower by about 22 percent. The proposed formula considerably strengthens incentives for improved performance, particularly on governance criteria.

74. The proposed formula retains the current weight on per capita income, -0.25. Lower income countries would therefore continue to receive larger ADF shares other things equal. The treatment of lower income countries would remain more favorable in ADF than in either IDA or AfDF.

Box 6: Proposed Allocation Formula

Country Allocation Share =

$$\begin{aligned} & \text{Country Policy Rating}^{1.4} \\ & \quad \times \\ & \text{Country Governance Rating}^2 \\ & \quad \times \\ & \text{Country Portfolio Rating}^{0.6} \\ & \quad \times \\ & \text{Population}^{0.6} \\ & \quad \times \\ & \text{Per Capita Income}^{-0.25} \\ & \quad \times \\ & \text{Scaling Factor} \\ & \quad (\text{Box 1}) \end{aligned}$$

75. For two otherwise identical countries, one with twice the population of the other, the current policy allocates about 19% more in per capita terms to the smaller country. During ADF VII, this premium was around 34%. It is proposed that that the formula be recalibrated so that, at this population ratio, the premium on per capita allocations favoring small country increases to about 30%. To a reasonable approximation, an exponential weight of 0.6 on the population variable achieves this. Even with this adjustment, only small countries that are performing satisfactorily are likely to get increased allocations, given accentuated performance impacts.

76. It is proposed that PDMCs continue to compete for a separate pool of ADF resources on an identical basis to that of Group A and B1 countries. ADF donor shareholders agreed that PDMCs should be allocated the same share of ADF IX resources that they had access to in ADF VIII. Specifically, PDMCs would be allocated a pool equal to 4.5% of ADF resources to support country programs, excluding Afghanistan and Indonesia.

E. Extra-Formula Allocations

1. Postconflict Needs, Disasters, and Emergencies

77. The review proposes that allocations to support postconflict needs remain within framework of the policy, but that the current IDA framework should now explicitly guide these (Appendix 3).⁴² Consequently, decisions on eligibility for postconflict assistance should be made

³⁹ This is the sum of the exponential weights. Appendix 2 shows an alternative, but equivalent representation of the allocation formula where a composite performance rating is given a weight of 2. The formula there is more readily comparable to the IDA formula.

⁴⁰ An important property of the geometric allocation formula is that the responsiveness of shares to changes in performance and other variables progressively declines as the share in the allocation rises.

⁴¹ These ratios are more pronounced in IDA because the implicit weight on performance after the application of the governance factor is 5. See Appendix 2.

⁴² IDA. 2002. *Allocations to IDA Resources: 13th Replenishment. Supporting Poverty Reduction Strategies*. Washington, DC. It is anticipated that ADB would adopt any update of this framework.

in consultation with international partners. For eligible countries a “transitional support strategy” containing a monitorable action plan should be developed, identifying the role of ADF assistance and the scope of collaboration with international partners. Management decisions on allocations to support postconflict needs would be based on annual staff assessments of performance, based on IDA’s “postconflict progress indicators”, and country circumstances. A country would normally be expected to return to the normal PBA allocation process within three years, with the possibility of a two-years extension but only in exceptional cases. Per capita ADF allocations to eligible postconflict countries would be expected to exceed the ADF average for a country of the same population size.

78. Decisions on allocations to support disaster and emergency needs will be guided by the *Disaster and Emergency Assistance Policy* (footnote 29). To the extent possible, disaster and emergency needs will be met through the reallocation of resources within existing programs, and by drawing on loan cancellations and savings. If these prove insufficient, any additional country demands will be met through borrowing against future allocations, or, in exceptional cases, through reductions in other countries’ allocations. No ADF commitment authority will be kept in reserve to meet disaster and emergency needs.

2. Absorptive Capacity

79. Adjustments to allocations may be made on absorptive capacity considerations. Judgments about absorptive capacity cannot be reduced to a simple indicator or scoring system. A broad interpretation of absorption capacity is needed which recognizes macroeconomic (fiscal and debt), allocation and sector, and service delivery dimensions. At each of these levels, there may be institutional, physical and human, or social, cultural and political constraints to the absorption of external resources. PBA allocations may be reduced where analysis points to constraints in any of these areas. However, such analysis should also help guide assistance strategies that aim to relax constraints and expand absorptive capacity. This approach may be particularly useful for weakly performing countries. Care should be exercised in differentiating between absorption constraints for the client and institutional processing constraints.

3. Subregional Projects

80. The ADF IX Board of Governor’s Resolution provides for credits to support subregional projects. These are to be capped at 5% of ADF IX credits.

81. Conceptual and data limitations mean that it is not yet possible to rate the performance of regional programs in the way that country performance is assessed. For this reason, it is proposed that allocations are made on a project rather than program basis. In future, assessments of regional strategies and their record in delivering results would constitute an important basis for allocation decisions. Box 7 summarizes proposed eligibility criteria to guide allocations to support subregional projects. These criteria are similar to those that have been adopted in IDA and in the AfDF but admit a wider class of project. In Asia, some regional projects might occur in just one country, and some might involve cooperation with non-ADF borrowers.

**Box 7: Eligibility Criteria for Asian Development Fund
Regional Cooperation Credits and Grants**

Only countries that have access to ADF credits for national projects would be eligible for subregional credits.

Regional projects that have component activities in countries with ADF arrears would not be eligible.

Consistency between the project concept and the Regional Cooperation Strategy, the Operations Manual on Regional Cooperation, relevant national poverty reduction strategies and country strategies and programs and CSPUs must be demonstrated.

Sources of project benefits must include more than one country and may derive from complementary national projects, or a single project in neighboring developing member countries with costs allocable to individual beneficiary developing member countries. Where costs are not readily allocable, prior agreement among participating countries on cost sharing is necessary for ADB participation.

To demonstrate ownership and commitment, 20% of all project costs should be financed from combined national resources. National ADF allocations may be used for this purpose. Management may waive or lower this requirement for small countries, and for countries that do not derive substantial project benefits. This requirement will be waived for projects or project components that qualify for ADF IX grants.

If eligible demands exceed the volume of resources, projects will be prioritized by Management on the following criteria:

- Sources of cross-border benefits: projects with widely distributed benefits would be given priority.
- Cost-sharing (including from ADF national allocations): projects with larger external financing shares would be given preference to support catalytic use of the regional set-aside and ADF resources.
- Projects with components supporting institutional and policy harmonization: projects that support deeper integration and lowering cross-border transactions costs would be given preference.
- Projects that support and consolidate earlier, successful regional cooperation efforts would be prioritized.

ADF = Asian Development Fund, CSPUs = country strategy and program updates

4. Weakly Performing Countries

82. A cautious approach to allocations is needed for “weakly performing countries”, who might face, among other difficulties, external debt servicing problems. But given a coherent “engagement strategy”, aimed at supporting improved performance and expanded absorptive capacity, limited allocations might be provided for key activities. For weakly performing countries, the focus and quality of assistance rather than its volume should be of primary concern. An approach to assistance for weakly performing countries will be further developed by ADB in close collaboration with development partners.

5. Countries on Watch List for Graduation

83. In practice, allocations to Indonesia, the only country currently on the watch list for ADF graduation, have been determined as a set-aside and capped below its normative formula allocation. The review proposes that the revised policy formalize this treatment, and apply a cap to all countries that are being considered for graduation. The level at which resources would be capped would be determined on a case-by-case basis by Management.

6. Exclusions from the Policy

a. Abrupt Changes in Volumes

84. It is proposed that provisions to attenuate abrupt or sharp changes in lending volumes be removed from the policy. This would promote greater selectivity in allocations on a performance and needs basis. Rewarding and creating strong incentives for better country performance and addressing the needs of poor countries is not consistent with an approach that provides historical entitlements. Besides, constraints on changes in country allocations over historical lending could, as before, prove infeasible, as volume allocations depend on an exogenously determined resource envelope, not just on PBA formula shares. It is proposed that the collar be discontinued in ADF IX allocations.

b. Far Reaching Reforms

85. No special allocations for countries undertaking far-reaching reforms occurred during the ADF VIII period. This provision is redundant and might be removed from the policy. Country performance ratings should capture country reform efforts.

c. Triggers

86. It is proposed that assessments of country performance on country specific objectives, so called, "triggers", be discontinued from the start of the ADF IX allocation period. Implementation has proven costly for borrowers and for ADB, and difficulties have been encountered in ensuring consistent application of performance tests across countries. If no resources are set-aside to fund high lending scenarios, triggers can also obfuscate links between performance and allocations. Budgetary planning for country authorities would be easier if PBA allocations were known with greater certainty, and with a longer lead.

F. Disclosure

87. Greater disclosure of information about the PBA would promote improved public accountability for the use of shareholders funds, deepen client involvement in the PBA process and, through greater public scrutiny, help improve the quality of assessments. From the perspective of clients, greater disclosure should help focus and improve the quality of dialogue, strategies and operational assistance. At a broader level, ratings disclosure would serve the public interest in monitoring country results and progress toward internationally agreed development policy objectives. CPAs would also provide an important new resource to the policy research community.

88. It is proposed that full public disclosure of numerical performance ratings starts with the 2005 CPA exercise. An annual report on the CPA would also be produced. The

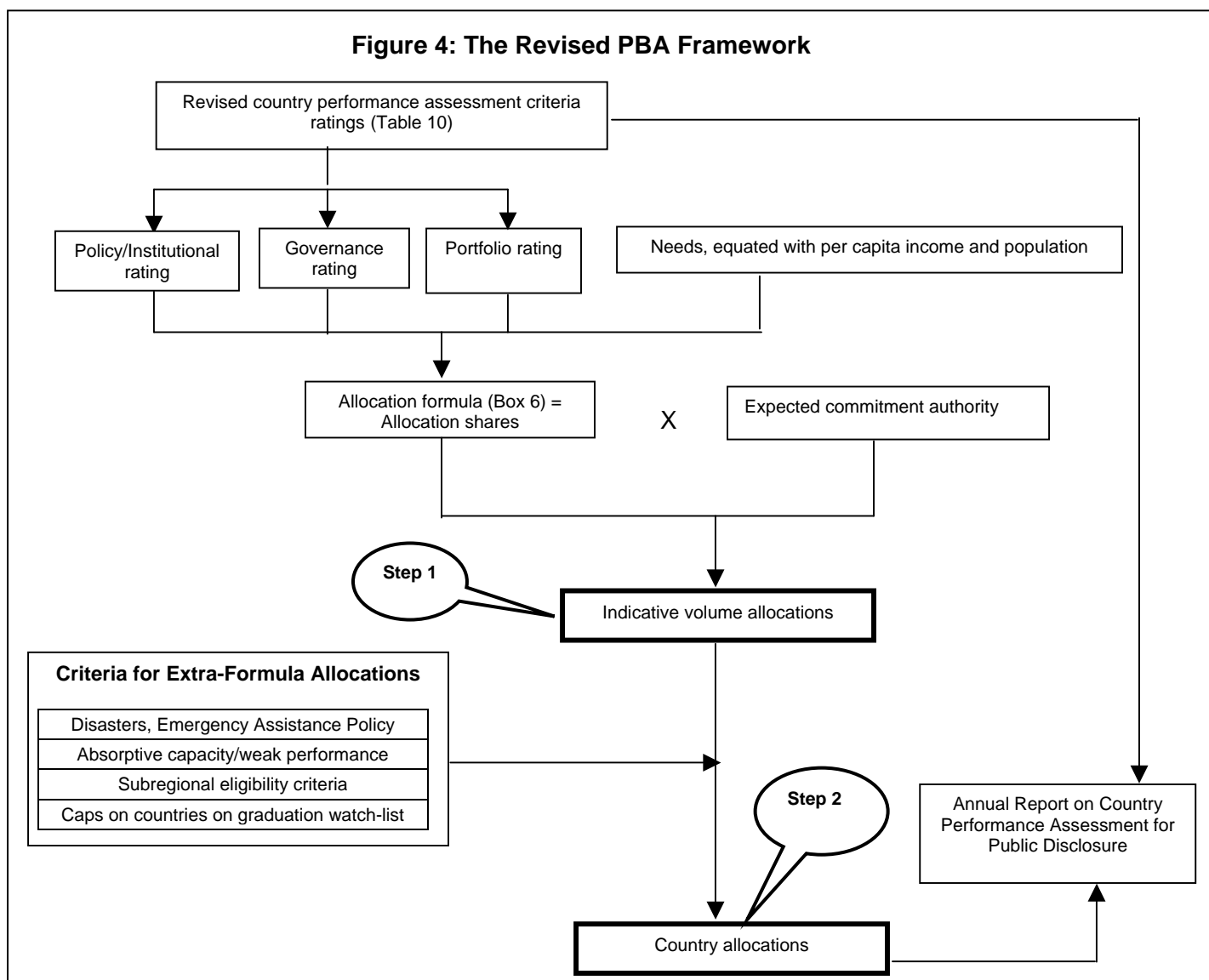
misinterpretation or the misuse of CPA information should be monitored. A vehicle for clients to comment publicly on ratings will be provided. Consistent with the forthcoming Public Communication Policy, internal documents, including CPA narratives, and *aide memoires* would remain confidential.

G. Monitoring the Policy

89. The annual CPA report will monitor evolving country performance and links between performance and allocations. The use of CPA information in results-based country strategies and programs will also be tracked and better integrated with operational procedures. A report on the revised policy will be presented to ADF donor shareholders at the time of the ADF IX mid-term review.

H. Summary

90. A summary of the proposed allocation model under the revised policy is shown in Figure 4. This can be compared directly with Figure 1.



V. IMPLEMENTATION

91. Two core activities fall within the ambit of the policy: (i) the conduct, review and accreditation of country performance ratings and (ii) the allocation of ADF resources to country programs and other uses. Proposed implementation arrangements seek to strengthen ownership, transparency and accountability and deepen client engagement. They also seek to address operational constraints but in a way that does not jeopardize underlying performance principles. A key proposal is to establish a PBA Focal Point that will have the authority, independence and resources to ensure effective implementation of the policy.

A. PBA Focal Point

92. A PBA Focal Point will be established in the Office of the Director General, SPD. The terms of reference of the Focal Point are summarized in Box 8. Director General, SPD will be the head of the Focal Point, and accountable for implementation of the policy. The Focal Point's independence and authority will derive from its location in the President's Group. SPD's established resource management and interagency responsibilities also provide a good fit with the role and functions of the Focal Point. Two professional staff positions will be created in the Focal Point through the redeployment of SPD staff positions at Levels 7 and 6. The seniority of these positions reflects the institutional importance of a reliable and effective PBA system, as well as its inherent complexity.

Box 8: Reporting Arrangements and Responsibilities of the PBA Focal Point

Location and Reporting

- The PBA Focal Point will be located in the Office of the Director General, Strategy and Policy Department. Director General, Strategy and Policy Department will be the head of the Focal Point and will report to the President on all matters concerned with PBA implementation.

Responsibilities

- Decisions on all ADF allocations covering country programs, special needs and subregional allocations.
- Management support for the review and accreditation of country performance ratings.
- Preparation of an annual report on country performance assessment ratings for public disclosure.
- Client and staff support on PBA training.
- Interagency coordination on PBA matters.
- Lead the ADF IX mid-term review of the PBA.
- Periodic technical reviews of the country performance assessment and allocation systems.

ADF = Asian Development Fund, PBA = performance-based allocation

93. Management decisions on ADF allocations will be made on the basis of recommendations made by the head of the Focal Point. To ensure that allocations are consistent with the institutional capacity to deliver bankable projects and programs and country capacities to absorb them, they will be considered by Operations Groups' Vice Presidents in a "ADF allocation review meeting". The head of the Focal Point will chair the review meeting and will be responsible for final allocations submitted to Management for approval.

94. The PBA Focal Point will support and coordinate the review and accreditation of country performance ratings. Given public disclosure, there must be full ownership of ratings at an operational and a broad corporate level. The role of the Focal Point in this context will be to provide independent advice to Management on the credibility of the ratings and rating process. Final decisions on ratings will rest with Operations Groups' Vice-Presidents and the Vice President, Knowledge Management and Sustainable Development.

B. Country Performance Assessments

95. To ensure that information is current, CPAs will be conducted annually for all countries with population greater than 1 million. For countries with population less than 1 million, CPAs may be conducted biennially, except if they are considered eligible postconflict countries or weakly performing. A CPA should be conducted for all countries under revised criteria and guidelines in 2005 (Table 10).

96. Given their expertise, Country Teams will conduct and be responsible for the CPAs and initial ratings. To promote quality assurance and ownership, a narrative record should support ratings on each criterion. For the 2005 CPA exercise onwards, the World Bank's CPIA rating guidelines will be used, superseding those of Appendix 2 of the original policy (footnote 1).⁴³

97. To ensure cross-country consistency, a CPA Working Group, will review all country ratings. The group's membership will include staff representing each operations' department and nonoperational specialists from the Regional and Sustainable Development Department, the Economic and Research Department, and the Central Operations Services Office. Recognizing that subjective assessments are unavoidable, rating adjustments agreed by the Working Group should be appropriately recorded. A staff member of the PBA Focal Point will chair the group and coordinate its activities.

98. The CPA Working Group will pass recommendations on country ratings to a CPA review panel consisting of regional directors general, the director general of the Regional and Sustainable Development Department, and the chief economist. The head of the PBA Focal Point will chair the CPA Panel. If the Working Group is unable to agree on a country rating, the CPA Panel will determine a final rating. Final ratings will be forwarded to operational Vice Presidents and to the Vice President, Knowledge Management and Sustainable Development for approval. These checks are intended to ensure that, with full public disclosure, there is institutional ownership of CPA ratings, both at an operational and at a broader corporate level. PBA activities should be recognized as an important result area in staff performance assessments and appropriately resourced and rewarded.

99. So that PBA activities can better dovetail with other business processes, longer lead times are needed. From 2005, CPAs should be moved forward in the annual calendar and be conducted and completed by Country Teams by the end of the 2nd quarter of each year. CPA Working Group and CPA Panel review, and Vice Presidents' approval should be concluded by the end of the 3rd quarter. This will extend the lead-time between performance reviews and allocations⁴⁴ but will ensure a better fit between PBA and country programming activities.

⁴³ [URL](#) (forthcoming).

⁴⁴ From about 12 months currently, to about 18 months.

100. Country authorities should be consulted and informed of preliminary ratings by Country Teams at the time of country assessments. Country authorities views on ratings should be recorded in an *aide memoire*. Although this is intended to deepen client involvement and provide an important check on the process, ratings should not be “negotiated” with country authorities.

101. Final CPA ratings may be shared with country authorities during country program confirmation and their strategic and operational implications should be discussed thoroughly at the time of country programming. For benchmarking and comparisons, average ratings on all criteria for PDMCs, Group A and Group B1 countries should be provided to country authorities.

C. The Allocation Process

102. To reduce administrative overheads, to ease bunching and to provide greater operational flexibility in matching allocations to programs and projects, most country allocations will take place on a biennial basis. The first biennial allocation period will be 2005–2006.

103. Parameters to guide access to national allocations are summarized in Box 9. These attempt to balance the supply and use of ADF commitment authority. Without compromising the critical performance characteristics of the system, they also create incentives for internal resource mobilization, and through carryover provisions, support project quality at entry. The retention of loan savings and cancellations within operations groups provides a direct incentive for improved portfolio management. If, within the proposed parameters, demands exceed available commitment authority, priority will be given to projects with quick-disbursing tranches, with approvals for remaining projects being on a first come basis, subject to Management’s approval.

104. To ensure that programs are appropriately calibrated to changing circumstances, allocations for eligible postconflict countries and weakly performing countries will continue to be determined annually. For eligible postconflict countries, Management will determine allocations using the current IDA postconflict assistance assessments. Operational departments should complete these assessments by the end of the second quarter of each year, six months ahead of the following allocation period (Appendix 3). Funding submissions for weakly performing countries should also be completed in the second quarter so that allocations can be planned 6 months ahead.

105. Proposals for the funding of regional projects will be considered on a biennial basis, alongside decisions on national allocations.

106. Based on revisions to the ADF expected commitment authority, significant changes in country circumstances or performance, and operational considerations, Management may approve mid-term revisions to biennial ADF allocations. Such revisions would be reported to the Board in an information paper.

Box 9: The Use of Performance-Based Allocation Country Allocations

All proceeds from loan savings and cancellations will be retained within the originating operations' group.

At the end of each biennial period, unutilized country allocations can be carried forward for a period of 12 months. If still unused, they revert to the common pool.

For all countries whose biennial allocation is \$40 million or greater: Annual approvals, consistent with the ceiling on the biennial volume, are expected to be in a range from 62.5% to 37.5% of the biennial volume.

For all countries where the biennial allocation is less than \$40 million and population is 1 million or more: Annual approvals, consistent with the ceiling on the biennial volume, may be in a range from 100% to 0% of the biennial volume.

For all countries where the biennial allocation is less than \$40 million and population is less than 1 million:

- Approvals within the biennial period may vary from a high of 175% to a low of 0% of the biennial volume. Within these limits, annual approvals are unconstrained.
- Unutilized allocations within a biennial period may be carried forward to the next biennial period, but not beyond.
- Any excess of approvals over allocations in one biennial period will be deducted from the following biennial allocation.
- Unutilized allocations at the end of ADF IX can be carried forward for a period of 12 months. If still unused, they revert to the common pool.

D. Interim Arrangements

107. Management committed to ADF IX donor shareholders that ADF allocations during the period of ADF IX would be governed by revisions to the policy. This commitment will be met, but, for logistical reasons, it will not be possible to initiate a revised CPA until 2005. Therefore, allocations for the period 2005–2006 will be guided by the CPA ratings completed in 2004 under the old policy. Nevertheless, allocations will be based on the revised allocation formula and formula weights (Box 6) and the revised criteria for extra-formula adjustments (Figure 4).

108. To facilitate the transition to the new CPA and to provide an opportunity to discuss policy revisions and disclosure issues with country authorities, the annual CPA exercise planned for end 2004 will be deferred. The first CPA under the revised policy will be completed in the second quarter of 2005 and new ratings with the revised CPA structure will be finalized by the end of the third quarter of 2005. The results of the 2005 rating exercise will then guide allocations for the biennial period 2007–2008. This sequencing of activity provides 6 months additional lead-time between completing ratings and country programming. The results of the 2007 rating exercise will guide allocations in the first biennial period of ADF X. Although interim CPA ratings will not normally be used for allocation purposes, significant changes in country ratings could constitute a basis for Management decisions on revised allocations at the end of the first year of each biennial period.

109. Numerical disclosure of CPA ratings will begin with the Annual Report on the 2005 CPA. This will be disseminated after disclosure to country authorities. In 2005, ratings should be shared with country authorities during country program confirmation and their strategic

implications considered during country programming missions. As a precursor to full public disclosure, it is proposed that the numerical performance ratings on which 2005–2006 allocations will be based be disclosed to the Board on a confidential basis following approval of the proposed revisions to the policy.

110. Proposals for ADF funding for subregional projects for the period 2005–2006 should be submitted to the PBA Focal Point by the end of the first quarter of 2005. Management will provide further instructions on the format for these proposals. Management decisions on funding will be made in the second quarter of 2005. Subject to availability of resources, later proposals can be considered. This arrangement would apply for 2005–2006 only. A schematic showing revised implementation arrangements under the new policy is shown in Table 11. This can be compared with Table 8.

111. Regional workshops on PBA methods and the CPA will be held in 2005.

112. Subject to approval by the Board of the Recommendation, Management will carry out the following actions:

- (i) establish a PBA Focal Point in SPD to coordinate PBA and advise Management on all matters pertaining to ADF allocation;
- (ii) ensure that adequate resources are available for conducting CPAs and for deeper client involvement in and understanding of the process;
- (iii) establish stronger links between CPAs and country planning processes, operations, and results frameworks;
- (iv) support and promote deeper interagency collaboration on PBA matters with a view to reducing clients' transactions costs;
- (v) report to donor shareholders on the revised PBA during the ADF IX Midterm Review.

Table 11: Implementation Under the Revised Policy

Activities	Frequency	Institutional Node	Outputs	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Country Performance Assessments and Ratings																
Country Performance Assessments	Annual	Country Teams	Initial CPA ratings													
CPA Working Group Review of Ratings	Annual	Interdepartmental, Focal Point Coordination	Revised CPA ratings													
CPA Panel Review and Vice Presidents' Approval of Ratings	Annual	Interdepartmental, Focal Point Coordination and Support → Vice Presidents Approval	Final CPA ratings													
Special Country Needs and Subregional Projects																
Assessments for Eligible Postconflict Countries and Weakly Performing Countries	Annual	Operations Departments → PBA Focal Point	Transitional Support Strategy, Postconflict Performance ratings													
Submissions for Funding for Subregional Projects	Biennial	Operations Departments → PBA Focal Point	Project Funding Proposals													
ADF Allocations																
Allocations of Resources to Support Country Programs, Subregional Projects, and Special Needs	Biennial/Annual	PBA Focal Point → ADF Allocation Review Meeting	Country allocations and allocations for eligible subregional projects													
ADF Allocation Review Meeting.	Biennial/Annual	PBA Head, Operations Group Vice Presidents	ADF Allocation Review Minutes													
Final Recommended Allocations for Management Approval	Biennial/Annual	PBA Focal Point → Management	Approved Allocations													
Country Programming Activities																
Country Program Confirmation/ Country Programming	Annual	Operations Departments	Confirmed Pipelines and CSPUs													
Ratings Disclosure																
CPA Report	Annual	PBA Focal Point	Annual CPA Report													

ADF = Asian Development Fund, CPA = country performance assessment, CSPUs = Country Strategy and Program Updates, PBA = performance-based allocation

RECOMMENDATION

113. This review identifies measures to enhance the policy on PBA and proposes that the policy be modified to incorporate the revisions discussed in Section IV. Specifically, the Board's approval is sought to:

- (i) align CPA criteria with those of IDA as per Table 10 and adopt the modified rating and allocation framework presented in Boxes 5 and 6;
- (ii) provide ADF support for operations in PDMCs in accordance with paragraph 76;
- (iii) fund subregional projects in accordance with paragraphs 80–81 and Box 7;
- (iv) accommodate extra-formula allocations and adjustments using the criteria of paragraphs 77–79 and 82–83;
- (v) discontinue country-specific performance assessments and triggers, collar adjustments to attenuate abrupt changes in lending, and special allocations to support far-reaching reforms; and
- (vi) publicly disclose numerical CPA ratings beginning with the 2005 CPAs.

114. This review proposes that the policy be subject to compliance review under ADB's accountability mechanism with respect to Sections IV and V.

ASIAN DEVELOPMENT FUND APPROVALS PRIOR TO PERFORMANCE-BASED ALLOCATIONS

1. During the ADF VII period (1997–2000) allocations were determined in two steps. Based largely on historical considerations and the available ADF commitment authority, resources were first allocated on a regional basis through Management’s Planning Directions. In each region, Vice Presidents then decided on country allocations based on the recommendations of, then, Programs’ Directors. Programs Directors’ recommendations reflected the information provided in “country performance assessments”. The format of these assessments differed across countries and regions. Even though in most cases recommended allocations emerging from these assessments included performance considerations, particularly portfolio performance, they were also influenced by “strategic” and operational considerations. Links between performance and allocations do not seem to have been concerted or transparent.
2. Approvals for the ADF VI and ADF VII periods are shown in Table A1.1. Data for 2001, which preceded the PBA are also shown. To control for year-to-year changes in the level of approvals, these data are expressed as shares in ADF. Although there is considerable year-to-year variation in shares only a few countries experienced consistently rising or falling shares. For most countries, ADF shares varied around a more or less stable mean.
3. In looking at the cross-country pattern of historical ADF resource use, two stylized facts emerge. First, by weight of their needs, large countries got larger shares in ADF. Second, consistent with ADB’s Charter obligations to small countries, less populous countries got larger per capita allocations.

Table A1.1: Historical Asian Development Fund Approvals, 1992–2000

DMCs	ADF VI (%)					ADF VII (%)					Mean	Cov (%)
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001		
Pacific Group												
Cook Islands	0.0	0.0	0.0	0.0	16.4	1.7	0.0	0.0	0.0	6.3	2.4	217
Federated States of Micronesia	4.9	14.4	17.8	18.9	34.8	39.3	0.0	0.0	13.3	37.1	18.1	82
Kiribati	0.0	0.0	0.0	0.0	0.0	0.0	16.1	0.0	0.0	0.0	1.6	316
Papua New Guinea	73.8	59.7	2.5	0.0	0.0	32.8	0.0	56.7	41.4	16.8	28.4	100
Marshall Islands	0.0	20.3	28.9	58.1	0.0	26.2	0.0	26.2	11.3	22.8	19.4	92
Samoa	21.3	4.4	0.0	0.0	0.0	0.0	11.8	0.0	17.4	17.1	7.2	121
Solomon Islands	0.0	1.1	0.0	0.0	0.0	0.0	40.8	0.0	16.6	0.0	5.8	228
Tonga	0.0	0.0	50.7	23.0	16.1	0.0	0.0	0.0	0.0	0.0	9.0	188
Tuvalu	0.0	0.0	0.0	0.0	0.0	0.0	0.0	11.3	0.0	0.0	1.1	316
Vanuatu	0.0	0.0	0.0	0.0	32.8	0.0	31.4	5.7	0.0	0.0	7.0	191
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0		
Group A and B1												
Bhutan	0.0	0.4	0.0	0.6	0.0	0.5	0.7	1.0	1.5	0.6	0.5	89
Cambodia	7.0	0.0	2.8	3.4	7.1	0.0	0.0	9.0	8.2	6.1	4.4	82
Kyrgyz Republic	0.0	0.0	3.9	3.0	5.4	6.0	8.4	7.4	2.7	6.1	4.3	67
Lao People's Democratic Republic	7.3	5.6	6.3	6.9	6.2	6.9	2.6	2.6	4.5	5.3	5.4	31
Maldives	0.0	0.8	0.0	0.0	0.0	0.5	0.8	0.8	0.0	1.4	0.4	119
Mongolia	0.4	5.9	6.3	6.3	4.3	4.2	0.0	5.1	3.1	2.9	3.9	59
Nepal	4.4	3.2	1.3	3.0	17.1	1.8	13.6	5.1	13.0	7.8	7.0	80
Tajikistan	0.0	0.0	0.0	0.0	0.0	0.0	2.6	2.6	4.0	0.3	0.9	160
Bangladesh	26.4	28.4	27.4	16.9	17.3	28.2	23.7	25.6	15.2	13.0	22.2	27
Pakistan	42.2	26.0	25.7	32.2	19.1	16.9	0.0	9.8	19.2	29.7	22.1	54
Sri Lanka	12.3	7.2	12.7	10.4	3.0	10.9	23.9	15.2	14.5	7.0	11.7	49
Vietnam	0.0	22.4	13.7	17.4	20.5	24.2	23.8	15.8	14.1	19.8	17.2	41
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0		

ADF = Asian Development Fund, Cov = coefficient of variation, DMCs = developing member countries

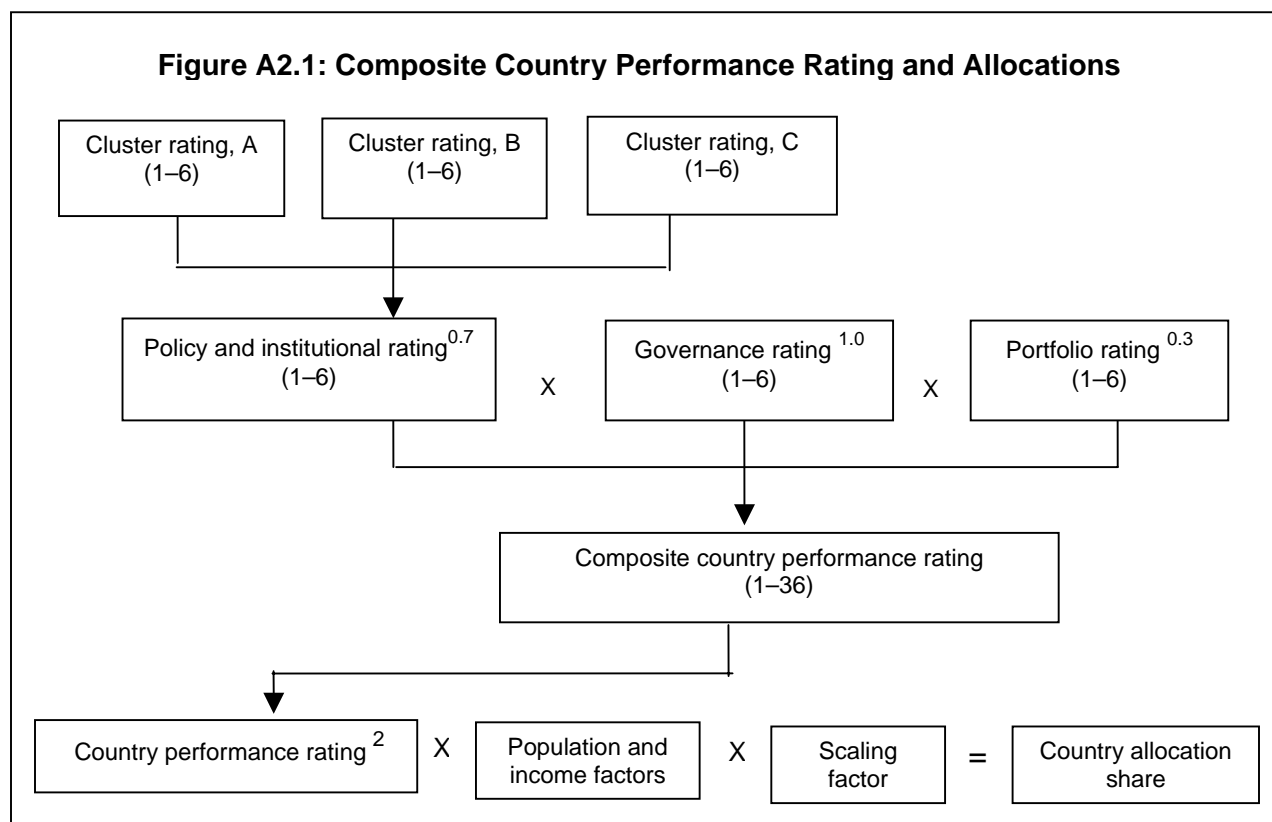
Note: The coefficient of variation of lending is defined as the standard deviation as a percentage of the mean over the sample period. The larger the number, the more volatile lending has been over the period.

Source: Project Coordination and Procurement Division loan, technical assistance, and equity approvals.

THE REVISED COUNTRY PERFORMANCE ASSESSMENT SYSTEM AND ALLOCATION FORMULA

1. The allocation formula presented in Box 6 can be constructed using an overall country performance rating. Figure A2.1 illustrates how this overall country performance rating is constructed. The scale on which ratings are recorded at each step is identified in parenthesis. The allocation shares that would result from the use of the framework of Figure A2.1 are identical to those generated by the modified formula of Box 6 and as such are “observationally equivalent”.

2. Although this representation of the modified allocation framework is similar to that of the original policy, a critical difference is the scale on which the country performance rating is measured. In this representation of the allocation formula, the country performance rating is measured in a range of 1 to 36. In the original allocation formula, the country performance rating is measured in a range of 1 to 6. The exponential weight on the composite country performance rating is 2 in the new formula and 1.8 in the old formula. Therefore, other things equal, the ratio of maximum to minimum performance related allocations under the new policy is $36^2 \div 1^2 = 1296$ to 1, which compares with $6^{1.8} \div 1^{1.8} = 25$ to 1 (approximately) under the old policy. The revised scoring system and formula weight is equivalent to applying an exponential weight of 4 to ratings measured in a range of 1 to 6, as this, too, would generate a ratio of maximum to minimum allocations of $1296 (=6^4)$ to 1 ($=1^4$). For IDA’s country performance ratings, see Figure 3 and Box 4, the corresponding ratio is about 6 times larger, specifically: $13.46^2 \div 0.153^2 = 7776$ to 1. The ratio using the AfDF’s rating system, which has a linear governance factor is, $10.286^2 \div 0.286^2 = 1296$ to 1, which is the same as the proposed modified allocation system



3. Performance impacts in the revised allocation system are summarized in Table A2.1. For ease of comparison, the criteria used follow those presented in Table 2, p4 of IDA (2004).¹ The modified system is compared with the earlier ADF system (a governance weight of 30% and no governance factor), and the results reported by IDA for non-linear (1.5) and linear (1) governance factors. All calculations are based on the weights shown in Figure A2.1. Note identical results would be obtained from the allocation model of Box 6.

4. The results of Table A2.1 confirm that governance ratings exert a substantially greater pull on ADF resource allocation in the proposed allocation system than under current arrangements. The theoretical weight of governance is 50%, but because of the distribution of actual performance ratings its empirical weight is 53%, compared with 30% in the current system. The “impact ratio”² (shown in the fourth row of the table) also shows a strengthened governance link. The impact of a unit reduction in a governance criterion rating on allocations is substantially larger than in the present system (shown in the fifth row of the table). The modified system also substantially stretches the gap between allocations for the best and worst performers. Using 2004 performance data, which are still based on the old CPA criteria, and holding other factors equal, the best performer would receive a per capita allocation 10.6 times as large as that of the worst performer, compared with just 2.8 times in the current system.

Table A2.1: The Impact of the Revised Country Performance Assessment and Allocation Formula

	Existing System	Modified PBA System	IDA with Governance Factor = 1.5	IDA with Linear Governance Factor = 1
Double Counting of Governance	—	No	Yes	Yes
Nominal Weight of each Governance Criterion in CPA/CPIA (%)	6	—	5	5
“Effective” Weight of Governance (%)	30	53	68	60
Governance to Non-Governance Impact Ratio	1.5	4.0	6.2	4.5
Allocation Reduction from a One-Point Reduction in Governance (%)	4	10 ³	13.8	10

— = not applicable

CPIA = country policy and institutional assessment, CPA = country performance assessment, IDA = International Development Association, PBA = performance-based allocation

Note: The calculations pre-date proposed revisions to IDA’s PBA. Since only a marginal reduction in the effective weight of governance is implied by IDA’s current proposals, results would be substantially the same.

Source: IDA. 2004. IDA’s Performance-Based Allocation System: Update on Outstanding Issues. Washington, DC (Table 2, p4).

5. Compared with the IDA allocation system, the revised approach has a more modest effective weight for governance (53% compared with 68%), and changes in governance have more modest impacts on allocations. If the exponential weight on the IDA governance factor

¹ IDA. 2004. IDA’s Performance-Based Allocation System: Update on Outstanding Issues. Discussion Paper presented at IDA 14 replenishment meeting. Paris. Table 2, p4.

² This is defined as the ratio of the impact on country ratings of a one-point drop in a governance rating (e.g., 3.5 to 2.5) compared to a one-point drop in a rating on economic and social policy criteria.

³ This is an average impact. Actual impacts vary by country and the distribution of policy, governance and portfolio ratings. The maximum impact for any country is over 13% and the smallest impact close to 8%.

were reduced from 1.5 to 1, as in AfDF, the impact of changes in governance ratings would be similar. The larger “effective” weight for governance with a linear governance factor stems from the double counting of governance ratings in the IDA system.

THE INTERNATIONAL DEVELOPMENT ASSOCIATION'S APPROACH TO ALLOCATING RESOURCES TO POSTCONFLICT COUNTRIES

1. The International Development Association (IDA) management has developed and tested a methodology that seeks to provide staff and management with a more systematic basis for calibrating IDA's response to the different phases of the postconflict period. The following outlines the key steps of IDA's methodology¹:

2. Step 1-Determining Eligibility

- (i) The engagement of a country affected by conflict will be assessed by Bank staff and management, in consultation with other international partners.
- (ii) Re-engagement opportunities will be specified in a Transitional Support Strategy, which sets out IDA's assistance program for the immediate postconflict period. The strategy also outlines the process of ascertaining if a country qualifies for exceptional allocations, and the size of the allocation.
- (iii) After a decision on initial engagement has been made, staff shall evaluate the country's eligibility for access to exceptional postconflict allocations. Eligible candidates are defined as:
 - (a) a country that has suffered from a severe and long-lasting conflict which has led to the inactivity of the borrower for an extended period, or at least a substantial decline in the level of external assistance, including from IDA;
 - (b) a country that has experienced a short but highly intensive conflict leading to a disruption of IDA involvement; and
 - (c) a newly sovereign state that has emerged through the violent break-up of a former sovereign entity.
- (iv) Generally, the eligible countries will be those that have experienced highly intensive conflicts. The degree of exceptional assistance depends on the intensity of the conflict, which is assessed on three key dimensions.
 - (a) the extent of human casualties directly or indirectly caused by the conflict;
 - (b) the proportion of the population that is either internally displaced, or in exile; and
 - (c) the extent of physical destruction.
- (v) Staff evaluation will rely mainly on qualitative judgment supplemented by quantitative evidence where available.

3. Step 2-Determining the Initial Allocation

- (i) Upon confirmation of country eligibility, staff shall initiate a consultative process to find the best possible match between the size of the initial allocation and country needs and circumstances, and the prospects for strong performance on a social and economic recovery program. This process shall assess the following four sets of issues that could have a bearing on the size of the initial allocation:
 - (a) the prospects of peace;
 - (b) country needs, capacity, and resources;
 - (c) Government commitment to sustainable development; and

¹ IDA. 2001. Adapting IDA's Performance-Based Allocations to Postconflict Countries. Discussion paper presented at the IDA 13 Replenishment meeting. An abridged version is available at <http://siteresources.worldbank.org/IDA/Resources/Annex2postconflict.pdf>

- (d) moral hazard considerations.
- (ii) An indicative list of ten sets of questions has been developed to guide the assessment (see Table A3.1), which should be summarized in the Transitional Support Strategy. Staff evaluation will rely mainly on qualitative judgment supplemented by quantitative evidence where available.

Table A3.1: Considerations for the Initial Allocation

Dimensions	Guide Questions ^a
Prospects of Peace	1. Reconciliation: Is a peace treaty in place? Which accompanying efforts have been carried out to safeguard the peace treaty or ceasefire agreement? Is a mediation process in place and how effective is it? 2. Domestic security: Have there been shootings over the past 6 months? Is movement around the territory unhindered? To what extent does security situation allow preparation, implementation and supervision of projects? 3. Impact of neighboring conflict: To what extent does conflict in neighboring countries affect internal conflict dynamics? How would stabilization impact its neighbors?
Needs	4. Damage assessment: What is the extent of destruction of social and economic infrastructures? Needs of conflict-affected groups? Estimated cost of comprehensive emergency recovery/reconstruction program? 5. Absorptive Capacity: what level of government and donor resources can be effectively absorbed? If low, can capacity be quickly augmented? Main constraints to absorb development assistance? 6. Adequacy of available resources: Is there a substantial unmet need given the available government and donor resources? Are other donors making substantial effort to ensure full funding of recovery program? If IDA has a portfolio in the country, what level of resources can be directed to support recovery program?
Government Commitment to Sustainable Development	7. Social and economic reform program: Does government intend to pursue social and economic policies that would contribute to sustainable/broad-based economic growth and poverty reduction? Identify constraints that impede implementation. 8. Economic management. Is the government putting in place adequate economic management functions, including fiduciary safeguards? Is it committed to normalizing relations with donors/creditors? Has it encouraged official creditors to participate in an orderly arrears clearance process?
Moral Hazard Concerns	9. Signaling impact of IDA involvement: Could a resumption of IDA assistance undermine the domestic or regional commitment to peace? What role did the incumbent government play in the conflict? Could IDA assistance be perceived to "reward" one or more parties to the conflict? 10. Probability of misuse of IDA assistance: Could IDA assistance fuel the conflict? To what degree should the fungibility of resources be considered a concern, either in the country or regionally?

^aCondensed from source.

- (iii) To avoid over allocation of resources, special attention should be given to assessing the absorptive capacity of countries with large populations. Higher allocations could be considered if warranted by special circumstances, e.g. where government capacity to implement recovery program has remained strong.
- (iv) The country team shall also undertake a "shadow" rating of country performance using a set of indicators (refer to Step 3). The main function of the rating results is to provide a benchmark against which future ratings can be compared.

4. Step 3-Determining the Subsequent Allocations

- (i) Allocation norms for the second and subsequent years are based on systematic performance measurement using postconflict performance indicators tailored to postconflict circumstances (Box A3.1). Performance is measured on the basis of the government's record of implementing pro-poor measures. The rating scale for postconflict performance indicators has been narrowed to 2 to 5, compared with 1 to 6 for the country policy and institutional assessment. The postconflict performance indicators should be updated at least once a year given the volatility of postconflict situations and the short-term horizon of the allocation mechanism. Where available, the portfolio rating shall be included, with a 20 percent weight, to form the postconflict performance rating.
- (ii) The postconflict performance rating is the basis for calculation of indicative postconflict allocation norms, which, in turn, shall be the basis for determining assistance levels for the program set out in the strategy for each country. The norms will increase or decrease depending on country performance. If the initial allocation were set at the high end, continued strong performance would be necessary to sustain that level for a second year.
- (iii) The scores on the postconflict performance rating are translated into indicative allocation norms using guidelines for maximum per capita per annum allocations. For instance, the upper bound for countries rated close to 5.0 has been set at \$20 while those rated close to 2.0, the upper bound is at \$4.
- (iv) Exceptional postconflict allocations are limited in duration, which is normally limited to 3 years. After which, the allocation is again determined by IDA's regular performance rating-based allocation norm. In some cases, it may be necessary to consider continuing exceptional assistance for an extension of 1 year, or at most 2 years. By the third year of postconflict allocation, the overall country policy and institutional assessment measure for the country is consulted to determine actual allocation with a view to phasing postconflict allocations back to a normal level.

Box A3.1: Postconflict Progress Indicators

- A. Security and Reconciliation
 - 1. Public Security
 - 2. Reconciliation
 - 3. Demobilization and Disarmament
- B. Economic Recovery
 - 4. Management of Inflation, External Debt; Adequacy of Budget
 - 5. Trade policy, Foreign Exchange, and Price Regimes
 - 6. Management and Sustainability of the Development Program
- C. Social Inclusion and Social Sector Development
 - 7. Reintegration of Displaced population
 - 8. Education
 - 9. Health
- D. Public Sector Management and Institutions
 - 10. Budget Formulation and Efficiency of Revenue Mobilization
 - 11. Reestablishing the Administration and Rule-based Governance
 - 12. Transparency, Accountability and Corruption in the Public Sector