ASIAN DEVELOPMENT BANK

POLICY ON PERFORMANCE-BASED ALLOCATION FOR ASIAN DEVELOPMENT FUND RESOURCES

February 2001

ABBREVIATIONS

ADB	—	Asian Development Bank
ADF	—	Asian Development Fund
CAP	—	country assistance plan
CAS	—	country assistance strategy
CPA	—	country performance assessment
CPIA	—	country policy and institutional assessment
CSP	—	country strategy and program
DMC	—	developing member country
GNP	—	gross national product
IDA	—	International Development Association
IMF	—	International Monetary Fund
IOTR	—	index of trade restrictiveness
NGO	—	Nongovernment organization
NTB	—	nontariff barrier
PBA	—	performance-based allocation
PDMC	—	Pacific developing member country
PR	—	performance rating

CONTENTS

EXECUTIVE SUMMARY

The sustainability of development is an issue at the heart of the recent decision of the Asian Development Bank (ADB) to adopt poverty reduction as its overarching goal, and to base its strategy for poverty reduction on three key pillars, namely, pro-poor economic growth, social development, and good governance. With the adoption of the poverty reduction strategy, ADB took a key step in transforming itself from a project-oriented organization into a broad-based development institution.

ADB's success in its future operations as a broad-based development institution will no longer be gauged by the inputs (projects and programs) that it provides into the process of development alone, but will depend on the outcomes achieved in terms of effectiveness and sustainability of the development process. Therefore, ADB must ensure that its scarce concessional financial resources are devoted to activities that most effectively contribute to sustainable development and poverty reduction, and are used by countries that make the best use of these resources.

Therefore, the successful achievement of ADB’s overarching goal of poverty reduction will require a strong partnership between the ADB and its developing member countries (DMCs). ADB will need to ensure that financial resources are allocated to countries that make the best use of these resources, while the recipient DMCs, in turn, will need to ensure that these resources are used efficiently and effectively. This dual responsibility is the basic principle behind the development of a performance-based allocation (PBA) policy for Asian Development Fund (ADF) resources.

The proposed PBA system is based on the understanding that efficient and equitable allocation of resources requires an assessment that blends performance, needs, and absorptive capacity of the recipient country. Country performance is evaluated in terms of policy adoption and implementation; needs are measured by per capita gross national product and population size. Allocations based on performance and needs must be modulated by considerations of absorptive capacity.

In this system, performance refers to how well a country’s efforts are in line with the goal of poverty reduction. Critical to the design of a PBA system is the selection of performance criteria that demonstrate such efforts. Basic principles for these criteria include the following:

(i) The selected criteria for performance should reflect ADB’s overarching goal of poverty reduction.
(ii) To the extent possible, each performance criterion should reflect policy adoption and implementation, not merely outcomes.
(iii) The objective should be to evaluate the current policy framework, i.e., efforts made to bring about sustainable development and to reduce poverty.
(iv) The criteria must combine relevance to each country with applicability across all ADF borrowers.
(v) The number of criteria included is less important than their effectiveness in eliciting the required responses to reach a balanced judgement on country performance.

Taking these basic criteria into account, the PBA system evaluates performance on two fronts: (i) the policies and institutional framework in place (divided into policies and framework on sustainable economic growth, socially inclusive development, and governance and public sector management), and (ii) the quality of portfolio performance.

This evaluation yields a basic measure of a country's performance. The PBA system then allows for multilayered adjustment to this measure:

(i) First, once performance is rated, the rating is combined with determinants of need (population and income per capita) to determine a baseline allocation for the country; in this relationship, income per capita inversely influences allocation, while population enters into the calculations in such a way as to allow a bias in favor of small countries.
(ii) Second, the country's own performance is influenced by its comparative position against the performance of all other ADF borrowers (who compete for the limited pool of available concessional resources).
(iii) Third, vulnerability modifies allocation. The PBA system defines vulnerability in terms of a country's suffering from natural disasters and economic shocks, and identifies the Pacific DMCs and other small island economies as the ADF borrowers that are vulnerable in this way.
(iv) Finally, considerations relating to absorptive capacity, and exceptional circumstances such as postconflict recovery affect allocation.

This PBA system is very similar to the one used by the World Bank for allocating International Development Association (IDA) resources. Both systems use country policy performance, need, and portfolio performance to determine allocation. Both allow common criteria across countries to be modified by country-specific elements.

A carefully crafted implementation arrangement for the PBA system is proposed:

(i) The performance rating determines a rolling, three-year, baseline allocation.
(ii) The rolling three-year country strategy and program (CSP) will incorporate this allocation as its baseline scenario.
(iii) Against this baseline scenario, the CSP will identify high and low scenarios.
(iv) The high and low scenarios will depend on country-specific factors identified in the CSP. Clear trigger mechanisms will be defined.
(v) Annual assessment of performance at year-end will influence the allocation for the next year's CSP.

Because these implementation arrangements cannot be put in place immediately upon approval of the PBA policy, 2001 will be a transition year to accomplish the following:

(i) An initial allocation will be made for 2001, most likely, based on past performance and allocation.
(ii) The country programming mission will draw up a CSP on that basis.
(iii) Agreements will be reached with the authorities on which country-specific criteria should be used to develop the baseline, low, and high scenarios, and identify well-defined trigger mechanisms.
(iv) An assessment of performance with these country-specific criteria will be made by midyear.
(v) At year-end, country performance will be assessed to determine the performance rating. These ratings will be used to initiate the full PBA system in 2002.

(vi) A further element to be put in place during 2001 is the decision-making system regarding the rating and allocation for each country. ADB's approach to determining the performance ratings and the impact of country-specific factors will not be a mechanistic one. Instead, an internal system will be put in place to ensure that final recommendations on allocations are made through a group consisting of the concerned departments. The details of this internal system will be spelt out in the context of staff instructions that would follow the approval of the policy on performance based allocation.

Decision making on the details of the PBA system will extend beyond the transition year, 2001. This year will only mark the first experience with benchmarking and pilot-testing of performance criteria. Performance criteria, indicators, and guidelines for performance assessment will be refined and improved over time.

The midterm review of ADF VIII will include an evaluation of experience in implementing the PBA system during 2001-2002 and available information on indicative allocations for 2003.

The proposed 2002 allocations for ADF borrowers will be submitted to the Board for formal endorsement in the context of the CSP process for each country.

INTRODUCTION

1. Developing member countries (DMCs) that borrow from the Asian Development Fund (ADF) are among the poorest and least developed nations of the world. Over the years, these DMCs have received sizeable volumes of development assistance from multilateral and bilateral sources. The primary objective of this concessional assistance was to promote long-term economic development and growth and to reduce poverty. However, the results have been mixed—some DMCs made remarkable progress while others lagged behind. Some achieved reasonably high rates of economic growth but did not manage to reduce poverty. Recent studies on aid effectiveness[1] have explained this mixed record in terms of differences in the quality of policies, institutions, and governance in the recipient countries. In settings where poor policies were pursued or where the institutional environment was weak, aid has not worked. Not surprisingly, where policies were sound and institutions strong, aid has accelerated the process of poverty-reducing growth. As a result, an international consensus has evolved that the flow of aid should be directed to poor countries that use it most effectively.

2. Thus, to realize its overarching goal of poverty reduction, the Asian Development Bank (ADB) must strengthen the linkage between country performance (in terms of efforts made to achieve effective development management) and the allocation of scarce ADF resources among recipient countries. This is the main reason why ADB has opted to introduce a performance-based allocation (PBA) system for ADF resources, a move endorsed by ADF donors.

3. Recognizing that the allocation of scarce ADF resources among borrowers should be based on needs and performance. ADB has been using a general system incorporating criteria to make allocation decisions. The introduction of a more formal system, to strengthen the link between allocations and a rigorous performance assessment based on measurable indicators, has long been under consideration. An approach to refining and systematizing the allocation process was outlined in the Performance-Based Allocation of ADF Resources among the DMCs.[2] Since then, work on developing a PBA system has been ongoing. This paper proposes using the results of these ongoing efforts to develop a system that combines regard for performance with concerns for objectivity and transparency, balanced by a reasonable degree of flexibility. The system, similar to the one used by the International Development Association (IDA), accommodates suitable modifications warranted by regional and institution-specific considerations.

4. This paper discusses the principles underlying the PBA system for ADF resources and how the system would work in practice. Chapter II focuses on PBA and its different forms, the potential uses of country performance assessment (CPA) in the context of ADF operations, and the factors that need to be taken into consideration when allocating ADF resources. Chapter III describes the proposed PBA system for ADF resources, chapter IV focuses on the key elements of IDA's approach to PBA, chapter V provides a comparison of the ADB and IDA systems, and chapter VI briefly describes the implementation arrangements. The main conclusions are listed in Chapter VII.

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[1] World Bank. 1998. *Assessing Aid: What Works, What Doesn't, and Why*. Policy Research Report, Washington, D.C.

[2] IN.284-98: *Performance-Based Allocation of ADF-Resources,* 2 November 2000.

II. PERFORMANCE-BASED ALLOCATION OF RESOURCES AND ITS DIFFERENT FORMS

A. Forms of Performance-Based Allocation

5. The DMCs eligible for concessional funds have very large needs for assistance because of the daunting development problems they face. Because the need far exceeds available resources, an allocation mechanism is required. One possible criterion is to base a country's allocation on the effectiveness with which it uses resources in general. This is a very important characteristic of the proposed PBA system: it does not punish a country that is poor, facing various internal and external problems, as long as the country is demonstrably putting in place appropriate policies and actions to remedy these problems. The system links the allocation to policies adopted, institutional capacities, and general economic management—in a word, country performance. PBA refers to the use of country performance as the primary determinant in apportioning limited resources among competing claimants. This does not mean that other relevant factors (such as needs and absorptive capacity) will not be taken into account. However, it does imply that differences in assessed country performance will be the most important factors in explaining variations in per capita allocations to recipient DMCs.

6. The essence of a PBA system is to divide a limited pool of resources among client countries using prespecified criteria and to provide a mechanism (formula) that links evaluated performance (and other relevant variables) to individual country allocations. The CPA and the related mechanism (formula) for determining the PBA are not intended to make projections of future demand for resources or the appropriate size of a replenishment. Such an exercise will be undertaken completely separately.[3] Nor is the system supposed to determine the allocation of resources among various sectors and across activities within a country; this is part of the country strategy and planning exercise. Furthermore, since ADB does not assign separate indicative planning figures to individual local governments within a DMC, therefore the performance of local governments will not be looked at individually, but will be taken into account when evaluating a country's overall performance and its indicative planning figure.

7. PBA can take a variety of forms. The top-down approach has evaluation criteria that are common (standardized) across all borrowers, e.g., economic growth or the stance of monetary policy. Alternatively, the bottom-up approach evaluates performance on the basis of highly country-specific actions, e.g., reforms in a particular sector, a specific policy reform or initiative, a statute change, or an individual tariff adjustment. In this case, the performance criteria will vary from country to country, i.e., they will not be comparable across countries. A CPA normally relies on a combination of the two approaches.

8. No matter which approach is adopted, some indicators of performance are amenable to objective assessment while others involve an element of subjectivity. In one case, criteria can be predicated on outcomes typically measured by quantitative indicators. In contrast, evaluation of policy adoption, implementation, and institutional capacities involves a judgement call. Often, measures of performance have to be a blend of qualitative and quantitative indicators. After a set of performance criteria is selected and finalized, allocations can be based on either past performance or commitment to future performance, or both. Typically, PBA systems use a combination of the two. In practice, PBA system designs incorporate all of these approaches.

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[3] For instance, IDA estimates demand for resources separately through medium-term projections.

B. Uses of Country Performance Assessment (CPA)

9. CPAs have many potential uses in ADF operations:

(i) **Aid Effectiveness and Aid Selectivity.** The essential rationale for the CPA is to increase the effectiveness of aid. The objective is to direct the flow of scarce resources to countries that can use these to the greatest advantage. The CPA can strengthen the country planning process and thus enhance efficiency of resource use.

(ii) **Input to Poverty Reduction and Governance Activities.** By identifying crucial institutional and capacity constraints, policy weaknesses, and bottlenecks in the poverty reduction effort, the CPA can provide valuable inputs to strengthening governance and improving poverty reduction, e.g., by restructuring ineffective poverty reduction programs and strengthening policy formulation capacity.

(iii) **Diagnostic Tool.** A CPA can help identify critical management vulnerabilities. Evaluation using a host of criteria can highlight specific weaknesses, e.g., lack of financial sector soundness or the presence of a restrictive foreign trade regime. Such diagnoses can help strengthen country strategy formulation, focus attention on areas requiring improved management, and shape the thrust of country assistance programs.

(iv) **Policy Dialogue and Capacity Building.** A critical component of ADB's development support is its nonlending services in the form of policy advice, institutional strengthening, and capacity building. A CPA can sharpen the focus of ADB's policy dialogue with its DMCs and buttress efforts to build capacity for policy and plan formulation at the sector and national levels.

(v) **Showcasing Achievements.** A CPA can identify policy successes, institutional strengths, and implementation achievements. This can be the basis for setting benchmarks and disseminating information on best practices.

(vi) **ADB's Graduation Policy.** A CPA can provide an incentive for better performance. Higher economic growth and faster poverty reduction, resulting from more effective resource utilization, will over time reduce a country's reliance on aid.

B. Making Allocation Decisions

10. Performance, though crucial, must be considered with other relevant criteria when determining the allocation of ADF resources. In apportioning resources, considerations for actual performance, needs, and abilities must be balanced.

11. A widely accepted summary measure of a country's needs is per capita gross national product (GNP). Using per capita GNP as an indicator of need allows measurement and comparability of the degree of equity in allocations. Other factors being the same, the poorer the country, the higher the allocation on a per capita basis—this is called the poor country bias in allocating resources.

12. A second factor that has a bearing on a country's need for development assistance is population size. At one level this is straightforward: the larger the population, the higher the total allocation. However, small countries merit special attention because in a straightforward system, their allocations could become too small to have a meaningful development impact. Of the 21 DMCs with access to ADF resources, 10 are very small island economies, 8 have small populations, and 3 have large populations. The 3 large DMCs account for over 80 percent of the total population with ADF access, and because of their size, large allocations to these countries can potentially crowd-out the smaller DMCs. Moreover, the small economies are ADF-only borrowers, i.e., they are poor and less developed. The Charter requires ADB to pay "special regard to the needs of the smaller or less developed member countries in the region." Thus, the interests of the small and very small economies must be safeguarded. This is addressed by adopting the principle that the smaller the country, the higher the per capita allocation. This is called the small-country bias and is in consonance with the Charter mandate.

13. In addition to the small-country effect, many of the very small island economies are structurally vulnerable to shocks because of high exposure to external economic forces, remoteness, and proneness to natural disasters. For this reason, the proposed PBA system provides an adjustment mechanism to account for their vulnerability to shocks.

14. Needs assessments must consider absorptive capacity. Limitations in capacity jeopardize the effective use of resources. Absorptive capacity has financial and institutional dimensions. Financial absorptive capacity refers to the government's ability to provide counterpart financing for each project and program supported by an ADB loan. It also includes the capacity to bear the recurrent costs of the project or program. These factors have implications for both ownership and sustainability of ADB-assisted projects. Institutional capacity is vitally important and involves capacity for general economic management, policy formulation, program and project design at the sector and national level, and implementation of policies and programs. An overall assessment of absorptive capacity must be factored into the final allocation decision. At the same time, efforts must also be made to build up this capacity so that more effective use is made of development assistance.

15. Efficient and equitable resource allocation requires an assessment that blends performance, needs, and absorptive capacity. Country performance is evaluated in terms of policy adoption and implementation; needs are measured by per capita GNP and population size. Allocations based on performance and needs must be modulated by considerations of absorptive capacity.

III . THE PROPOSED PERFORMANCE-BASED ALLOCATION SYSTEM

A. Performance Criteria

1. Principles

16. Performance refers to how effectively a country's efforts are in line with poverty reduction on a sustainable basis. This is the objective of providing concessional resources to the DMCs. Critical to the design of a PBA system is the selection of performance criteria that demonstrate such efforts. Thus, some basic principles must be enumerated.

17. First, the selected criteria should reflect ADB's overarching goal of poverty reduction. The criteria must be able to gauge an ADF recipient's

(i) demonstrated commitment to reducing poverty,
(ii) adoption and implementation of policies in pursuit of this goal, and
(iii) ability to set up necessary institutions and governance structures to sustain the effort.

18. Policies, institutions, and processes that matter for poverty reduction are not narrowly defined, but encompass macroeconomic management, structural and distributional policies, programs for the poor, institutions, and governance structures. As the emphasis is on the effort made by the government, performance criteria should reflect the prevailing policy and institutional setup, and recent progress made in making that environment more conducive to poverty reduction.

19. Second, to the extent possible, each performance criterion should reflect policy adoption and implementation, not merely outcomes. Policy milieus shape outcomes; so do random events and other uncontrollable factors. However, the government is responsible for policy itself.

20. Third, the objective should be to evaluate the current policy framework. Demonstrated commitment and policy performance ought to be rewarded rather than the promise of future performance. In assessing recent policy initiatives, due consideration should be given to the country’s capacity to undertake and sustain policy changes within the time frame of the assessment. The PBA system is not intended to set implicit targets for policy change that may overstrain a country’s policy delivery capacity.

21. Fourth, the criteria need to combine relevance to each country with applicability across all ADF borrowers. If the criteria inadequately reflect a country’s development effort, the very purpose of assessing performance is defeated. On the other hand, if the chosen criteria are too country-specific, then cross-country comparisons will be difficult. Criteria tied too closely to individual countries will also reduce the transparency of the allocation system. The objective is to strike a balance between common criteria (applicable to all countries) and country-specific criteria.

22. Fifth, the number of criteria included is less important than their effectiveness in eliciting the required responses to reach a balanced judgement of country performance. To the extent possible, criteria selection should be based on whether information is available that is (i) reliable, acceptable, neutral, and comparable; (ii) has coverage across ADF recipient countries; and (iii) can be updated over time.

2. Country Performance Assessment

23. PBA systems typically blend top-down and bottom-up approaches. Using a standardized set of criteria to evaluate performance of all countries makes cross-country comparability easy. However, a country’s specific situation must also be considered. This bottom-up approach considers (i) a country’s efforts to cope with its development challenges, (ii) the differing initial conditions from which various DMCs start, and (iii) that the problems encountered by DMCs at any particular point of time will differ. This implies that priorities vary across DMCs and from situation to situation. This is the essential rationale for a incorporating country focus into the CPA exercise. This country flavor is captured by assessing performance against a set of specific actions and policy initiatives to be taken by an individual DMC within a specified time frame. Obviously, such performance criteria vary from country to country and are therefore termed country-specific.

24. CPA in the proposed PBA system combines these two approaches, i.e., it uses both common and country-specific criteria. This is done by first evaluating country performance using a set of common criteria to determine a cross-country comparable performance rating. The performance ratings are then used to determine a baseline for individual country allocations of ADF resources. The indicative allocations are used in the country planning exercise. In a subsequent stage, performance is evaluated against identified country-specific criteria and this is used as the basis for making appropriate adjustments to the indicative allocations.[4] In sum, performance evaluation using a set of common criteria yields an initial allocation, and subsequent evaluation against country-specific criteria enables a "below-the-line" adjustment.

3. The Common Criteria

25. Performance is assessed on two fronts. First, a set of criteria is used to evaluate the policies and institutional framework in place. In a sense, the goal is to assess how well a DMC uses resources in general. Second, another set of criteria is used to evaluate the quality of portfolio performance. The objective here is to assess how well a DMC uses ADF resources. The same two sets of criteria are used for performance evaluation across all DMCs.

a. Policies and Institutional Framework

26. The first set of criteria evaluate the quality of development management in terms of objectives to be achieved. The criteria are grouped into three main clusters: (i) sustainable economic growth, (ii) socially inclusive development, and (iii) governance and public sector management. Policy and institutional performance criteria have been identified for each of these three clusters (Box 1).

[4] This is exactly the same as in the IDA system where an indicative allocation is determined and then the country assistance strategy is used to incorporate the bottom-up approach.

Box 1: Country Performance Criteria

A. Sustainable Economic Growth

(a) Macroeconomic Management
Fiscal Policy
Monetary Policy
External Financing Policies

(b) Structural Policies
Trade Policy and Foreign Exchange Regime
Financial Sector Efficiency and Soundness
Factor and Product Markets and Prices
Enabling Environment for Private Sector Development

(c) Environmental and Protection
Environmental Laws and Institutions
Environmentally Damaging Subsidies

B. Socially Inclusive Development

Framework for Poverty Monitoring and Policy Formulation
Enhancing the Economic Capital of the Poor
Developing the Human Capital of the Poor
Equity and Social Safety Nets
Empowerment and Participation

C. Governance and Public Sector Management

Rule of Law
Anticorruption and Accountability Institutions
Civil Service
Revenue Mobilization and Budgetary Management
Management and Efficiency of Public Expenditures

27. Sustainable economic growth is critical to reducing poverty. This is echoed in ADB's Poverty Reduction Strategy.[5] The first cluster evaluates what economic management and policies have been adopted to promote sustainable economic growth and private sector development. This assessment covers macroeconomic management, structural policies, and environmental protection. The first subset, macroeconomic management, assesses whether (i) fiscal policy adopted is geared to render the fiscal balance sustainable, (ii) monetary policy is effective in containing inflation, and (iii) the current account balance is being financed in a sustainable manner. The second subset, structural policies, assesses whether (i) trade policies

[5] R179-99: *Fighting Poverty in Asia and the Pacific, The Poverty Reduction Strategy of the Asian Development Bank,* 19 October. "Despite the Asian crisis, countries have shown how robust growth can reduce poverty… The lesson is clear: growth can reduce poverty by generating employment and income."

promote pro-poor growth by promoting job-creating private sector activities (e.g., freer trade, lowering tariffs and nontariff barriers), (ii) efficiency and stability of the financial sector are being promoted by policies that place greater reliance on market discipline supported by sound prudential regulation and supervision, (iii) factor and product markets and price policies permit markets to work better and provide the jobs and incomes needed by the poor, and (iv) the overall environment enables private sector development.[6] The third subset, environment protection, assesses whether (i) a country has specific laws to protect the environment, and institutions to monitor and enforce such laws (evaluation will focus on development, implementation, and enforcement of laws and regulations); and (ii) the government is making efforts to eliminate environmentally damaging subsidies.

28. Poverty reduction is a cross-cutting theme of the PBA. A separate cluster is devoted explicitly to efforts to make development socially inclusive. This cluster covers (i) monitoring poverty and the linkage to policy formulation; and (ii) enhancing the economic and human capital of the poor, equity and social safety nets, and empowerment and participation. The criteria for enhancing the economic capital of the poor include, the government's efforts to increase the access of the poor to land, credit, infrastructure, information, and technology. The criteria for developing the human capital of the poor will evaluate efforts made to ensure adequate provision of essential social services that benefit the poor, such as basic education, primary health care, and family welfare (emphasis will be on, for example, efforts made, and budgetary resources devoted to health and education, rather than the existing number of schools and hospitals in place). Gender aspects of poverty will receive special attention. The assessment will specifically examine efforts made to promote gender equity and the participation of women in development. In evaluating outreach of education and health services, attention will explicitly be paid to girls' education, and maternal and other family welfare services. Performance assessment will look at government efforts to support programs designed especially for women, such as microcredit for women, and child development and nutrition, as well as the gender coverage of antipoverty programs in general, e.g., safety nets and employment programs. Recognizing that the poor often lack the voice required to participate in customary activities, the criteria for empowerment and participation will focus on measures and institutional mechanisms to empower the poor socially, e.g., legal remedies for disadvantaged groups, measures to improve equality of opportunity, raise awareness, and provide support for nongovernment organizations.

29. Because governance plays a crucial role in poverty reduction, the third cluster is devoted to efforts at good governance. Studies have confirmed a strong relationship linking good governance to better development outcomes. In this context, governance refers to the manner in which government policies are formulated and implemented. Clearly, governance and public sector management is important in all sectors. However, the focus here is on core governance areas affecting the entire system. One subset of criteria focus on government policies and actions to promote general aspects of good governance: rule of law; anticorruption and accountability institutions; and merit-based, accountable civil service. This covers the whole gamut of property rights (private and common), impartial dispute resolution mechanisms, independent audit and vigilance institutions, accountability, and, enhancing institutional capacity for policy formulation and program implementation. The other criteria in this cluster evaluate the quality of public financial management. This covers a wide range: efforts to enhance revenue mobilization; improve budgetary processes; and enhance financial control, public investment

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[6] R78-00: *Private Sector Development Strategy, Promoting the Private Sector to Support Growth and Reduce Poverty,* 9 March. "ADB will utilize the capabilities of both its public and private sector operations to deliver synergistic solutions to problems that impede private sector growth in its DMCs."

programs, and the thrust and efficiency of public expenditures; as well as efforts to reduce untargeted subsidies and nonproductive expenditures. In sum, the criteria seek to provide a systemwide view of governance and general public sector management.

b. Portfolio Performance

30. Portfolio performance measures the effectiveness with which ADF resources are utilized for specific projects and programs. The proposed system uses the "project at risk" concept as the basic measure of portfolio performance.[7] The concept comprises reporting on projects at risk of not meeting their objectives. Projects at risk consist of actual and potential problem projects. An actual problem project is one that does not meet criteria for implementation progress and/or development objectives; a potential problem project is one rated satisfactory on implementation progress and development objectives, but having risk factors historically associated with unsatisfactory outcomes. Potential problem projects are identified using criteria related to implementation experience and past portfolio performance in the country and the sector. An indicative list of such criteria is presented in Appendix 1. After the projects at risk in a portfolio are identified, the quality of the portfolio can be assessed on the basis of the percentage of projects/programs at risk. This is then translated into a performance rating.

B. Rating and Assigning Allocations

1. Rating Using Performance Criteria

31. To map performance assessments onto country allocations, a performance rating scheme is needed. Each country will receive a rating from 1 (poor) to 6 (strong) for each criterion in the CPA.[8] In addition, each score will be followed by a plus sign (+), a minus sign (-), or the word "stable" to indicate whether performance under the criterion is improving, getting worse, or has stayed the same, compared with the country's score last year. However, only the numerical score enters the performance rating. Guidelines to assess performance for each criterion are given in Appendix 2.

32. The clusters are assigned different weights (Appendix 3). The first cluster has three subclusters each with a different weight. However, criteria within a subcluster have equal weights. In the same way, criteria within the other two clusters all have equal weights. The highest weight is given to the clusters on socially inclusive development and governance (30 percent each).

2. The Aggregate Performance Rating

33. The country performance rating is computed using the ratings received for the two components of the CPA. An 85 percent weight will be attached to the ratings on the policies and institutional framework clusters and 15 percent weight to the portfolio performance rating. The overall performance rating (PR) is the weighted average across all criteria.

3. The Allocation Formula

[7] This would harmonize ADB's approach with that of other multilateral development banks (African Development Bank, Inter-American Development Bank, World Bank) and would avoid introducing a new system to the DMCs.
[8] The numerical rating scale to be used is exactly the same as the one adopted by IDA.

34. While performance is crucial in allocating resources, two other factors, must also be considered: population and per capita GNP. The formula to determine allocations incorporate these three variables, and is based on the following principles.

35. First, the formula must reward good performance (defined in terms of efforts, not outcomes), thus all things being equal, a country with a high PR (i.e., stronger and more appropriate efforts at poverty reduction) ought to be allocated more resources than a country with a lower PR.

36. Second, country size matters. The formula should ensure that the larger the population, the larger the allocation on an absolute basis. However, because large allocations to big countries may crowd-out small countries, the effect of population in the allocation formula must be moderated. The formula incorporates what is termed the small country bias, namely the smaller the population the higher the per capita allocation.

37. Third, the formula must cater to needs. The general principle is the poorer the country, the larger the allocation, other factors being the same. This implies an inverse relationship between allocation and per capita GNP. Excluding the Pacific Development Member Countries (PDMCs) that have relatively high per capita incomes, ADF recipient countries have a wide range of per capita GNP, from $210 for Nepal to $1,230 for the Maldives.[9] Overemphasis on per capita GNP can distort the allocation of resources among ADF recipients. While the formula must retain the poor country bias, it has to be carefully calibrated.

38. The manner in which the emphasis on performance, country size, and relative poverty is built into the formula is explained in detail in Appendix 4. The resulting formula is given below.

$$\text{Allocation share of country}_i\ (\%) = \frac{PR_i^{\,1.8} * GNPC_i^{\,-0.25} * Pop_i^{\,0.75}}{{}_i\sum (PR_i^{\,1.8} * GNPC_i^{\,-0.25} * Pop_i^{\,0.75})}$$

39. The proposed allocation formula relates the chosen variables, performance (PR), per capita income (GNPC), and population (POP) in a logical way to satisfy identified priorities in the distribution of resources. Salient features of the formula include the following:

(i) A share is allocated not an absolute amount. Since ADF resources are constrained, amounts allocated to a country must be linked to allocations to all other countries. By determining each country's share of ADF resources, the formula ensures that the resource constraint is exactly met. Thus, the formula is responsive to an aggregate budget constraint.

(ii) Performance and allocations are strongly and progressively linked. All other things being equal, a 20 percent better performance rating yields a 38.8 percent higher allocation. In the same vein, if country X has a PR of 4 while country Y has a PR of 2, and all other factors are the same, the formula allocates Country X three and a half times country Y's allocation.

[9] ADB's policy on ADF eligibility takes into account not only per capita GNP but also debt repayment capacity in determining which countries should have access to ADF resources. The DMCs that currently are ADF-eligible and have ADF access are identified in R204-98: *A Graduation Policy for the Bank's DMCs,* 4 November.

(iii) Allocations are responsive to relative poverty. A country with a per capita GNP of $200 will, all else being equal, receive a 26 percent higher allocation than a country with a per capita GNP of $500.

(iv) The formula takes into account the small country problem. If country X has a population of 1 million, while country Y has a population of 100 million, and all other factors are constant, country X's per capita allocation will be about three times that of country Y.

(v) Performance is the most important factor driving allocations. A 20 percent lower per capita GNP raises the allocation by 5.7 percent; a 20 percent smaller population raises allocation per capita by 5.7 percent; but, a 20 percent better performance rating raises total and per capita allocations by 38.8 percent.

40. The formula has other key aspects. First, a country's allocation depends not only on its own performance but also that of others. The formula compares the country's PR with that of all other competitors. The implication is that no single country allocation can be determined without reference to the performance of all. Further, since allocations are determined by relative performance, the formula has a built-in mechanism to spur performance improvements. For instance, if a country merely maintains its PR while others improve, its allocation will decrease. Second, the calibration of the formula seeks to ensure that historical shares for most countries are broadly maintained but with necessary corrections for consistency in treatment across countries. Thus, assuming average performance by all, absolute levels can be generally maintained. This is a useful feature, particularly in the transition period, so that DMCs are not exposed to major changes in terms of resource allocations.

4. Vulnerability and Small Population Size

41. The ADB system recognizes that (i) many very small DMCs, especially the PDMCs, are structurally vulnerable to natural disasters and shocks; and (ii) allocating resources based on population and income per capita as measures of need will miss the fact that a project or program has to have a certain minimum size to have any meaningful development impact. These two facts are reflected in the allocation formula as a small-population bias is built in, and a separate pool is assigned for PDMCs to take account of their vulnerability to shocks.

42. Application of the allocation formula to the PDMCs alongside the relatively larger DMCs can result in allocations to the PDMCs as a group, and individually, that are too small to be operationally meaningful. The small-island economies are to be treated as a distinct category. A specific amount (the size of which could be broadly based on the historical share of this group of countries in ADF VII allocations) will be set apart for them as a group. However, country performance will determine allocations within this group. Performance assessment will be undertaken for all the island economies; and the formula (or a variant thereof) will be used to determine allocations. In essence, the small-island economies will be competing among themselves for allocations from the pool. The other ADF countries will compete separately. Further, efforts will be made to adapt and/or develop indicators of structural vulnerability as determinants of the allocation for small countries. Indicators of performance more suited to the small island economies will be refined and adopted over time.

C. The Country Planning Process and Country-Specific Criteria

43. The CPA provides a crucial link to the country planning process. The top-down approach (using a set of common criteria) to assess performance yields the formula-based allocations. These indicative allocations will be used for planning and can serve as the anchor for the base-case lending program in individual country strategy and programs (CSP). The bottom-up approach, using country-specific criteria, is introduced at this stage. The logical basis for this two-step approach is that allocations based on relative performance on common criteria ensure consistency and equity among borrowers but do not capture individual countries' opportunities and constraints.

44. The country-specific criteria are identified in the CSP. They focus on specific policy initiatives, institutional measures, and actions identified during the country planning exercise as meriting priority attention of the government, given the country's particular circumstances. In this sense, the country-specific criteria will complement and reinforce the common criteria.[10] The performance criteria identified in the CSP must be limited in number, clearly delineated, and time-bound. Further, action on identified priorities must be selected and calibrated to be achievable within the stipulated time frame. The CSP will specify base, high, and low scenarios for a country's economic performance. Each scenario is characterized by the implementation of particular (country-specific) policies, reforms, and action. The CSP can propose levels of lending above (high case) or below (low case) the base case allocation. Country performance with respect to the identified criteria will trigger changes to lending from the base case. Setting clear milestones for identified priority actions and adjusting indicative allocations keeping in view actual performance will provide the right incentive. Linking performance assessment with the CSP in this manner will strengthen the country planning process and policy dialogue.

D. Adjustments to Allocations: The Need for Flexibility

45. PBA can be a powerful management tool. Performance assessment is essentially based on judgement. Thus care must be taken to fully realize the potential of PBA as a management tool. In determining country allocations a mechanical formula-driven approach must be avoided. First, as noted at the very outset, allocations based on performance and needs must be modulated by considerations of absorptive capacity. Thus, adjustments may have to be made to reflect absorptive capacity constraints. Second, devising a formula that fits a diverse set of countries is indeed difficult. Sharp and abrupt changes in allocations must be avoided. Third, exceptional circumstances must be acknowledged, e.g., postconflict countries, countries facing catastrophes, and countries undertaking far-reaching reforms. A degree of flexibility is essential. The intention is to avert undue rigidity in allocations. In the ultimate analysis, judgement must be exercised to enhance the quality of performance-based allocations. What is critical is that, even with this flexibility, the system will retain the basic robust relationship between performance and allocations.

[10] Given the comprehensiveness of the common criteria, the country-specific criteria will likely broadly fall under one of the major common criteria clusters but will differ from the common criteria in regard to the specific nature of the country.

IV. PRACTICES OF THE WORLD BANK

46. The World Bank has undertaken CPAs in various forms for the past 20 years. The approach has evolved from focusing primarily on macroeconomic and structural factors to emphasizing poverty reduction and governance. Simultaneously, rating criteria and evaluation methodology have become progressively more refined and complex. The CPA system blends top-down and bottom-up approaches. The starting point is the top-down approach using a set of common criteria. Country performance is assessed on two broad counts: policies and institutions and portfolio performance. The first provides an assessment of how effectively a country uses its resources in general; the second judges how well it uses IDA resources for specific projects/programs. Ratings of the two components are combined to yield a country performance rating.[11]

A. Performance Criteria

1. The Country Policy and Institutional Assessment

47. The country policy and institutional assessment (CPIA) seeks to assess the quality of each borrower's policy and institutional performance in areas relevant to economic growth and poverty reduction. The CPIA is essentially based on judgement, not on data-based indicators, although the latter are used to provide the context in which performance is assessed. In selecting criteria, the CPIA focuses on each country's prevailing policy and institutional environment (referred to as levels) rather than on recent changes in that environment (referred to as trends). The rationale for focusing on levels is that while changes are important, these will automatically be reflected in the annual updated performance ratings in subsequent years. Also, focusing on levels facilitates cross-country comparisons.

48. The CPIA comprises 20 criteria in four clusters:[12]

(i) **Economic Management (4 criteria).** Indicators focus on the quality of macroeconomic management.

(ii) **Structural Policies (6 criteria).** Indicators focus on the incentive framework for competitive markets and private sector development.

(iii) **Policies for Reducing Inequalities (5 criteria).** Criteria aim to capture the extent to which the country's policies and institutions ensure that the benefits from growth are widespread and result in greater social inclusion.

(iv) **Public Sector Management and Institutions (5 criteria).** Criteria focus on governance dimensions that can be systematically evaluated and that affect economic and social development and effective resource use.

49. Ratings are assigned on a scale of 1 to 6 for each of the 20 criteria. Equal weights are assigned to all 20 criteria to derive an initial overall score.

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[11] Country performance assessments are carried out both for International Development Association (IDA) and International Bank for Reconstruction and Development (IBRD) countries but only IDA has a direct linkage between country performance ratings and allocations.

[12] World Bank. 1999. *Country Policy and Institutional Assessment 1999.* Washington, D.C.

2. Portfolio Performance

50. Portfolio performance is measured in terms of the number of projects at risk of not achieving their development objectives. Projects at risk consist of actual and potential problem projects. Eleven criteria are used to measure portfolio performance, including a governance-related criterion pertaining to procurement practices. Countries with more than 35 percent of projects at risk are considered as showing signs of unsatisfactory use of external assistance. A portfolio with a risk percentage below 25 percent indicates that the country is likely to use external aid well.

B. Rating and Assigning Allocationis

1. The Aggregate Performance Rating

51. To determine country's PR, 80 percent weight is assigned to its CPIA rating and 20 percent to its portfolio performance rating.

2. Governance and the Performance Rating

52. Governance has assumed significant importance in the CPA. In 1998, the World Bank introduced the concept of a governance discount. This is applied to countries considered to have serious governance problems. Countries receiving highly unsatisfactory ratings on the governance criteria [13] have their PR cut by a third. This results in an even larger reduction in the country's IDA allocation.

3. The Allocation Formula

53. Individual PRs are translated into an allocation for each borrower using the following two-tier allocation formula that includes per capita GNP (GNPC) and, implicitly, population:

(i) For countries with performance rating above three:

$$\text{allocation per capita} = GNPC^{-0.125} * PR^{2.0}$$

(ii) For countries with performance rating of three and below:

$$\text{allocation per capita} = GNPC^{-0.125} * PR^{1.75}$$

54. Salient features of the formula include the following:

(i) The formula determines per capita allocations. In practice, a scaling factor is used to normalize the country allocations. The normalization is tantamount to a pro rata adjustment to ensure that allocations add up to match available resources. In effect, this is equivalent to determining a share for each country and then applying it to a given budgeted amount.

(ii) Allocations are largely determined by performance ratings. The World Bank notes that the difference in allocations between the better performers and poor performers is five-fold.[14]

[13] Six governance criteria of the CPIA and the procurement criterion of the portfolio performance component.

[14] The World Bank also notes that at the extreme the difference between the best and the worst performers is 12-fold.

(iii) The problems of relative poverty and country size are addressed. Given the same PR, countries with differences in per capita GNP can have differences in allocations (in the extreme) of up to 30 percent. Similarly, very small countries can receive per capita allocations that are 15-20 percent higher.

C. The Country Planning Process, Country-Specific Criteria, and International Development Association (IDA) Allocations

55. The bottom-up approach (using country-specific criteria) is introduced at this stage. Formula-based allocations are made on a three-year rolling basis, with each borrower's allocation adjusted with successive CPAs. The allocations are basically used for planning purposes and serve as the anchor for individual country assistance strategy (CAS) lending programs. The indicative allocations represent the top-down approach to allocating resources. Lending to a country can deviate from the formula-determined allocations if performance in between assessments has changed and if exceptional country circumstances must be considered. This is taken into account in the CAS, which represents the bottom-up approach to resource allocation. The rationale for this two-step approach is that allocations based on relative performance on common criteria ensure consistency and equity among borrowers, but do not capture individual countries' opportunities and constraints.

56. A CAS specifies one or more (base, high, or low) scenarios for a country's economic performance.[15] Typically, the base case is anchored at the level of the indicative allocation. The CAS may propose levels significantly above (high case) or below (low case) the base case allocation.[16] Each scenario is characterized by the implementation of particular policies and reforms; these are the country-specific performance criteria. Each scenario is associated with a specific level (or a certain range) of IDA resources. On average, low case lending volumes are 41 percent and high case lending volumes are 168 percent of the base case lending scenario. Triggers that activate the response for moving between the scenarios are detailed in the CAS. These are country-specific macrofiscal triggers, structural reform triggers, and portfolio triggers. Basically, the triggers judge performance on the country-specific criteria. In practice, a gray area exists between the formula-based allocations and the lending scenarios of the CAS. This provides greater flexibility and added leverage to engage borrowers in policy dialogue.

D. Adjustments to Allocations: The Need for Flexibility

57. The World Bank discourages the use of a mechanistic formula-driven approach to allocating IDA resources, and acknowledges that the straitjacketing effect of a formula needs to be suitably modulated. The rationale for flexibility is essentially the same as for the ADB system. The World Bank's formula-based allocations are adjusted to (i) ensure that the total allocation to an individual country does not fall below a specified minimum; (ii) factor in the amount of International Bank for Reconstruction and Development borrowing for blend countries; (iii) reflect absorptive capacity constraints; and (iv) take account of exceptional circumstances, e.g., postconflict countries, countries facing catastrophes, and countries undertaking far-reaching reforms. The basic point is that both the ADB and World Bank systems require safety valves. The flexibility will provide the latitude to adjust for impractical outcomes. This enables the systems to avoid undue rigidity while preserving the strong basic relationship between performance and allocations.

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[15] *Country Assistance Strategies: Retrospective and Outlook.* SecM98-242. March 30, 1998.

[16] Currently around two-thirds of the CAS fully specify base, low, and high case lending scenarios.

V. COMPARISON OF THE ADB AND WORLD BANK SYSTEMS

58. The proposed PBA system for ADB and that used by the World Bank share a number of similarities.

59. First, both PBA systems combine the top-down (common criteria) and bottom-up (country-specific criteria) approaches. Both systems use a similar two-step process. In the first step, evaluation against common criteria yields a performance rating and an allocation. The second step is to integrate this with the country planning process; here indicative formula-based allocations are used to anchor country lending programs, and adjustments are made according to performance against country-specific criteria.

60. Second, two common criteria are used to assess country performance. One set evaluates the extent to which country policies and institutions serve to realize the goals of promoting broad-based sustainable development and poverty reduction. The emphasis on poverty reduction and good governance is mirrored in the criteria used by both systems. The second set assesses portfolio performance, namely how well the country uses the concessional resources.

61. Third, in effect, both formulas determine a share, and individual country allocations are computed applying the share to resources available (Appendix 5). Further, the variables in the formula are the same, namely population, per capita GNP, and performance. In both formulas, performance is the most important factor determining allocations. Both formulas attempt to deal with problems of country size and relative poverty (needs of the recipient countries).

62. The differences between the two systems are mostly a matter of degree.

A. Evaluating Policies and the Institutional Framework

Table 1: Comparison of Performance Criteria of ADB and IDA

ADB (Proposed)	World Bank
A. Sustainable Economic Growth (25%)	**A. Economic Management (16%)**
1. Macroeconomic Management (10%)	Management of Inflation and Current Account
Fiscal Policy	Fiscal Policy
Monetary Policy	Management of External Debt
External Financing Policies	Management and Sustainability of the Development Program
2. Structural Policies (10%)	**B. Structural Policies (24%)**
Trade Policy and Foreign Exchange Regime	Trade Policy and Foreign Exchange Regime
Financial Sector Efficiency and Soundness	Financial Stability and Depth
Factor and Product Markets and Prices	Banking Efficiency and Resource Mobilization
Enabling Environment for the Private Sector Development	Competitive Environment for the Private Sector
	Factor and Product Markets
3. Environment Protection (5%)	Policies and Institutions for Environmental Sustainability
Environment Laws and Institutions	
Environmentally Damaging Subsidies	
B. Socially Inclusive Development (30%)	**C. Policies for Social Inclusion and Equity (20%)**
Framework for Poverty Monitoring and Policy Formulation	Equality of Economic Opportunity
Enhancing the Economic Capital of the Poor	Equity of Public Resource Use
Developing the Human Capital of the Poor	Building Human Resources
Equity and Social Safety Nets	Safety Nets
Empowerment and Participation	Poverty Monitoring and Analysis
D. Governance and Public Sector Management (30%)	**D. Public Sector Management and Institutions (20%)**
Rule of Law	Property Rights and Rule-Based Governance
Anticorruption and Accountability Institutions	Quality of Budgetary and Financial Management
Civil Service	Efficiency of Resource Mobilization
Revenue Mobilization and Budgetary Management	Efficiency of Public Expenditures
Management and Efficiency of Public Expenditures	Transparency, Accountability, and Corruption in the Public Sector

ADB = Asian Development Bank IDA = International Development Association

Key to Table 1

Closely Matching Criterion	Similar Criterion	No Matching Criterion

63. ADB's proposed criteria for assessing macroeconomic policies differ from those adopted by the World Bank for IDA in the following respects. First, the World Bank criterion for managing inflation and the current account is defined in general terms, with reference to a stabilization program. The proposed ADB PBA system has two separate criteria to evaluate monetary policy and external financing, thus permitting it to focus on how effective monetary policy has been in promoting low-inflation growth, and separately evaluating the sustainability of external financing of the balance of payments. Second, the ADB system does not include criterion for management and sustainability of the development program as does the World Bank. A

criterion defined in such broad terms may render measurement difficult, thus reducing the criterion's utility.

64. ADB's criteria to assess structural policies correspond closely to the criteria used by the World Bank. The two sets of criteria basically cover the same terrain. The individual criteria are also very similar. The ADB system, subsumes the World Bank criterion for financial stability and depth under financial sector efficiency and soundness.

65. Environmental concerns and issues are of significant importance in the region. Moreover, protection of the environment is one of ADB's strategic development objectives. ADB's system has a separate subcluster on environmental protection, and the criteria are more specific than the World Bank's. Performance assessment using ADB criteria will focus on enforcement of laws and regulations and efficacy of institutions.

66. ADB's proposed criteria for poverty reduction broadly correspond to those of the World Bank for social inclusion and equity. The ADB criteria take a more holistic view of poverty reduction efforts, focusing on government efforts to build the economic, human, and social capital of the poor. For instance, ADB's criterion for building economic capital is based on equality of economic opportunity (a World Bank feature), but focuses on the government's efforts to raise the incomes of the poor. This is assessed in terms of the environment created for increased access of the poor to land, credit, infrastructure, information, and technology. Similarly, the proposed ADB criterion for building human capital is more specific than the World Bank counterpart criterion for human resource development, with the former placing particular emphasis on the education of girls and women. The ADB system has a criterion for equity and social safety nets that seeks to assess efforts being made to promote social inclusion and protect the disadvantaged and poor. This includes an assessment of the equity of public resource use, i.e., whether the composition of public expenditure reveals a pro-poor stance. A separate criterion for empowerment and participation is included in the proposed ADB system. The goal is to gauge the extent to which the poor, and particularly women, are enabled to participate in development and civil society. It assesses efforts made to develop social capital by decentralizing, promoting cooperation and augmenting self-reliance among local organizations, and increasing community support and commitment to local development activities. It also covers efforts made to empower the vulnerable and disadvantaged groups that have suffered from social practices.

67. Criteria to assess governance and public sector management are similar under both systems. Both have criteria on core governance issues, e.g., accountability, anticorruption, rule of law, and transparency. ADB's system includes the civil service as a separate item; the basic rationale is that a merit-based and capable civil service provides the needed institutional capacity for policy formulation and program implementation, which is a determinant of effective governance. The World Bank has three criteria for public resource management, while the proposed ADB system has two criteria to evaluate the quality of public financial management. Essentially the criteria cover the same terrain, namely, revenue mobilization, budget processes and management, financial control, public investment programs, efficiency of public expenditures, and efforts to reduce untargeted subsidies and nonproductive expenditures.

68. CPA is an evolving process. For the World Bank system, rating criteria and evaluation methodology have changed over the years and have become progressively more refined and complex. The World Bank's experience demonstrates that considerable effort has gone into improving the measure of performance and devising new criteria that capture critical aspects of performance. Seen in this broader perspective, the few minor differences observed in the two

sets of criteria are not significant. ADB and the World Bank will continue to learn-by-doing and incorporate improvements in their systems and criteria in the light of actual experience. Thus, greater convergence is likely with the passage of time.

69. A draft of the CPA questionnaire included in Appendix 2 is a work in progress. The guidelines on how to rate performance against each criterion will need to be refined. Pilot-testing of the criteria and benchmarking of performance against criteria will take time. Pilot-testing may also identify problems such as nonavailability of statistical or other data that enables cross-country comparability. Similarly, evaluation experience may lead to improvements in measuring performance against a set of criteria. Setting benchmarks for individual criteria will require an actual performance assessment across all countries. While this is a time-consuming process, it will provide essential feedback to improve the evaluation guidelines.

B. Weighing Country Performance Assessment Components

70. The CPA consists of two parts: (i) an assessment of policies and institutions, and (ii) a separate assessment of portfolio performance. The two systems differ slightly in the weights assigned to the two broad components. The World Bank assigns 80 percent weight to country performance, and 20 percent to portfolio performance. The ADB system places comparatively more emphasis on actions taken by the government to demonstrate its willingness to put resources to appropriate use because these actions, in turn, can also affect portfolio performance. Therefore 85 percent is assigned to the assessment of policies and institutions, and 15 percent to portfolio performance.

71. In the policy and institutional assessment, different weights are assigned to different clusters of criteria. The World Bank assigns all 20 criteria an identical weight of 4 percent totaling 80 percent. Thus, the weight assigned to an individual cluster of criteria is implicitly determined by the number of criteria in the cluster. In contrast, the ADB system assigns separate weights to each cluster (and this is not linked to the number of criteria in a cluster). The ADB system accords a higher weight to the poverty reduction and socially inclusive development cluster — 30 percent as against the World Bank's 20 percent. For the cluster on governance and public sector management, the World Bank assigns a 20 percent weight and has a governance discount. The ADB system assigns a weight of 30 percent to the governance criteria.

C. The Formulas and Treatment of Special Problems

72. The ADB formula determines a country's share in the pool of ADF resources. The World Bank formula does the same for IDA resources, but in stages: it first determines a per capita allocation, and then translates this into an absolute country allocation. The absolute allocations for all countries are then normalized to ensure that the total budget constraint is met: this is equivalent to determining a share for each country and then applying it to a given budgeted amount. Thus, in actual practice the two formulas are very similar. Once again, differences are only of degree.

73. The allocation formula for IDA resources has no explicit small-country bias. Since the basic formula determines an allocation per capita, the World Bank implicitly assigns a value of 1 to the population component. The ADB formula explicitly incorporates a small country bias by assigning a value of 0.75 to the population component. In effect, the smaller allocation mathematically reduces the importance of a large population (Appendix 4). The implication is

that the ADB formula allocates more on a per capita basis to small countries. Box 2 provides an illustration.

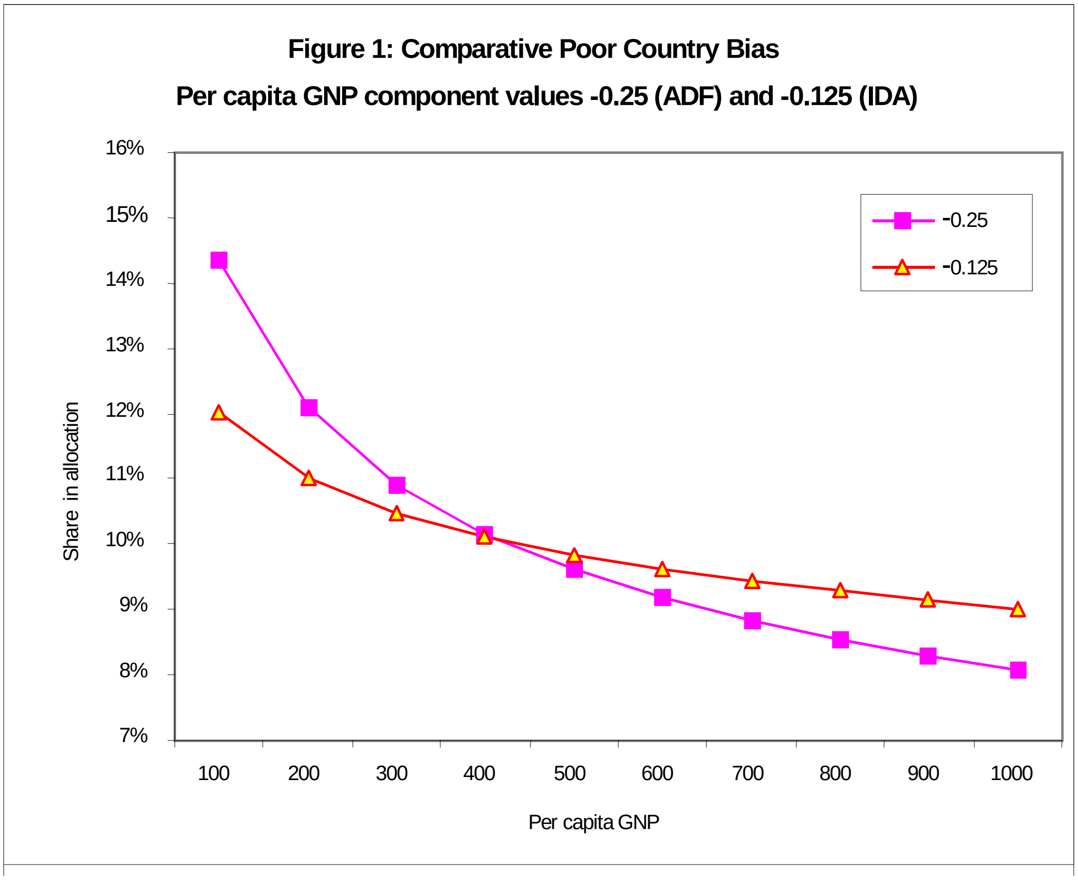
Box 2: Small Country Bias: An Illustration

- Resource Envelope: $100 million; five countries – A, B, C, D, and E
- Assume all countries have the same PR, same GNPC; different POP.

	A	**B**	**C**	**D**	**E**
PR	3	3	3	3	3
POP (million)	1	10	50	100	200
GNPC ($)	200	200	200	200	200
Total Allocation ($ million)					
IDA	0.28	2.80	13.80	27.70	55.40
ADF	0.90	5.10	17.10	28.70	48.20
Allocation per Capita ($)					
IDA	0.28	0.28	0.28	0.28	0.28
ADF	0.91	0.51	0.34	0.29	0.24

ADF = Asian Development Fund; GNPC = Per Capita GNP; IDA = International Development Association
PR = Performance Rating; POP – Population

74. Both formulas include a poor-country bias, namely, the poorer the country, the larger the allocation. This is achieved by assigning a suitable weight to the per capita GNP variable. This weighting determines the effect of the variable on the allocation (Appendix 4).



ADF = Asian Development Fund; GNP = Gross National Product; IDA = International Development Association

D. Transition Arrangements

75. For the past 20 years, the World Bank has been undertaking some form of country performance evaluation. In the past, ADB has undertaken general country performance assessment as an integral part of the country planning exercise. Country performance has been evaluated in general in the process of determining the country assistance plans, i.e., the activities that ADB plans to undertake in a particular DMC. ADB now proposes to undertake its first formal, structured performance rating based on the system proposed in this paper. Since the performance rating will determine the allocation on a three-year rolling basis, basing this allocation on a single-year evaluation may seem somewhat unfair. The World Bank has the advantage that it can use historical experience and past ratings to come to a fair conclusion, ADB does not have access to formal past ratings. Hence, an element of flexibility could be provided in the transition, i.e., as ADB moves to regular annual rating, some latitude could be available in the initial years, perhaps the first two years, to make necessary adjustments.

VI. IMPLEMENTATION ARRANGEMENTS

76. The policy on PBA for ADF resources will come into effect immediately on its approval by the Board. The process for putting the PBA system in place will begin in early 2001, the transition to the new system will encompass most of 2001.

77. On the basis of a PR (and before DMC-specific issues are factored in), the PBA system will determine a rolling three-year allocation: this forms the basis for the base-case scenario in the CSP (which is a rolling three-year plan). The CSP will also contain base, low, and high case scenarios, departures from base case scenarios will depend on performance against country-specific criteria identified in the CSPs. CPAs at the end of the year will form the basis for revising the allocation and be reflected in the next year's CSP. Finally, because the CSP is revised every year, the ADB system will require the CSP to have a rolling three-year allocation, and an allocation for the first year.

78. ADB's approach to determining the performance ratings and the impact of country-specific factors will not be a mechanistic one. Instead, an internal system will be put in place to ensure that final recommendations on allocations are made through a group consisting of the concerned departments. The details of this internal system will be spelt out in the context of staff instructions that would follow the approval of the policy on performance based allocation.

79. Appendix 6 provides a summary picture of the one-year cycle for PRs, allocations, and the country plans. For 2001, an initial allocation will be made, for instance, on the basis of past allocations and general performance assessment. The country programming missions will then draw up the CSP. While doing so, country-specific performance criteria will be agreed on with the DMC government; base, low, and high case scenarios will be detailed in the CSPs with triggers clearly identified for the low and high case scenarios. A midyear assessment against country-specific criteria will have to be undertaken. This will be followed by an year-end CPA to determine a PR. With this system, sudden and unexpected large fluctuations in allocations will be avoided.

80. Effectively, the first full set of PRs, on the basis of common criteria that enable cross-country comparability, will become available only at the end of 2001. Moreover, the first year will also mark the first experience with benchmarking and pilot-testing of performance criteria; performance criteria, indicators, and guidelines for performance assessment will be refined and improved over time.

81. Operationalizing the performance-based allocation system will not be budget neutral. Additional staff resources will be needed to (i) carry the initial workload of the transition period, and (ii) bring the implementation of the system to a full scale operation starting from 2002 and regularly report to the Board on the implementation. During the transition period in 2001, substantial staff time will be devoted to (i) collecting additional information as required (including additional mission travel), (ii) discuss internally the harmonization procedures to ensure that all countries are evaluated similarly, and (iii) define options and decide on other elements of the system (e.g., treatment of small-island economies, benchmarking of portfolio performance, and so on). This will require some reprioritization of the responsibilities during the transition period. In addition to these tasks, which are expected to be on-going for sometime, starting in 2002, mechanisms will have to be created to make intercountry comparisons and determine shares of ADF resources for individual countries. At that point, the departments involved will require some additional staff with strong macroeconomic and development backgrounds. Any additional staff requirements will be identified at a later stage in the process when more experience with implementation has been achieved.

82. The proposed allocations for ADF borrowers will be provided to the Board for formal endorsement in the context of individual CSP processes. As part of the midterm review of ADF VIII experience, the Board will also review implementation of the new PBA system during 2001-2002 and available information on indicative allocations for 2003.

VII. RECOMMENDATION

83. Approval by the Board is requested to put in place a performance-based allocation system for distribution of ADF resources as described in this paper. The key elements of the proposed system for performance-based allocation of ADF resources are as follows:

(i) Country performance assessment will be based on common and country-specific criteria.

(ii) Policies and institutional frameworks will be assessed for all ADF recipients on the basis of a set of common criteria listed in Box 1.

(iii) Portfolio performance of all ADF recipients will be based on the "project-at-risk" principle.

(iv) The weights assigned to different clusters in the country performance assessment will be according to the scheme in Appendix 3.

(v) While small-island economies will be treated as a distinct category for the purpose of resource allocation, performance assessment will be undertaken for all and will be the basis of the allocations.

(vi) Country-specific criteria for performance assessment will be integrated with the country planning process.

(vii) Performance-based allocations are to be a crucial management tool; hence, to avoid undue rigidity, a mechanistic formula-driven approach will be avoided while maintaining the basic robust link between performance and allocations.

APPENDIXES

PORTFOLIO PERFORMANCE: INDICATIVE CRITERIA AND BENCHMARKING

A. Indicative Criteria

1. Implementation Progress. Criteria include

(i) delays in implementation schedule;
(ii) project field mission, i.e., – planned mission, actual days per projects or program;
(iii) changes in scope;
(iv) changes in implementation arrangements
(v) cost overruns;
(vi) counterpart funding;
(vii) implementation of covenants; and
(viii) audited project/program and environmental assessment financial statements

2. Development Objectives. These include

(i) key policy assumptions being implemented (policy-based covenants, e.g., cost recovery, tariffs, environmental assessment, financial performance),
(ii) assumptions on environmental sustainability are valid and applied,
(iii) assumptions on beneficiary participation and stakeholder ownership,
(iv) assumptions on economic and financial viability and cost recovery (e.g., costs and prices remain within viable range),
(v) assumptions on institutional capability, budget availability, and operation and maintenance are valid,
(vi) political stability (peace and security),
(vii) baseline data availability and mandatory mechanisms, and
(viii) assumption of poverty impact.

3. Potential Problem Projects/Programs. Criteria include the following, although the number of flags is to be determined

(i) loan signing and effectiveness delay (more than six months after loan signing or one year from approval),
(ii) poor compliance with covenants (implementation, reform or financial covenants but not financial statements),
(iii) project management problems,
(iv) shortage of counterpart funds,
(v) procurement problems,
(vi) poor compliance with audited financial statements,
(vii) environmental or resettlement problems
(viii) significant disbursement delays (less than 70% of projections for the last two quarters), and
(ix) At risk sector/subsector with history of past problems (unsatisfactory implementation progress and development objectives for two or more years in annual report).

II. Benchmarking

To translate a country's performance using these indicative criteria into a rating system of 1 to 6 as is done for all other performance criteria in the system, a realistic set of benchmarks will need to be established. The indicative criteria will be applied to each project to determine if that project is at risk or is a potential risk case. At the next stage, the percentage of projects at risk or potential risk cases in a country's portfolio will be calculated. Benchmarking will mean that, after having seen the results from all Asian Development Fund borrowers, decisions be made on, for example, what percentage of projects at risk should earn a rating of six for a country, or five, and so on (Table A1). Establishment of such benchmarks will obviously have to await some one or two years of data collection.

Table A1: Illustrative Benchmarking Table

Rating	**% of Projects at Risk**
6	0% for 2 years or more
5	0-10%
4	15-34%
3	35-40%
2	41-70%
1.5	70-100%
1	100% for 2 years or more

COUNTRY PERFORMANCE ASSESSMENT QUESTIONNAIRE

A. Criteria

1. The criteria used for evaluating performance are carefully selected so they are interrelated in ways that they are expected to be, but are not prone to double-counting. The macroeconomic adjustment criteria are interrelated and cannot be rated in an abstract and a mechanical way. They operate within a general equilibrium framework. Seeking balance of payment or fiscal surpluses, lower inflation, trade liberalization, freely floating exchange rates, elimination of tariffs, and so on, cannot always be recommended under all circumstances.

2. Double counting has carefully been avoided in selecting the criteria. For example, in evaluation of fiscal policy, public financial management, and revenue mobilization, the evaluator is looking at three different things: (i) fiscal policy is evaluated based on selection of the optimal and appropriate tax system for the country in question, prudent deficit financing methods, fiscal policy conducive to pro-poor growth, and protection of the poor; (ii) public financial management is evaluated based on the appropriate involvement of the legislature, transparency of the budgetary processes, consistency of public expenditure management with announced strategic vision of the government, existence and strength of accountability mechanisms to oversee leakages, waste, ad hoc appropriations, appropriate audit systems, and so on; (iii) revenue mobilization is evaluated based on capacity and strength of the tax administration machinery to implement whatever tax system was adopted under item (i) above.

1. Sustainable Economic Growth

3. Macroeconomic management includes three criteria:

(i) Fiscal Policy
(ii) Monetary Policy
(iii) External Financing Policies

4. Structural policies include

(i) Trade policy and foreign exchange regime,
(ii) Financial sector efficiency and soundness,
(iii) Factor and product markets and prices, and
(iv) Enabling environment for private sector development.

5. Environmental protection includes

(i) Environmental laws and institutions, and
(ii) Environmentally damaging subsidies.

2. Socially Inclusive Development

6. Criteria involve

(i) Framework for poverty monitoring and policy formulation,

(ii) Enhancing the economic capital of the poor,
(iii) Developing the human capital of the poor,
(iv) Equity and social safety nets, and
(v) Empowerment and participation.

3. Governance and Public Sector Management

7. Criteria include

(i) Rule of law,
(ii) Anticorruption and accountability institutions,
(iii) Civil service,
(iv) Revenue mobilization and budgetary management, and
(v) Management and efficiency of public expenditures.

B. Rating Scale

8. Each country will receive a rating from 1 (poor) to 6 (strong) on each criterion in the set of common criteria used to assess country performance.[1] In addition, each score is followed by a plus sign (+), a minus sign (-), or the word "stable" to indicate whether the factor is improving, getting worse, or has stayed the same compared with the country's score the previous year. The numerical ratings in each criteria cluster are added and averaged, the average for each criteria cluster is multiplied by the weight assigned to the cluster, and an overall performance rating is then computed as the weighted average of the ratings across all criteria clusters.

C. Guidelines for Rating Countries On Each Criterion

1. Sustainable Economic Growth

a. Macroeconomic Management

9. Given that (i) macroeconomic policies need to be conducive to the objective of poverty reduction, and (ii) various stages of the business cycle will need to be addressed in the conduct of macroeconomic policies, judgement on the quality of performance in this area cannot be mechanistically applied. Less fiscal deficit is not always better than more fiscal deficit, there is a limit to how far inflation can be pushed down before it becomes unhealthy, and so on. Strict guidelines in this regard will have to give way to judgements based on the state of the economy and overall objectives of sustainable growth with poverty reduction.

i. Fiscal Policy

10. Efforts of the government to achieve sustainability of the fiscal deficit is assessed along with the pro-poor stance of the fiscal policy.[2] The goal is to evaluate the policies that affect the overall fiscal position. International Monetary Fund (IMF) staff appraisals on the fiscal stance provide the bulk of the relevant data.

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[1] The numerical rating scale used is identical to the one adopted by IDA.
[2] A sustainable fiscal position is defined as the primary balance needed to keep the ratio of public sector debt to gross domestic product constant. For an example of fiscal sustainability analysis see IMF. 1996. *Thailand: The Road to Sustained Growth.* IMF Occasional Paper 146, Washington, D.C.

11. **Poor performance, score of 1.** Based on current fiscal policies, and given the terms of financing available, the fiscal deficit is unsustainable over the medium term and/or is not pro-poor. Some of the factors to be taken into account in making such a judgement are: (i) Fiscal deficit can be financed only through expensive borrowing (domestic or foreign) resulting in crowding out of the private sector or accumulation of external debt, (ii) public savings are low and/or declining; (iii) current expenditures absorb most tax revenues; and (iv) essential expenditure levels are low, e.g., for crucial social programs and public investment. Weak tax effort results in low resource mobilization. IMF staff appraisals express concern that the projected stance of fiscal policy falls well short of what is required to support macroeconomic stabilization.

12. **Average Performance, score of 3.5**. Current fiscal stance results in a fiscal deficit that is sustainable in the short-term; however, sustainability is not fully established. IMF staff appraisals indicate that the fiscal stance needs strengthening to ensure sustainability. Tax effort and resource mobilizations are improved, but are still falling short of requirements. Public expenditures have been partly rationalized; current expenditures are being curbed to raise levels of public investment and other essential programs.

13. **Strong Performance, score of 6**. The government has put in place sufficient policies to ensure the fiscal position is sustainable over the medium term and is supportive of pro-poor growth. The primary operating budget is in surplus. Public savings finance most public investment. Expenditures on crucial social programs have been raised to levels deemed necessary. Tax and resource mobilization efforts are robust. IMF staff appraisals indicate that the fiscal stance is satisfactory.

14. An additional consideration that may be taken into account if information is available includes efforts made to protect public programs for the poor and priority capital expenditure.

ii. Monetary Policy

15. The effectiveness of monetary policy in promoting low-inflation pro-poor growth is assessed. The development of monetary policy instruments will also be evaluated, e.g., the reliance on indirect versus direct controls.

16. **Poor performance, score of 1**. Inflation is high (above 30 percent) and accelerating. The government does not have explicit monetary objectives or strategies to pursue them. The exchange rate policy is inconsistent with other macroeconomic policies. The central bank has little or no autonomy to pursue monetary policy targets. The central bank automatically provides credit to the government to finance fiscal deficits. Monetary policy instruments, if any, are based on direct controls and government decree.

17. **Average performance, score of 3.5**. The inflation rate is moderate (between 10 and 15 percent) or inflation has decelerated markedly. The government has set explicit monetary objectives but has not realized all of them. The central bank has some degree of autonomy in pursuing monetary policy goals; however, it is still obliged to finance the government's fiscal deficit. Increasing reliance is placed on indirect market-based instruments to attain policy goals, e.g., development of open-market operations, gradual lengthening of maturity of treasury bills and other debt instruments. Efforts are being made to end inconsistencies between the exchange rate and other macroeconomic policies.

18. **Strong Performance, score of 6**. The inflation rate is low (3 to 5 percent) or has been brought down sharply. The government has set explicit monetary objectives; and strategies for achieving them have been effective. The central bank has considerable independence in pursuing monetary policy goals. Instruments used to realize monetary policy goals are predominantly indirect and market-based; reliance on direct controls has been mostly phased out. The exchange rate policy is consistent with other macroeconomic policies.

19. Additional considerations that may be taken into account if information is available include

(i) existence of direct controls on interest rates (deposit and lending), aggregate and individual bank credit ceilings, and selective credit controls;
(ii) incidence and magnitude of directed credits to specific sectors;
(iii) coherence of mandate and accountability of the central bank;
(iv) extent to which fiscal deficits are monetized;
(v) structural reforms that may have caused inflation, e.g., price liberalization in transition economies, and removal of restraints on administered pricing; and
(vi) nature of exchange rate regime and impact on monetary aggregates.

iii. External Financing Policies

20. Sustainability of the current account balance is assessed based on current government economic policies, given the exogenous external factors and an evaluation of whether the balance of payment disequilibrium is short term or represents a structural problem. External sustainability is judged in terms of whether the country is likely to meet its current and future external obligations without resorting to rescheduling or accumulation of arrears, or harsh domestic adjustments that can increase poverty rapidly. The capacity of the external debt management system is also evaluated.

21. **Poor performance, score of 1**. Trade and external financing policies are not conducive to pro-poor domestic growth. Appropriate action is not being taken to remedy large and persistent current account deficits that are estimated to be unsustainable over the medium term. The country has been in arrears on its external debt for the past three years, and no agreed strategy for debt restructuring exists. Actions are not being taken to enhance capacity to monitor and manage external debt, and improve debt-servicing capacity given the country's exports and prospects for growth in foreign exchange earnings. While the balance of payment is in structural disequilibrium, short-term credits are excessively relied on to finance current account deficits.

22. **Average performance, score of 3.5**. Current account deficits are moderate but sustainability is not established. The country has been current on debt servicing over the last

three years. However, there are some concerns about the sustainability of contracted debt service, e.g., the size of debt service in relation to projected export earnings. An external debt monitoring system is in place but has significant information gaps, e.g., on the extent of private sector external liabilities, and the extent of contingent external liabilities of the government (and/or the public sector). The maturity profile of external debt shows reliance on medium or long-term debt, but short-term credits are not negligible.

23. **Strong performance, score of 6**. The current account is in surplus or deficits are sustainable over the mediumterm. Debt service has been current during the last three years. Prospects for foreign exchange earnings are good, and the country has the capacity to service its debt and undertake more external borrowing if so required. The country has a sound external debt management system. The maturity profile of external debt shows dominance of long-term or medium-term debt; short-term credits are insignificant in total debt.

b. Structural Policies

i. Trade Policy and Foreign Exchange Regime

24. Progress made in trade reform to reduce average tariff rates and nontariff barriers (NTBs) is assessed based on their contribution to pro-poor growth. A key indicator is IMF's index of trade restrictiveness,[3] Other criteria are elimination of administrative procedures that impede trade, shifting from quantitative restrictions to tariffs, removal of rationing and requisitioning in the foreign exchange market and other exchange controls, and phasing out of multiple exchange rates.

25. **Poor performance, score of 1**. The trade system is highly restrictive; average tariff rate of 30 percent or higher, export barriers, extensive reliance on quantitative restrictions (quotas), and very high NTBs in many sectors. A wide range of customs duties have proliferated, i.e., large dispersion in duty rates. Trade restrictions exacerbated by cumbersome customs procedures, and customs authorities can make ad hoc exemptions. Valuation for customs duty purposes is not consistent with international practice. Foreign exchange is rationed for a prespecified list of transactions. Different exchange rates are used for different current account transactions, i.e., multiple exchange rate practices.

26. **Average performance, score of 3.5**. The foreign trade system has been partially liberalized; tariff rates average 15-20 percent; NTBs impact on at least one important sector but are not pervasive; quotas have been replaced by tariffs but not all quotas have been phased out; some export barriers are still in place. Customs clearance procedures have been improved. Dispersion in customs duty rates has been lowered. The foreign exchange regime has become more market-based; however a number of exchange restrictions remain. Valuation practices are being harmonized with internationally accepted norms.

27. **Strong performance, score of 6.** The trade system has been successfully liberalized; tariff rates average about 5 percent and NTBs are either absent or very low; and there are no export barriers, and few or no quotas. Dispersion in customs duty rates is low. The interbank foreign exchange market is well functioning and soundly regulated. The exchange rate has been unified for all current account transactions, i.e., no multiple exchange rate practices.

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[3] IMF. 1998. *Trade Liberalization in IMF-Supported Programs.* Washington, D.C.

iii. Financial Sector Efficiency and Soundness

28. The efficiency and soundness of the financial sector is assessed, as well as its diversity, depth, and maturity. The focus is on the extent to which reliance is placed on market discipline, internal governance of financial sector institutions, and prudential regulation and supervision.[4]

29. **Poor performance, score of 1**. The sector is dominated by a few banks (mostly state-owned) and barriers to entry are high; few private-sector banks exist. Nonbank financial institutions are few or not significant. Real interest rates are negative (or very high) and unstable. Lending and deposit rates are regulated by government controls or flat. The spread between deposit and lending rates is high. There is a large amount of directed credit. The government preempts credit flows at the cost of crowding-out the private sector. The share of nonperforming loans is likely to be very high, but poor loan classification practices make it difficult to determine the extent of nonperforming loans. Prudential regulation is very weak. There is no regulatory agency or the existing one has little autonomy or independence of action. Supervision and enforcement is poor.

30. **Average Performance, score of 3.5**. Barriers to entry have eased. The presence of private sector banks is increasing, as is competition in the sector. The financial sector includes some nonbank financial institutions, e.g., equity and debt markets, and insurance. However, the depth and maturity of these institutions is not yet established. Real interest rates are generally positive. Liberalization of lending and deposit rates has been largely completed; interest rates are increasingly market determined. The share of nonperforming loans based on established loan classification policies is declining but still high. A regulatory agency has been established with some degree of independence or autonomy. Prudential regulation has been set up but compliance needs to be improved. Supervision is inadequate; the necessary institutional capacity needs to be built.

31. **Strong Performance, score of 6**. The financial sector is diversified and competitive with mature nonbank financial institutions. The banking industry is competitive; margins have narrowed significantly. Deposit and lending rates are market determined. Real interest rates are stable and positive. Directed credits have been phased out; credit flows are driven by commercial evaluation. Internationally accepted norms of income recognition, provisioning, and loan classification are enforced. Nonperforming loans of banks are at low or manageable levels. An independent agency oversees prudential regulation and supervision of banks. Regulation of NBFIs is independent and effective.

32. Additional considerations that may be taken into account if information is available include

- (i) laws and regulations on corporate governance in general and their application to commercial banks;
- (ii) quality of management of banks and internal governance practices;
- (iii) capital adequacy standards;
- (iv) adequacy of loan classification policies;

[4] Rossi, Marco. 1999. *Financial Fragility and Economic Performance in Developing Countries: Do Capital Controls, Prudential Regulations and Supervision Matter?* Washington, D.C.: International Monetary Fund.

(v) gap between supporting accounting and legal standards, and international standards;
(vi) external audit requirements and their frequency;
(vii) stock markets and their regulation; and
(viii) existence of contractual savings institutions and their regulation.

iii. Factor and Product Markets and Prices

33. Quality of the incentive regimes in the factor and product markets is assessed. In addition, the existence and effectiveness of competition policies are considered.

34. **Poor Performance, score of 1**. Prices and wages are almost completely controlled by the government. Interventions in product markets are extensive, ranging from what is to be produced to government-set production quotas, and administered prices. Major barriers exist to entry and exit. The legal framework for bankruptcies and foreclosures is weak. There is no competition legislation, and no institutions to combat monopolistic and restrictive trade practices. Factor market interventions distort prices of labor and land.

35. **Average performance, score of 3.5**. A mixture of market forces and government regulations (orders) determine wages and prices. In product markets, prices have been partly liberalized; but some administered prices are still in place. Some barriers to entry or exit of firms remain. Competition policies have been introduced but there are sectoral exemptions to their application. Institutions have been set up to curb restrictive trade practices but enforcement needs to be strengthened. Distortions in labor and land markets are being reduced, e.g., by enhanced labor mobility and freer markets for trading in land.

36. **Strong Performance, score of 6**. Prices and wages are market determined. Licensing procedures are simple and transparent, where necessary. Product markets are basically competitive. Competition laws are fully and effectively enforced. Easy exit policies permit enterprise restructuring and liquidation. Controls and regulations on land and labor markets are few and justified on grounds of welfare, efficiency, or safety.

iv. Enabling Environment for Private Sector Development

37. The extent to which the government has adopted policies that are conducive to private sector economic activity are assessed, e.g., does the state inhibit or actively promote the private sector through the business and policy environment it establishes.

38. **Poor performance, score of 1**. The government reserves significant economic activity for the public sector. Restrictions prevent private sector entry into major productive sectors and trade activities. An industrial licensing regime is in place that promotes rent-seeking, chokes entrepreneurial drive, and harbors inefficiency. Cumbersome regulations and administrative practices raise costs of doing business and stifle any incentives to continue in business. Access to credit (and foreign exchange) from commercial banks is restricted for private sector entities.

39. **Average performance, score of 3.5**. Sectors reserved exclusively for the public sector (or state enterprises) have been reduced. Entry in some sectors has been opened up; regulations now permit entry of the private sector but the sector is still dominated by the state. Industrial licensing has been significantly pruned and is now confined to strategic sectors. The policy environment has become more friendly to private investors and costs of doing business

have come down, e.g., single-window clearances for various government approvals, and easier access to scarce inputs such as credit and foreign exchange. Foreign investment is permitted (subject to some limits) in some sectors.

40. **Strong performance, score of 6**. Private sector firms are free to enter and exit from virtually all sectors. The industrial licensing regime has been dismantled; the few remaining regulations or restrictions can be justified on grounds of health, safety, the environment, or welfare. Markets for credit and foreign exchange have been liberalized enabling equality and ease of access. Laws and regulations have been simplified and streamlined to reduce the costs of doing business. The general government policy stance is to leave business and commerce to the private sector.

c. Environment Protection

i. Environmental Laws and Institutions

41. **Poor Performance, score of 1**. The country has no specific policies or institutions for protecting the environment. Some sectoral laws (e.g., transport, power, navigation laws) have provisions that impact the environment. However, these are not effective deterrents to activities and practices that result in serious air, water, land, and noise pollution. No pollution standards have been established or, if set up, are just not adequately enforced. Laws to safeguard forest cover are not in place or are poorly enforced.

42. **Average Performance, score of 3.5**. Basic environmental protection laws have been enacted, and clearly identified institutions for monitoring and enforcement set up. Environmental impact assessment (EIA) requirements for economic activities have legal force; discharge and ambient standards have been promulgated; and an institutional system of environmental data collection for air, water, and soil established. Enforcement has improved but limited experience and institutional capacity hinder full-scale compliance. A statute on protection of forest cover exists, and enforcement has improved but could be better.

43. **Strong performance, score of 6**. The country has laws on environment protection in place and well-run institutions ensure compliance. EIA requirements and discharge and ambient standards are uniformly and rigorously enforced. Sophisticated environmental management systems involving at least the existence of a law on environmental liability and the use of economic instruments for pollution abatement have also been instituted. Laws on forests, harvesting of timber, etc., set high standards and are rigorously enforced to ensure improvement in forest cover.

ii. Environmentally Damaging Subsidies

44. **Poor performance, score of 1**. The country has significant explicit and implicit environmentally damaging subsidies on fossil fuels or fossil fuel-based electricity, chemical fertilizers, pesticides, irrigation water, forestry, mining, and fisheries. These encourage overuse/misuse of resources and lead to long-run environmental damage. No attempt is being made to correct the explicit/implicit distortions.

45. **Average performance, score of 3.5**. The country has implicit and explicit environmentally damaging subsidies on fossil fuels or fossil fuel-based electricity, chemical fertilizers, pesticides, irrigation water, forestry, mining, and fisheries. Efforts have been made to correct the distortions. Royalties, fees, and charges have been set to contain environmental

damage, but are either set too low or enforcement is patchy. Some steps have also been taken to reduce the explicit subsidies in place.

46. Strong performance, score of 6. The country has effectively removed most, if not all, explicit and implicit environmentally damaging subsidies on fossil fuels, or fossil fuel-based electricity, chemical fertilizers, pesticides, and irrigation water for forestry, mining, and fisheries. Resource rents are realized by the government by setting royalties, fees, and charges.

2. Socially Inclusive Development

47. Poverty reduction efforts are assessed using a multidimensional approach encompassing economic, human, and social dimensions. Efforts to improve poverty monitoring and its linkage with policy formulation are also assessed.

a. Framework for Poverty Monitoring and Policy Formulation

48. The policy and institutional framework for the government's poverty reduction efforts is assessed. The quality of poverty monitoring is assessed in terms of whether (i) a statistical system is available to identify the poor on a regular basis through household surveys, (ii) the survey results are widely disseminated, and (iii) poverty monitoring is linked to policy formulation. The institutional framework is assessed in terms of whether (i) there is a focal point to develop and refine the government's strategy for poverty reduction, coordinate the government's poverty programs, and monitor their performance; (ii) efforts are being made to enhance the poverty content of sectoral programs of line agencies; and (iii) the private and nongovernment organization (NGO) sectors are involved in poverty reduction efforts. Performance will also be evaluated in terms of the targets set in the partnership agreement with ADB.

49. **Poor performance, score of 1**. The national poverty reduction strategy is poorly designed, i.e., too vague to be implemented, poor diagnosis, no targets, etc. Household surveys are conducted irregularly and are of uncertain quality. Access to survey data is highly restricted. The high degree of institutional fragmentation makes it difficult to set priorities or identify target groups. No links (or very limited linkage) is made to policy formulation, or any framework of priorities or impact monitoring systems. There is no strategy to involve the private and NGO sectors in poverty reduction efforts. Progress on targets agreed in the partnership agreement is minimal.

50. **Average performance, score of 3.5**. The national poverty reduction strategy is based on a reasonable diagnosis and sets targets. Household surveys are conducted and reported at regular intervals, but delays in compilation and dissemination limit their usefulness in public policy formulation. Surveys contain only aggregate indicators of poverty and no gender disaggregated data. There is some linkage to policy formulation; policies give credence to poverty reduction issues. Coordination of poverty programs is ad hoc. Occasional program impact evaluations and policy refinements are made. Some efforts have been made to involve the NGO and private sectors. About 50 percent of the agreed targets in the partnership agreement have been met.

51. **Strong performance, score of 6**. The national poverty reduction strategy identifies key problem areas and contains mutually supportive time-bound actions. The strategy is backed up by necessary budget allocations. Reliable household surveys are conducted and reported at minimum five-yearly intervals. *C*ompiled data informs about current status of poverty, and

desegregates data by different groups of poor and by gender. Results are disseminated widely by means of bulletins, seminars, and workshops. The government's poverty reduction strategy has a focal point for coordination. Priorities for poverty reduction activities are clear and there is regular coordination, program impact evaluation, and policy refinement. The government's poverty reduction strategy includes the involvement of the private and NGO sectors in poverty reduction activities. Almost all targets agreed to in the partnership agreement are met.

b. Enhancing the Economic Capital of the Poor

52. The government's efforts to raise the incomes of the poor are evaluated. This, in turn, is assessed in terms of the environment created for increased access of the poor to land, credit, infrastructure, information, and technology. Nutrition aspects are included here given that the main economic resource of the poor is their physical ability to work. The outreach and self-sustainability of rural financial institutions[5] is assessed. The adequacy of public investment in rural infrastructure and the building of public infrastructure through labor-intensive means are taken into account.

53. **Poor performance, score of 1**. Legal impediments and the institutional framework hinder basic land administration; high transaction costs in the land market perpetuate barriers to access to land by the poor. Extremely unequal land distribution is combined with uncertain or poorly defined land tenure rights. The unemployment rate is high (rural and urban); significant biases exist against labor-intensive methods of production; and, few, if any, rural public employment programs are targeted at the poor. The incidence of malnutrition is high; large numbers have below minimum levels of dietary consumption. The level of public investment in rural infrastructure is low. Population with access to basic infrastructure has remained low. The outreach of rural financial institutions is low; few of these institutions are commercially viable; few supply microcredit facilities. Poorly targeted credit schemes that claim to benefit the poor are misdirected. Asset-creating antipoverty program do not exist, or if there do, they bypass the poor. No information or technology services are available; or if available, cater only to influential/wealthy groups.

54. **Average performance, score of 3.5**. Legal impediments to effective functioning of a land market have been removed. However, procedures for establishing rights (tenure or ownership) and registering properties need to be improved and made more cost-effective for the poor to gain greater access. Employment creation programs for rural areas have been set up but implementation or design is not fully satisfactory; budgeted amounts are still not significant relative to the size of unemployment. Nutrition has improved somewhat special nutrition programs are in place especially for children and women, albeit on a limited basis. Public investment in rural infrastructure is increasing but is still at a relatively low level; access of the poor to water, electricity, etc. is improving. The outreach, number, and viability of rural financial institutions are growing; microcredit programs are in operation, including some designed specifically for women, but have limited geographic coverage. However, scope for expanding clientele to the low-income rural population and lowering the cost of delivery is still significant. Asset-creating antipoverty programs are better targeted to reach the poor, especially women; however, program size is still relatively small, and efficiency of delivery needs improvement. Extension services exist to provide information relevant to the needs of the poor; however, services do not have the network to reach the intended target group.

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[5] The outreach and sustainability criteria have been translated into quantitative indices. See Yaron, Jacob. 1992. *Successful Rural Financial Institutions*, Washington, D.C.: World Bank Discussion Paper No. 150.

55. **Strong performance, score of 6**. The poverty reduction efforts linking land access for the poor with other factors (rural credit, off-farm income, information) have been effective in reducing the incidence of poverty and the number of landless poor. Public employment programs are well designed and cater to the landless and the poor. Public investment in rural infrastructure is high and access of the poor to water, electricity, etc. has significantly improved. The coverage and viability of rural financial institutions is good. Microcredit programs are available in virtually all areas. Specialized microcredit programs for women are also more widely available. School-feeding programs for children, and nutrition programs for women and infants have much wider coverage. Asset-creating antipoverty programs are well targeted to reach only the poor, particularly women. Extension services to provide information relevant to the needs of poor have improved and the network reaches the intended target group.

56. Additional considerations that may be taken into account if information is available include

(i) share of landless poor in total rural population,
(ii) labor costs in public infrastructure programs,
(iii) outreach and sustainability indicators for rural financial institutions, and
(iv) share of investment in rural infrastructure in the total public investment program.

c. Developing the Human Capital of the Poor

57. The efforts made by the government to develop the human capital of the poor is assessed in terms of basic education, training, primary health care, and family welfare.

58. **Poor performance, score of 1**. Large segments of the population, especially the rural and urban poor, girls and women, and indigenous peoples, do not have access to basic education. The quality of basic education in terms of relevance of curriculum and motivation of staff is poor. There are few functional literacy or adult education programs. Primary health care and family welfare facilities are not accessible to the poor. The budget allocation for primary health care, family welfare, and basic education is less than adequate.

59. **Average performance, score of 3.5**. Although access to primary education has improved for the poor, dropouts are disproportionately higher among the poorer families and girls. Some efforts are being made to promote girls' education and raise female literacy rates. Some programs are also in place to increase retention rates (or lowering dropout rates) of children from poor families, and some scholarship schemes exist for students from poor families. There is scope to improve targeting of education programs and schemes designed explicitly for the poor. Adult education and functional literacy schemes are in place. In health, public subsidies to better-off groups need to be phased out. Outreach of family welfare, public health, and immunization programs has improved (especially for infants and women). Access of the poor to primary health care facilities is better but can be improved. The budget allocation for primary health care, family welfare, and basic education is adequate.

60. **Strong performance, score of 6**. Good basic education infrastructure is in place providing access to primary schooling for all children, especially girls, combined with information programs that create a stronger demand for education on the part of parents. Special education programs/schemes for children from poor families are well targeted. Well-designed programs to increase female literacy are in place. Adult and functional literacy programs are well run with the support of NGOs. The health system is broad-based and

decentralized with well-functioning primary and public health care services targeted at major childhood and adult diseases. Maternal, family welfare, and immunization programs have good outreach to the poor.

61. Additional consideration that may be taken into account if information is available. Ideally, indicators should be disaggregated by income strata (quintile of income distribution), gender, and vulnerable groups (ethnic, minorities, etc.). Indicators to measure progress could include net enrollment for primary education (female and male), dropout rates, percentage of people who are functionally literate, percentage of infants with low birth-weight, percentage of one-year olds fully immunized, percentage of women under the age of 20 giving birth, fertility rate, infant mortality rates, the gender-related development index, proximity of nearest primary health center, and doctors per capita in rural areas. This is not an exhaustive list.

d. Equity and Social Safety Nets

62. Efforts to promote equity and protect the disadvantaged and poor are assessed. This includes an assessment of the equity of public resource use, i.e., does the composition/structure of public expenditure reveal a pro-poor stance.

63. **Poor performance, score of 1**. The overall development strategy and policies adopted are not conducive to reducing inequalities in income distribution. No policies and programs are in place to redress imbalances or disparities among individuals, regions, or socioeconomic groups. No social security system is in place; the only safety net that functions is informal, working through community solidarity. Few public programs exist to protect the handicapped and aged, and other vulnerable or destitute groups. The pattern of public expenditure does not reveal a pro-poor stance. General antipoverty programs and schemes to address food security (public distribution systems for the poor, food-for-work, etc.) are either not in place or have poor outreach. Public subsidies favor the well-off or are not well targeted and bypass the poor. Publicly funded programs are captured by vested interests and do not reach the intended beneficiaries.

64. **Average performance, score of 3.5**. The development strategy blends issues of growth and distribution. At the macro level, public policy aims to reduce inequities in income distribution (across individuals and regions) and access to public services. However, translation of broad policy into action is partial. Some sort of public social security system is in place, but coverage is restricted and benefits are few. Systems based on private contributions or personal savings for old-age pension and endowments exist, but these do not help the really poor and vulnerable; they mainly insure the slightly better off. Some schemes exist to provide transfer payments for the aged, infirm, and handicapped, but benefits are small. Nutrition programs, food-for-work schemes, and public distribution systems targeted to help the poor and vulnerable are in place; however, implementation coverage is partial and benefits limited. A revamp of public subsidies has resulted in better targeting and improved flows to poorer sections of society. Publicly funded programs reach some of the designated beneficiaries, but there are still leakages and unintended gains for the better off.

65. **Strong performance, score of 6**. The development strategy clearly accords priority to equity and socially inclusive development. Policies and programs to realize distributional objectives are in place and well implemented. Public and private systems for social security together provide adequate cover to the poor and vulnerable groups in society. Safety nets for specially disadvantaged groups are in place. The pattern of public expenditure reveals a pro-poor stance. Anti-poverty programs and schemes to address food security are well funded and

have good outreach. Special programs for the aged, infirm, and disabled are successfully implemented. Public subsidies largely accrue to the poor. Publicly funded programs reach the intended beneficiaries, namely the poor and disadvantaged.

66. Another considerations is that performance on redressing inequities can be measured in terms of changes in the headcount index and the Gini coefficient, i.e., reducing poverty as a percentage of the population and narrowing the gap between the poorest and richest quintiles of the population. However, given the nature of the process, perceptible impacts on statistical indicators are not likely to be seen year-to-year. Hence, this aspect of performance could be assessed once in 3-5 years.

e. Empowerment and Participation

67. The extent to which the poor, and particularly women, are enabled to participate in development and civil society is evaluated. This also covers vulnerable and other disadvantaged groups who have suffered from social practices and outmoded laws. The criterion assesses efforts made by the government to develop social capital by decentralizing; promoting cooperation and augmenting self-reliance among local organizations; increasing community support and commitment to local development activities; engendering an enabling environment—characterized by transparency, simplicity, and consistency—to foster growth of community-based organizations, NGOs, and other local institutions; and maximizing the interaction between governmental, corporate, and community representatives, which may lead to the establishment of solid partnerships for community development.[6] It also seeks to assess efforts made to actively support the disadvantaged and improve equality of economic opportunity.

68. **Poor performance, score of 1**. Mechanisms in society for the poor (or their representatives) to participate and monitor performance of government are weak or nonexistent. Knowledge of government programs at the local level is low, and there is scant evidence of community involvement in monitoring basic public services such as education and health and development programs. NGO-state relations are weak or difficult. NGOs have little to no role in development programs. Local/community-based organizations suffer from isolation, lack of interorganizational communication and/or coordination. Vertical networks of patronage reinforce existing inequalities and perpetuate poverty. Laws and social practices prevent women or some socioeconomic groups from owning land, inheriting property, taking up certain occupations, and having equal access to public services. Moreover, few initiatives or programs have been taken up to redress these inequities.

69. **Average performance, score of 3.5**. Participatory mechanisms exist but are not strong. The principle that primary stakeholders participate in development activities that affect their lives is accepted by the government but its capacity to promote participatory approaches to development is limited. Horizontal social capital in the form of various organizations exists at the local level. However, most of the people are not members or do not participate actively. NGO-state relations have been codified. There are laws/regulations governing NGOs but these are characterized by discretion in who may be given approval, lengthy registration procedures, and high endowment requirements. NGOs are involved in assisting the government in delivering programs but institutional mechanisms have not been established for an enhanced

[6] Adapted from World Bank. 1998. *Initiative on Defining, Monitoring, and Measuring Social Capital*, Washington, D.C.

role for NGOs, e.g., managing and decision making on programs. Existing networks of patronage are being challenged as local/community organizations grow and gain strength, and the poor and vulnerable groups acquire a voice. The government has taken action to redress various inequities arising from outmoded laws and nonprogressive social practices; however, it will still take some time before equality of access and economic opportunity is ensured for the disadvantaged.

70. **Strong Performance, score of 6**. The community actively participates through various organizations in local government and in development. Community involvement in monitoring performance in the provision of public services (basic education and health) and development programs is actively encouraged or mandated by law through decentralized powers to local government bodies. People participate actively in community-based organizations. There is a set of clear, simple, and widely disseminated laws and regulations that allow NGOs to come into existence with reasonable promptness and ensures autonomy. Local organizations have demonstrated capacity to form networks of cooperative linkages with outside organizations including national and international NGOs. The government holds regular and meaningful consultations with NGOs. Effective policies and programs to ensure equality of access for disadvantaged groups (including women) are in place and well enforced. Laws protect the rights of women and other socioeconomic groups to own assets, obtain credit, receive nondiscriminatory treatment in labor markets, etc.

71. Other considerations that may be taken into account if information is available include

(i) the extent to which cooperatives (production, credit, marketing of produce, and others) have spread;
(ii) organizations and clusters of self-interest (and self-help) groups among the vulnerable and poor, e.g., small holders' organizations, handloom or handicraft workers groups, etc;
(iii) women's groups for credit, production, marketing, and social organizations; and
(iv) gender empowerment measure of the Human Development Report to also be considered although it may only approximate the situation of poor women, as it reflects women's participation in the political arena and the formal employment sector.

3. Governance and Public Sector Management

72. The criteria in this cluster seek to provide a system-wide view of the state of governance and general public sector management. Governance here is understood as the manner in which government policies are formulated and implemented. While governance and public management considerations are important in all sectors, the focus here is on "core governance" areas affecting the entire system. One subset of criteria focus on general aspects of good governance: property rights and rule-based governance, anticorruption, and accountability institutions, and the efforts to put in place a merit-based and accountable civil service. This covers the whole gamut of property rights (private and common), impartial dispute-resolution mechanisms, independent audit and vigilance institutions, accountability, and, institutional capacity for policy formulation and program implementation. The other criteria evaluate the quality of public financial management. This covers a wide range: budgetary processes, financial control, public investment programs, thrust and efficiency of public expenditures, and efforts to reduce untargeted subsidies and nonproductive expenditures, etc.

a. Rule of Law

73. **Poor performance, score of 1**. Appropriate actions are not being taken to address an overall environment in which property rights are not well defined and there is no system to protect such property rights. Contracts cannot be enforced through formal mechanisms. Laws governing business and commercial entities are nonexistent or outdated and are not consistently followed or enforced. Access to judicial, administrative. and other regulatory systems is limited and not effective. Discretion in administering regulations, policies, and laws is excessive and nontransparent; decision making is often ad hoc in the absence of clear established rules. Corruption in the judicial and regulatory systems is widespread. Processes in the legal and administrative system are very weak or have broken down. The legal system in general does not operate or has virtually collapsed.

74. **Average performance, score of 3.5**. Private property rights are defined and a system is in place to protect such rights. However, the system's functioning results in patchy or uneven protection of rights. Dispute resolution mechanisms are in place. Contracts are enforced through formal mechanisms; however, enforcement can be sporadic and some inconsistencies arise from time to time. Laws governing business entities and activities do exist; some are well enforced, while others are not. Business regulations entail cumbersome procedures and complicate compliance. Access to judicial, administrative, and other regulatory systems formally exists; in practice, equality of access cannot be assured. Rules are established and published to reduce the exercise of nontransparent discretion in administering regulations, policies, and laws. The judicial system is formally independent but is subject to external influences.

75. **Strong performance, score of 6**. Private property rights are well defined, and an effective and accessible system is in place to guarantee and protect such rights. Enforcement of contracts through formal mechanisms, including judicial processes, is effective, consistent, and efficient. Laws governing business entities and activities exist, and are consistently enforced and generally followed. Business regulations have been simplified to facilitate ease of compliance. Access to judicial, administrative, and other regulatory systems is effective and equal. The judiciary is strong and independent.

b. Anticorruption and Accountability Institutions

1. **Poor performance, score of 1**. The country ranks poorly in comparison with regional counterparts in international corruption perception rankings. Allegations of corruption are widespread at all levels of government. Aid-funded projects and programs encounter repeated delays and problems, some of which are related to corruption. Anticorruption institutions are weak and lack autonomy. Institutions to ensure accountability for decision making are either weak or nonexistent, e.g., no independent audit body is in place to assess spending decisions of the executive and/or accountability of the executive to the legislature is also weak. Few politicians and civil servants are sanctioned for corruption, particularly those who are powerful or politically connected.

77. **Average performance, score of 3.5**. The country falls in the midrange in comparisons with regional counterparts in international corruption perception rankings. Corruption is not unknown within the government, but it is concentrated in certain areas and does not appear to be widespread or systemic. Anticorruption laws have been enacted and vigilance institutions set up to check corruption in public life. Institutions and legislation are generally adequate; however, enforcement of anticorruption law could be improved and independence of vigilance bodies strengthened. An independent audit body has been established, and accountability of

the executive to the legislature has been strengthened. Most sanctions for corruption are imposed upon lower and midlevel officials.

78. **Strong performance, score of 6**. The country ranks well in comparison with regional counterparts in international corruption perception rankings. Cases of corruption are isolated and infrequent at all levels of government. The government is strongly committed to fighting corruption, and has an appropriate legal framework and strong independent vigilance institutions in place to do so. Laws for anticorruption cover all public officials including the head of the executive. A strong independent audit institution submits timely reports to the legislature. The legislature has a strong committee that enforces accountability of the executive branch of government.

c. Civil Service

79. **Poor performance, score of 1**. There is no established civil service or the existing civil service is intrinsically weak. The skill base is narrow. Patronage hires are common. The staff mix is heavily weighted toward semi-and unskilled workers with pronounced shortages in critical skill categories. Institutional capacity for policy formulation and program implementation is poor. Procedures for monitoring the civil service establishment (public employees) are weak. The government is uncertain about the total number of civil servants—"ghost workers" are known to exist in large but undetermined numbers. Pay and productivity is low, and absentee rates are high. Formal disciplinary procedures are not working, and rules are frequently violated. The civil service's accountability for actions is nonexistent or poor.

80. **Average Performance, score of 3.5**. A civil service is in place. Recruitment for public employment is based on established rules. The civil service is either at a nascent stage of development, or shortages of certain skill categories exist. Institutional capacity for program and project implementation has improved; however, policy formulation capacity is not yet adequate. Procedures for establishing monitoring and control are in place, and the human resource database is improving. Pay is adequate for some categories, but lagging behind in others (particularly in critical areas). Staff incentives are adequate. Recruitment and advancement are generally merit-based, although patronage can be a problem in certain ministries and at certain levels of government. The civil service's accountability for actions taken has improved; formal disciplinary action is taken to ensure compliance.

81. **Strong performance, score of 6**. A mature civil service is in place, comprising an adequate number of honest, productive, and technically competent staff. Civil service recruitment is done through a transparent process and is merit-based. Institutional capacity for policy formulation and program implementation is strong. Accurate information exists on the size and composition of the civil service, which is regularly linked and cross-checked with other data sources (such as payroll). Advancement in the civil service is conducted by open and competitive procedures, and meritocracy is firmly protected. Pay is sufficient to retain talented staff, particularly those whose skills are in high demand. Appropriate procedures are utilized for human development and career management, and to ensure integrity within the civil service. Systematic feedback from the public is obtained and used to improve performance.

d. Revenue Mobilization and Budgetary Management

82. **Poor performance, score of 1**. Tax laws are unclear, ad hoc exemptions are frequent, numerous tax expenditures that benefit vested interests, and revenue forecasts are unreliable. Tax administration is weak resulting in poor compliance, enforcement, and low collections. The

administration of customs and excise taxes is corrupt. Budget figures are unrealistic, partly owing to the unreliable revenue forecasts; budget approval by the legislature is either not required or is a formality. Budgetary processes and institutional mechanisms are not in place to ensure that budget execution matches approved/authorized appropriations. Budget coverage is narrow, and "black boxes" and extrabudgetary funds proliferate. Overall budgetary management is poor; the government is unable to exercise control. Cash is released to spending agencies in unpredictable and discretionary ways; financial controls are lax.

83. **Average performance, score of 3.5**. Tax laws are clear. However, compliance is still partial and enforcement is uneven. Tax evasion remains common although prosecutions for tax fraud do occur. Exemptions in numerous laws enable tax avoidance resulting in low collections. Ad hoc exemptions and tax expenditures have been reduced but not eliminated. Corruption in customs and excise is frequent, but not the norm. Tax administration has improved but needs strengthening in institutional capacity, staff resources, and equipment. Legislative approval of the budget is not a mere formality. Fiscal transparency is improving. The budget covers nearly all government expenditure, but extrabudgetary funds still exist indicating an element of nontransparency. Budget formulation begins to take account of multiyear implications of spending decisions. Budgetary processes have been instituted to ensure compliance with approved appropriations; however, during the year, budget amendments are frequent. Financial control is good, but strategic allocation of resources is weak.

84. **Strong performance, score of 6**. The tax structure is progressive. Tax laws are clear, and uniformly and consistently enforced. Tax laws and regulations have been simplified and rationalized. Exemptions are kept to a minimum and are nondiscretionary. Tax administration is reasonably competent and robust; tax evasion is limited. Revenue forecasts are reliable. Fiscal transparency is good. Budget coverage is broad; extrabudgetary funds are limited to those with a clear revenue-benefit link. The budget is formulated in a multiyear perspective, for both capital and current expenditure. Budget approval by the legislature is informed and well debated. Budget processes and authorizations ensure that budget execution is very close to the approved budget. Cash is released to spending agencies in predictable amounts and on a regular schedule. Amendments to the budget to change appropriations require formal approval of the legislature and are limited to one or two occasions per year. The public is well informed: budget documents are easily accessed, and public financial results are released. Financial control is very good, the policy-budget link is strong, conditions exist for good operational management, and due process is observed at all levels.

e. Management and Efficiency of Public Expenditures

85. **Poor performance, score of 1**. Public spending is dominated by current expenditures; capital expenditure or public investment is minimal. Subsidies are numerous, open-ended, and untargeted. Expenditure programming is very weak. Expenditure categories are not clearly or well defined. Allocations for public spending are not linked to expected program results or actual performance. No institutional mechanism or process is in place to review the impact of public spending under different programs; allocations are often arbitrary or based on past allocations. Auditing of public spending is limited or does not exist. Unproductive or wasteful expenditures are frequently made. Public spending decisions are often ad hoc and not linked to budgetary appropriations. No method has been instituted to determine the size of public investment or attempt to prioritize components in the public investment program. Weak linkages between line ministries and the ministry of finance result in public investment decision making that is not effective.

86. **Average performance, score of 3.5**. Some rationalization/restructuring of public spending has been done. Spending on investment and capital is a growing proportion of total expenditure. However, current expenditure still dominates and public investment falls short of requirements. Efforts have been made to pare budgetary subsidies and target them more effectively; even so, some subsidies with questionable benefits and equity implications remain. Expenditure programming has improved. Expenditure categories are clearly defined. Allocations are closely aligned to appropriations under different expenditure heads. There has been an attempt to link allocations to program benefits; however, the primary determinant of allocations is still past spending, not actual performance or achievement of goals. A feedback process has been instituted to review program impact. However, it is not applied to all categories of expenditure; also there are delays in evaluating a program's impact. This dilutes the link between performance review and allocations. An audit of public spending has been established but reports are not prepared in a timely way or regularly because of capacity limitations. An institutional mechanism has been set up to determine the public investment program and decision-making on individual investment proposals; it is still in a nascent stage and needs to mature.

87. **Strong performance, score of 6**. The public expenditure pattern meets the needs for public investment and capital expenditure adequately. Budgetary subsidies are few, close-ended, and well targeted. Expenditure programming is well structured. Allocations to expenditure heads scrupulously match approved appropriations. Some form of performance-based expenditure budgeting has been instituted, e.g., zero-based budgeting. Allocations are linked closely to program benefits and evaluated past performance. Process for program impact review has been institutionalized and applied uniformly to all major expenditure heads and significant public programs. Reports on the audit of public spending are submitted regularly and in a timely manner to the legislature. The public investment program has been constituted on a sound basis with necessary linkages across line ministries and the ministry of finance. The decision-making process on individual investment proposals is mature.

COUNTRY PERFORMANCE RATING: THE COMMON CRITERIA

	Item	Weight
A.	**Sustainable Economic Growth**	**25%**
	1. Macroeconomic Management	10%
	Fiscal Policy	
	Monetary Policy	
	External Financing Policies	
	2. Structural Policies	10%
	Trade Policy and Foreign Exchange Regime	
	Financial Sector Efficiency and Soundness	
	Factor and Product Markets and Prices	
	Enabling Environment for Private Sector Development	
	3. Environmental Protection	5%
	Environmental Laws and Institutions	
	Environmentally Damaging Subsidies	
B.	**Socially Inclusive Development**	**30%**
	Framework for Poverty Monitoring and Policy Formulation	
	Enhancing the Economic Capital of the Poor	
	Developing the Human Capital of the Poor	
	Equity and Social Safety Nets	
	Empowerment and Participation	
C.	**Governance and Public Sector Management**	**30%**
	Rule of Law	
	Anticorruption and Accountability Institutions	
	Civil Service	
	Revenue Mobilization and Budget Management	
	Management and Efficiency of Public Expenditures	
D.	**Portfolio Performance**	**15%**
	Total	**100%**

THE ASIAN DEVELOPMENT FUND ALLOCATION FORMULA – A NOTE

1. The Asian Development Fund (ADF) allocation formula is derived from three variables: performance rating (PR), population (Pop), and per capita gross national product (GNPC).

2. The basic equation relating allocation to PR, Pop, and GNPC is as follows:

$$\text{Allocation} = \frac{K * PR * Pop}{GNPC}$$

where K is a proportionality constant whose value is to be determined. And the basic equation can be written as:

$$\text{Allocation} = K * PR^{a} * Pop^{b} * GNPC^{-c}$$

where the exponents a, b, and c are numbers, not necessarily integers.

3. Note that

(i) an exponent value greater than 1, enhances the effect of that variable on the dependent variable;
(ii) a value between 0 and 1 diminishes the effect;
(iii) a value of 0 neutralizes the variable completely; in effect, the variable is assigned a value of unity and has no influence on the dependent variable; and
(iv) negative values of the exponent imply that the variable has an inverse relationship with the dependent variable.

4. With the three exponents a, b, and c attached to the three variables and with the range of numerical values that can be assigned to the exponents, a variety of objectives can be achieved in the allocation process.

A. Performance Rating

5. First, consider a, the exponent of the PR variable. If a a value of 1.8 is assigned to this exponent, this will ensure that it remains the most important variable in determining the allocation. The built-in nonlinearity incorporates the required progressiveness in the formula linking performance and allocations. For instance, an exponent of 1.8 implies that, all other things being equal, the allocations of the poorest performer (PR of 1) and the best performer (PR of 6) would be in the ratio of 1:25.2.

B. Population

6. The value of b, the exponent attached to the population variable, needs careful consideration because of the wide disparities in the population figures of countries with ADF access. Excluding the Pacific developing member countries (DMCs), populations range from 256,000 to 138 million, a ratio of 1:540. Moreover, three DMCs—Bangladesh, Pakistan and Viet Nam—account for 80 percent of the population with ADF access. If the influence of the population variable is overwhelming, the bulk of the ADF resources would go to these 3 DMCs.

In effect, the smaller DMCs would be crowded-out, i.e., they would receive very limited allocations. The influence of the population variable must be moderated. There is clearly a case for assigning a value less than 1 to b, the exponent attached to the population variable.

7. The following simple example with only two countries are involved demonstrates this point. Assume that the PRs and GNPCs are equal, and the countries differ only in population size. Country X has a population of 70 million whereas country Y has a population of only 30 million. In this scenario, if the population exponent was set at 1, 70 percent of the resources would be allocated to country X and the remaining 30 per cent to country Y.

8. To impart a bias in favor of the small country, in this case country Y, the value of b can be set at, say, 0.75. The implication of a reduced exponent is to lower the significance of population in determining allocations. This would modify the respective shares of the two countries in the total population to 65.4 percent and 34.6 percent. Country Y (the smaller country) now receives an allocation that is 4.6 percent more than before; and the allocation for the bigger country X is correspondingly reduced. The impact of lowering the exponent is equivalent to increasing the population of country Y by a factor of 1.15 (i.e., 34.6/30) and reducing the population of country X by a factor of 0.934. (i.e., 65.4/70).

C. Per capita GNP

9. The negative exponent for GNPC ensures an inverse relationship between GNPC and allocations. This is the poor-country bias. GNPC values for the regional DMCs (excluding the Pacific DMCs) with ADF access show wide variations. At one end, the Maldives has a GNPC of $1,180, while at the other end, Nepal has a GNPC of $220. This is a ratio of 5.36 to1. In the interest of equity, a small negative correlation needs to be maintained between allocation and GNPC. A value of c=0.25 would meet this requirement. Until recently, the International Development Association used a similar exponent.

D. The Overall Formula

10. The overall formula ensures the following:

(i) Performance is the most important factor in determining allocations.
(ii) Larger countries (in terms of population) receive a higher allocation in absolute Terms.
(iii) Smaller countries receive higher per capita allocations because of the built-in small-country bias.
(iv) The poorer the country (in terms of GNPC) the higher the absolute allocation because of the built-in poor-country bias.

EQUIVALENCE OF THE APPROACHES TO ALLOCATIONS

1. The Asian Development Bank and World Bank approaches to determining performance-based allocations are essentially the same. The World Bank system initially determines an absolute allocation but this is subsequently normalized to ensure that overall resource constraints are met. This normalization is equivalent to determining a performance-based share and then applying it to a budgeted amount. The following example illustrates this general proposition.

2. Assume there are 6 countries — A, B, C, D, E, and F — which have identical populations (20 million) and per capita incomes ($350). They differ only in their performance ratings (PR). Also assume that the amount available for allocation is $100 million. The starting point for the World Bank system is to determine a per capita allocation using the following formula:

$$\text{Per capita allocation to country i} = GNPC_i^{-.125} * PR_i^{2} \qquad (1)$$

Table A.5 shows the per capita allocations given the performance ratings and the country allocation given the population of 20 million.

Table A5.1: Per Capital Allocation Given the Performance Rating

Item	Country					
	A	B	C	D	E	F
PR	2	2.6	3.2	3.8	4.4	5
Per Capita Allocation ($)	1.92	3.25	4.92	6.94	9.31	12.02
Absolute Allocation ($ million)	38.4	65	98.4	138.8	186.2	240.4
Allocation ($ million)	5	8.5	12.8	18.1	24.3	31.3

4. The absolute allocations total to $767.2 million. However, the resource envelope limits the total amount to $100 million. At this stage, the World Bank system normalizes the allocations. The absolute allocation for each country is divided by the total absolute allocation for all countries and then multiplied by $100 million to determine the country's allocation Table (A5.1).

The allocations now total exactly $100 million. In effect, the normalization scales back the originally determined absolute allocations (i.e., $767.2 million) to fit the resource envelope (i.e., $100 million).

5. To look at the World Bank system, in a different way, suppose the World Bank adopted the ADB system of determining a share for each country. How would it go about it? The absolute allocation to a country in the World Bank system is

$$\text{Allocation to country i} = GNPC_i^{-.125} * PR_i^{2} * Pop_i \qquad (2)$$

Simply, this is the expression in equation (1) multiplied by the population. It follows that

$$\text{Total allocations to all countries} = {}_i\Sigma\, GNPC_i^{-.125} * PR_i^{2} * Pop_i \qquad (3)$$

Then, the share allocated to country i is simply the expression in (2) divided by that in (3), namely

$$\text{Share allocated to country i} = \frac{GNPC_i^{-.125} * PR_i^{2} * Pop_i}{{}_i\Sigma\, GNPC_i^{-.125} * PR_i^{2} * Pop_i} \qquad (4)$$

Table A5.2 shows the shares that would be allocated to the countries based on their performance ratings using the formula at (4) above

Table A5.2:

	Country					
Item	**A**	**B**	**C**	**D**	**E**	**F**
PR	2	2.6	3.2	3.8	4.4	5
Share (in %)	5	8.5	12.8	18.1	24.3	31.3
Allocation ($ million)	5	8.5	12.8	18.1	24.3	31.3

The share computed is now applied to the resource envelope of $100 million to determine the country-wise allocations would be as below

Thus, the formula-determined allocations are exactly the same as before (Tables A5.1 and A5.2). That is, the two processes —starting with an absolute allocation and then normalizing the allocations to fit into a resource envelope or determining a share and then applying the share to a given budgeted amount—are equivalent in terms of the allocations they yield. Now, the proposed ADB formula for determining shares is

$$\text{Share allocated to country i} = \frac{GNPC_i^{-.25} * PR_i^{1.8} * Pop_i^{.75}}{{}_i\Sigma\, GNPC_i^{-.25} * PR_i^{1.8} * Pop_i^{.75}} \qquad (5)$$

Except for the exponents assigned to various variables, this formula is identical to that in (4).

6. Two conclusions emerge. First, the World Bank and ADB approaches to determining allocations are essentially the same. In effect, both systems determine shares and then apply the shares to a given resource envelope. Second, both allocation systems exhaust the resource envelope.

AN INDICATIVE ONE-YEAR CYCLE

December-early January: Country performance assessment (CPA)

Mid-January: CPA concluded, performance ratings determined

Mid-January to end-January: Performance ratings checked for cross-country consistency; three-year rolling allocations finalized

February—March: Country planning — country programming to draw up the CSP; use three—year allocation as base—case; also determine an indicative allocation for first year of CSP – some figure to start planning — could be based on past allocations and performance – or if CPA has been done for a number of years, an average annual allocation could be determined using the three—year rolling indicative allocation; draw up the CSP; identify country—specific performance criteria and triggers. Short term triggers can affect existing cycle, while most will affect the next year's cycle. Link triggers to low and high case scenarios; set levels of lending associated with low and high case scenarios; reach agreement with the government and finalize the CSP.

July—September: Assess performance against country triggers that are relevant to the existing cycle, to determine whether performance is above or below base case; adjust current year's lending program accordingly; if performance has slipped to low case, reduce the lending program from that planned in the CSP; this will entail slowing down/halting the processing of projects originally planned for the current year;

April—September: Review by nodal unit of last year's Bank—wide CPA to identify weaknesses, strengths of the system and come up with improvements/refinements in criteria and how to measure performance;

October—November: Final review of performance against country—specific triggers;

November: Guidelines to be issued by nodal unit on any changes in methods of assessment and/or indicators to be used for performance assessment. In parallel, initiate assessment of country economic performance for the current year; begin gathering data on the numerous indicators and criteria;

December—early January: Country Performance Assessment (CPA)

Mid—January to end—January: Performance Ratings checked for cross—country consistency; three—year rolling allocations finalized for new three—year rolling plan;

February—March: Country Planning — country programming to draw up the CSP; use revised three—year allocation as base—case; determine an indicative allocation for first year of CSP – could be an average annual allocation based on the three—year rolling indicative allocation; draw up the CSP; identify new country—specific performance criteria and link triggers to low and high case scenarios; reach agreement with the Government and finalize the CSP.

There is an ongoing exercise to revise and streamline the operational business processes of ADB. The entire performance rating and allocation process will have to be integrated and harmonized with the changes being made to the country planning process.