

## **MANAGEMENT RESPONSE ON THE 2006 ANNUAL EVALUATION REVIEW**

On 21 August 2006, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

### **A. General Comments**

1. Management appreciates the ambitious and broad-ranging analytical work and extensive internal consultations undertaken for this year's Annual Evaluation Review (AER). The AER provided us with valuable insights about common factors that contribute to good project performance, and raises challenging questions about the role of governance in fostering development, and the importance of staff incentives for improved development outcomes.

2. Management notes that the AER findings support the choice of priority sectors in the second Medium Term Strategy. We also note that the AER found that success rates for both OCR- and ADF-funded projects improved markedly in the 1990s compared with the previous two decades. We are also encouraged by the relative increase in the success rate of ADF projects, which used to lag far behind that of OCR projects. Management is committed to building on these achievements.

### **B. Comments on Recommendations**

#### **1. Governance and the Performance-based Allocation**

3. Management has reservations about the AER recommendation to review "the high weight given to governance variables in the current performance-based allocation (PBA) formula in the context of the upcoming review of the ADF IX replenishment." The claim that the governance weighting is too high runs contrary to the observation that the weighting is consistent with the preferences of ADF donors, and is still significantly lower than the 66% weight assigned to governance in the World Bank's PBA formula. The AER also notes the importance of harmonization with other MDBs on prominent cross-cutting issues such as governance, and that our method of assessing governance under the PBA policy is fully harmonized among MDBs.

4. The recommendation to reduce the weighting of governance is based on several propositions: (i) governance has many definitions and is hard to measure, (ii) there is a relatively weak relationship between all dimensions of governance and the level of development in ADB's DMCs, and (iii) there is a generally weak relationship between good governance and development results in ADB-funded projects. These propositions follow from a statistical exercise using broad governance indicators that are different from the detailed and specific governance benchmarks used in the PBA questionnaires of ADB and other key MDBs. Furthermore, the emphasis of the analysis is on the instrumental value of governance in affecting other development outcomes, such as portfolio performance, rather than the intrinsic value of governance as an important development outcome in itself. Furthermore, the evidence cited and

presented in the report to support a “relative weak relationship between all dimensions of governance and the level of development in ADB’s DMCs” is misleading. Contrary to the impression given in the report, one of the more robust results to emerge from a large literature on the (cross-country) determinants of growth is that governance matters. Finally, in examining the impact of governance on other development results, the research cited in AER is methodologically weak. Robust conclusions can hardly be drawn regarding the causal role of governance in effecting other development results or outcomes from mere statistical association between different variables, or the lack thereof, in the absence of a sound theoretical model and causality tests because of the ‘missing variables’ problem.

## **2. Strengthening ADB’s Staff Performance Appraisal System**

5. Although we disagree with some of the sweeping generalizations made about the lack of incentives or recognition for project implementation, we support the recommendation to better align staff incentives with development results. It may not be practical to try to capture the discreet contributions of individual staff to development results on an annual basis, however, because project impacts are measured over years, and many different staff are involved from project concept to completion. We do know that project success is correlated with quality at entry, readiness for implementation, and the intensity of implementation supervision. Portfolio administration and performance therefore must feature prominently in departmental workplans, and cascade down to the division and staff level. The new PDP system, which includes performance indicators based on workplan outputs, provides the flexibility for greater emphasis on project implementation. The challenge for Management is to ensure that performance indicators are fair, create the right incentives, and are applied consistently across departments.

6. At the institutional level, the Work Program and Budget Framework and annual budget exercises provide the opportunity to rebalance allocation of resources between project processing and administration. Management has already committed to improving overall portfolio performance through, for example, more delegation to Resident Missions.

7. It should be stressed that other critical factors contributing to project implementation success are beyond the immediate control of ADB and require long-term engagement with DMCs with particular focus on capacity improvement and capacity building. These factors include the performance of the Executing Agency, the availability of counterpart funds, and the complexity of government approval procedures.

## **C. Conclusions**

8. Management welcomes AER’s endorsement of the sector focus in MTS II, and appreciates the many trenchant observations on the determinants of project success. On the issue of the weight of the governance factor in PBA, we will look forward to the discussions in the forthcoming ADF IX mid-term review. We will consider conducting a study to strengthen ADB’s staff performance appraisal system to promote project quality at entry and project administration.