

**ASIAN DEVELOPMENT FUND (ADF)
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**REVIEW OF THE POLICY ON
PERFORMANCE-BASED ALLOCATION: SCOPE AND ISSUES**

**Asian Development Bank
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ABBREVIATIONS

ADB	—	Asian Development Bank
ADF	—	Asian Development Fund
CSP	—	Country Strategy and Program
DMC	—	Developing Member Country
MDG	—	Millennium Development Goal
UNDP	—	United Nations Development Program

In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. In March 2001, the Asian Development Bank (ADB) adopted a policy on performance-based allocation (PBA) for the Asian Development Fund (ADF) resources.¹ ADF allocations for the period 2002-2004 have been made within the framework of that PBA policy. A paper reviewing implementation experience with the PBA system in 2001 and 2002 was provided to donors during the ADF VIII Midterm Review Meeting. As committed, ADB has now initiated a review of the PBA policy and its implementation. This note summarizes the objectives and scope of the review, highlighting important issues to be addressed and seeking donors' views on the proposed approach.

II. THE OBJECTIVE AND SCOPE OF THE REVIEW

2. The purpose of the review is to make recommendations for an improved allocation system. PBA systems are intended to provide for priority development needs, and both reward and provide incentives for improved country performance. Ultimately, however, a good PBA system must contribute to improved development effectiveness and strengthen the compact between donors and ADF borrowers. Consequently, this review will examine salient aspects of the policy, as well as issues relating to its implementation. A discussion paper examining the issues and suggesting directions for improvement will be presented at the next ADF meeting. Following incorporation of donor and other stakeholder inputs, a working paper (W-paper) will be prepared for Board discussion in early 2004.

III. SELECTED ISSUES²

3. During the ADF Midterm Review, donors expressed a variety of concerns about the structure and implementation of the PBA. Questions about the PBA and its implementation have also been raised during Board discussions of country strategies and programs (CSPs). Feedback about the PBA from ADF clients has been provided to operational missions. Issues that have been raised refer to: (a) the content and coverage of the policy, (b) processes and implementation, and (c) outcomes and uses.

A. The Policy

4. A number of issues have been raised in relation to the content and coverage of the policy. At one level, these refer to technical issues about allocation rules (the formula), and the measurement of performance and need. At another level, they relate to issues of disclosure, accountability and the scope of the PBA in improving organizational and development effectiveness. In this connection, the impact of country-specific performance criteria and "triggers" will be considered.

5. Experience of PBA systems in other multilateral development banks, as well as more recent initiatives, such as the proposed Millennium Challenge Account³ and country performance assessments systems linked to monitoring of policies and actions on the

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

² An annex summarizes a rather more extensive list of issues that have been raised by various stakeholders. The actual selection of issues will be defined under the further planning and conduct of the review.

³ See Steven Radelet "*Challenging Foreign Aid*," Center for Global Development, Washington, D.C., May 2003.

Millennium Development Goals (MDGs),⁴ are also germane. Going forward, an important challenge for PBA systems will be to meaningfully capture “results” at a country level. Rewarding “results” in a way that does not discriminate against poor countries starting from a low base in terms of achievements may require consideration of modified rules.

6. In support of ADB’s Charter, the PBA policy provides for separate allocations to address the needs of the small Pacific Island economies and sub-regional cooperation. Special provisions for exceptional country circumstances are also supported. Delivering on these mandates may not always be consistent with a focus on rewarding performance. The review will seek to clarify to what extent such tensions exist, and how they might be managed.

B. Processes and Implementation

7. ADB has had three years experience of implementing its PBA system. Over this period, new processes have been adopted, and additional organizational resources have been secured for implementation. progress has been made and much has been learned, recourse to “adjustments” to avoid abrupt changes in lending levels and to accommodate special country circumstances has invited criticism that the system lacks transparency and that intended links to performance have been delinked. Alternative arrangements that address these and related concerns will be examined.

8. The country performance assessments have imposed costs for borrowers as well as for ADB. DMCs have also expressed some reservations over the reliability of the ratings process. Within the framework of the review, consideration will be given as to how the ratings process can be made more efficient and reliable. The scope for increased collaboration with partners and in-country consultations will also be examined.

9. Currently, with minor departures, PBA allocations are made on a fixed annual budget cycle. This presents a number of practical problems in efficiently managing programs, and providing needed flexibility on the ground. Risks to project quality and program coherence are present. Rolling budgetary allocations warrant careful consideration as a way of addressing these difficulties.

C. Outcomes and Uses

10. In the initial years of implementation, application of the policy has tilted allocations toward blend countries with large populations. ADF-only countries and countries with small populations have experienced falling allocations relative to historical lending levels. Notwithstanding the need to reward performance, this pattern of resource allocation may not serve development effectiveness.

11. The impact of triggers on lending outcomes has, to date, been comparatively modest. Trigger assessments appear to have had a systematic tendency to increase allocations, presenting difficulties for overall resource management. The issue of whether, in practice, triggers provide incentives for improved performance will be examined.

⁴ Development Committee, *Achieving the MDGs and Related Outcomes: A Framework for Monitoring Policies and Actions*, DC 2003-03, Washington, D.C., March 2003.

12. ADF resources are limited and, in most countries, modest relative to overall needs. Given modest resources the issue arises as to how the PBA system can best provide incentives for improved performance. In this context, issues of disclosure, dialogue and strategic commitments are important. While serving the interests of accountability, appropriate disclosure within a framework of strengthened country partnerships may have important implications for improved effectiveness.

IV. DRAFT ANNOTATED OUTLINE

13. A draft annotated outline of the proposed discussion paper is provided in the box below. It attempts to draw together the main issues raised above and in the Annex. Donor views on its scope, content, and form are invited.

Draft Table of Contents

Executive Summary

I. Introduction

A. The Allocation Challenge

The rationale and scope of PBA systems. What they can and cannot achieve. The features of a useful PBA system.

B. The Purpose and Scope of this Review

To review the policy as well as its implementation. The objective is to refine and improve the system of allocation and improve implementation, including aspects related to quality assurance, resource management, accountability and disclosure with a view to enhancing development and organizational effectiveness.

C. The Issues

II. Country Performance Assessments

A. Performance Criteria

The scope of the ratings. The relevance and reliability of ratings criteria. Ratings' scales and weights.

B. Ratings Process

Rating instructions. Rating outcomes. Ratings validation and quality assurance. Ratings consultations. Scope for simplification.

C. Portfolio Ratings

The scope of portfolio assessments. "Project at risk" concepts. The treatment of small countries and immature portfolios.

D. Country Specific Performance Criteria

Role of country triggers. Setting coherent triggers. Evaluating triggers. Alternative incentive mechanisms.

E. Uses of Performance Ratings

The use of performance ratings for policy dialogue, and the development of country strategies and programs. Monitoring actions and policies for the achievement of the MDGs. Disclosure of ratings and related issues.

F. Issues

III. The Allocation Process

A. The Formula

The structure and rationale of the formula. A review of possible alternative approaches to measuring need. The role of population in the formula. Formula weights and their impact (across countries, and over time).

B. Allocations outside the formula

Possible roles for caps, floors and transitional limits on allocative changes. Program allocations for small island economies and subregional cooperation. Allocations in cases of exceptional and unforeseen circumstances. The scope for discretion. How to deal with grants, if established, within a PBA framework.

C. Resource Management

Rolling allocations versus fixed period allocations. Rollovers of unused allocations. Over-programming and annual limits. Resource management and links to the credibility of the policy.

D. Issues

IV. Implementation Arrangements

A. Country Teams

Data gathering and country performance assessments. Setting triggers. Evaluating triggers and lending scenarios.

B. PBA Working Group

Ratings' consistency. Quality assurance within and across countries. Secretariat functions. Trouble-shooting and periodic issue of clarifications and guidelines. Arrangements in other institutions.

C. Validation Group

Annual review of implementation for compliance with the policy. Review of recommended lending allocations. Arrangements in other institutions.

D. Approval Procedures

The roles of the Regional Departments, the Strategic Planning Department, and Management. Arrangements in other institutions.

E. Resources

Staffing requirement, training and orientation of staff and DMC officials.

F. Issues

V. Towards an Improved PBA System

The concluding chapter will draw together the issues raised in each of the preceding chapters and outline preliminary options for consideration by donors, Board members, and other stakeholders.

Annexes (as needed).

ANNEX: POTENTIAL ISSUES FOR THE REVIEW OF THE POLICY ON PBA¹

Policy

- The links between the PBA and the country strategy and program (CSP) and national poverty reduction strategies are weak.
- Greater disclosure is needed in the interests of public accountability.
- The framework needs to say more about strategies for poorly performing countries.
- Incentives for improved performance are not clear in a system that rewards relative performance.
- The analytical and empirical basis for the formula and the rating criteria are not clear.
- Elements of the country performance criteria are too subjective or coarse.
- There are difficulties in rating countries at different levels of development.
- Portfolio assessments need to take account of their different maturities and size.
- The formula should not be treated as “hardwired” within the framework of the policy.
- Governance considerations are not sufficiently weighted.
- Population exerts too much influence on allocations.
- Tensions between performance considerations and mandates to support sub-regional cooperation and allocations for small island economies exist.

Process and Implementation

- The country performance assessment (CPA) would benefit from streamlining.
- Country assessments need to draw more extensively on in-country consultation.
- Quality assurance needs to be improved.
- Staff instructions on ratings and triggers need refinement.
- Government’s views on the ratings are not weighted sufficiently.
- “Triggers” have not always been well specified or credible.
- Scope for collaboration on performance assessments should be explored.
- Adjustments to formula allocations have not been adequately justified.
- Allocation decisions do not embody adequate checks and balances, nor ensure proper accountability.
- The Validation Group does not have sufficient authority, exercising only an advisory role.

Outcomes

- Allocations are not linked strongly enough to performance.
- The link between country allocations and country performance is unclear.
- Population size exercises too much influence on allocations, thus penalizing countries with small populations.
- The formula favours blend countries relative to historical average lending levels.
- Abrupt downward adjustments in PBA allocations can impair project quality and undermine relationships with Government.
- Triggers seem to have had only a marginal impact on outcomes.
- Disclosure of ratings on investor perceptions.
- DMC views on ratings, should be recorded and disclosed.
- Ratings outcomes inadvertently attach more weight to some criteria than others.
- A systematic audit trail for ratings is needed.
- Fixed annual budgeting impairs needed operational flexibility and may compromise project quality and program coherence.

¹ The actual selection of issues will be defined under the further planning and conduct of the review.