

**ASIAN DEVELOPMENT FUND (ADF)
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**PERFORMANCE-BASED ALLOCATION AT ADB:
PROPOSED ENHANCEMENTS**

**Asian Development Bank
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ABBREVIATIONS

ADF	—	Asian Development Fund
AfDF	—	African Development Fund
CPA	—	Country Policy Assessments
HDI	—	Human Development Index
IDA	—	International Development Association
MDB	—	multilateral development bank
OCR	—	ordinary capital resources
PBA	—	performance-based allocation
PDMCs	—	Pacific developing member countries
PNG	—	Papua New Guinea
RCSP	—	Regional Cooperation Strategy and Program
UNDP	—	United Nations Development Programme

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

CONTENTS

	Page
EXECUTIVE SUMMARY	i
I. INTRODUCTION	1
II. COUNTRY ALLOCATIONS	1
III. PROPOSED POLICY MODIFICATIONS	2
A. Realigning Countries	2
B. Increasing Flexibility	2
C. Closing Strategic Gaps	3
D. Broadening Disclosure	4
E. Triggers and Changes in Country Performance	4
IV. STRENGTHENING IMPLEMENTATION ARRANGEMENTS	5
A. PBA Focal Point	5
B. Biennial Allocation cycle	6
C. CPA Cycle	7
V. REFINEMENT OF PBA METHODS	7
A. Background	7
B. Measurement of Needs	7
C. Measurement of Performance	8
D. Formula Weights	8
E. Changes in Performance	9
F. Formula Adjustments	10
VI. SUMMARY AND NEXT STEPS	10

EXECUTIVE SUMMARY

The policy. Contingent on needs, the PBA policy directs resources to good performers. By putting resources where they are best used, the PBA enhances ADF's contribution to poverty reduction. Despite progress, some parts of the policy are not yet firmly established. Links to country strategies and operations continue to evolve; the transition from historical to policy-based allocations is ongoing; and country-specific performance triggers have had only a small impact on lending. Preliminary recommendations for strengthening the PBA draw on ADB's and other multilateral development banks' (MDBs') experiences.

Strategic Directions for the PBA

Refining country focus. In developing proposals for strengthening the policy, Management reaffirms the strong role that performance must play in allocating ADF resources. But there should also be congruence between the policy and broader strategic considerations. Management believes that a sharper focus in ADF on poor, small and mid-size countries will better serve agreed institutional objectives. Most such countries do not have access to OCR, cannot easily mobilize private sector resources, and face deeply embedded structural disadvantages. But, the weight of needs in larger countries ensures that they will continue to attract a large share of ADF resources. This perspective guides the proposed revisions to measurement and allocation systems.

Country pools. Per capita ADF allocations to Pacific Developing Member Countries (PDMCs) are over three times larger than for other countries. These allocations are intended to compensate for vulnerability and other special needs of small island economies. But Papua New Guinea, which benefits from special consideration, is more comparable in size to other countries. Management recommends that ADF IX incorporates these significant differences by (i) moving PNG to the larger Group A and B pool; and (ii) earmarking a pool of ADF IX resources for the remaining Pacific Island countries that would preserve their historical share in ADF. This arrangement would provide larger incremental rewards for improved performance to PNG and would not crowd-out allocations to smaller PDMCs. In this way, the proposal expands potential resources at the disposal of the Pacific. If PNG's performance deteriorated, it would lose resources, but allocations for smaller PDMCs would be protected.

PBA methods. Although the PBA policy should be durable, it should not constrain measurement and allocation methods. Periodic technical revisions, drawing on experience and improved knowledge, would better serve the policy's objectives. Revisions might also be needed to better align PBA systems across MDBs. Management proposes that the policy be reformulated to allow such changes, without requiring formal revisions to the policy. Technical proposals could be reviewed by the Development Effectiveness Committee and reported to the Executive Board in information papers. The Executive Board would retain the prerogative to request Management for formal recommendations.

Strategic gaps. The policy provides for flexibility in determining allocations under "exceptional circumstances." But the policy is not specific about these circumstances, nor about associated allocation criteria. The revised policy will close this gap. First, it will require the use of the IDA 13 framework to guide allocations to support post-conflict needs, including IDA monitoring and performance frameworks. Second, it will set out eligibility and allocation criteria for regional and subregional cooperation projects. On a pilot basis, Management proposes that 5% of ADF resources be set aside to support these demands. Third, the policy will expressly address the circumstances of weak performers. Engagement remains crucial. This should rest

on strong partnerships with other donors, a strategic approach that focuses on strengthening capacity and development management capabilities, and the judicious application of the available instrument mix.

Disclosure. Management is committed to transparency. In full consultation with the Executive Board, Management will prepare a roadmap for broadened disclosure. Management recommends the following immediate steps: (i) disclosure of country ratings scores at an aggregate and cluster level to each borrower, with average scores for all borrowers; (ii) on a confidential basis only, disclosure of aggregate and cluster scores to Executive Board members on completion of country programming missions; and (iii) public disclosure of an annual PBA report, modeled on the IDA format. These measures are broadly consistent with IDA practices.

Strengthening Implementation

PBA focal point. Accountability for the policy is spread across operations departments. Arrangements do not differentiate adequately between operational and resource management responsibilities. To clarify accountabilities and strengthen implementation, Management recommends that a PBA focal point be established outside operations' departments. The focal point would assume responsibility for all recommendations to Management about ADF resource allocation. Operations departments would continue to conduct country performance assessments.

Biennial allocation cycle. For all countries except the PDMCs, PBA allocations and loan approvals are aligned annually. Shoehorning projects and programs to fit allocations in each year can undermine project quality and program coherence. To ease constraints, Management supports a biennial allocation cycle. Approvals would be constrained by commitments within each biennial period. Limits might also be placed on the proportion of biennial resources to be used in any year. In small countries where infrequent loan projects make it impractical to align approvals and commitments biennially, alignment should occur over the replenishment period.

The CPA cycle. For most countries, the annual country performance assessment (CPA) cycle should be retained. For small PDMCs, and perhaps other small countries, the CPA might be undertaken on a biennial basis. CPAs should be completed by the end of the third quarter of the preceding year. If triggers are retained (see below), their assessment should be brought forward and conducted during country programming. These steps would contribute to better business processes and improved communications with the borrower.

Improving PBA measurement and allocation methods

Guiding principles. Management is committed to improving PBA measurement and allocation methods. Enhancements will be guided by core policy and strategic considerations. Changes might also be needed to move forward on harmonization.

Measuring needs. Country need is approximated by country population size and per capita income. But for given per capita income and population, countries where income distribution is more uneven will have more poor people. The severity of poverty is also likely to be greater the more unequally income is distributed. At this time, Management is considering the use of more direct poverty measures but appreciates that this may not be possible because of gaps in data and doubts about their consistency and quality. Options for incorporating

indicators of non-income poverty in the formula will also be presented to the Executive Board for consideration.

Performance measures. The World Bank has convened an expert panel on country performance measurement. Consideration of the panel's conclusions will precede Management recommendations on revisions intended to streamline and enhance CPAs. The panel's recommendations on disclosure will also be studied closely.

Triggers. Executive Board members have expressed concerns over the coherence and consistency of country-specific performance triggers. Also, within a fixed pool of resources, high or low lending scenarios in large countries can cause substantial revisions in baseline allocations for other countries. This complicates the link between performance and eventual allocations. Although options for strengthening triggers will be considered, Management believes that scarce staff resources might be better expended in strengthening the country planning process and progressing with results-based CSPs.

Rewarding performance. To complement efforts to improve the measurement of needs, Management will consider how performance can exert increased leverage on allocations. One approach would be to reward improved performance, as captured by the CPA, directly in the formula. Among other advantages, this would strengthen incentives, particularly for countries starting from a low base. To ensure that a sharper focus on poor, small countries does not blunt ADF's efficiency, Management proposes to increase the weight given to the country performance score in the allocation formula.

The collar. The collar places an upper and lower bound on allocations centered on their historical average. Allocations can be no less than 75% and no more than 125% of the (three-years) historical average allocation. If formula allocations fall outside this band, allocations are set at the nearest boundary. Donors have expressed the view that a protracted adjustment to formula allocations undermines the intent and integrity of the policy. In the context, of other proposed changes, Management supports removal of the collar by the end of ADF VIII.

I. INTRODUCTION

1. **Scope.** The discussion paper on Performance-Based Allocation (PBA) presented to representatives in Tokyo¹ concludes that despite good progress, some parts of the policy are not yet firmly established. Links to country strategies and operations are still evolving; the transition from historical to policy allocations is not yet complete; and, as yet, country-specific performance triggers have had little impact on allocations. Drawing on the earlier technical analysis and feedback from donor and borrower representatives, this paper contains preliminary recommendations for enhancing ADB's PBA system. Decisions on policy issues will follow discussion and formal review by the Executive Board. It is anticipated that a revised policy should be in place by ADF IX. Decisions on implementation matters that do not require formal revision of the policy will proceed on a faster track.

2. **Structure.** In Section II, the impact of the PBA on lending outcomes is considered from the perspective of ADB's strategic interests. Section III then explains proposed changes to the scope of the policy. Section IV identifies measures for strengthening implementation. Section V canvasses possible improvements in measurement and allocation systems. A brief concluding section summarizes proposed changes and sets out next steps. A technical analysis of allocations under alternative PBA methods is given in a separate note, as is a description of PBA allocations in Bangladesh over the period 2002–2004.

II. COUNTRY ALLOCATIONS

3. **Performance and population.** Contingent on needs, the PBA policy directs resources to good performers. Over the period 2002–2004, better performance has been rewarded with an increased share of ADF resources.² But the influence of the population component of needs has been decisive. The PBA formula earmarks substantially more ADF resources for more populous countries than they attracted historically. As the transition to formula allocations unwinds, larger countries will attract an even larger share of ADF. But the policy does not foreshadow this shift. Indeed, it justifies the application of a “small country bias” as a measure to protect against the possibility that “large allocations to big countries crowd-out small countries.”³ The policy also proposes that in circumstances where performance is uniform across countries, historical allocations should be broadly maintained.⁴ Regardless, the shares of most small countries in ADF are shrinking despite better than average performance.

4. **Charter provisions.** The Charter requires that ADB give “special regard to the needs of the smaller or less developed member countries in the region.” Although size does not pre-ordain outcomes, special attention to small countries might be justified on several grounds. Often small countries face more severe structural disadvantages, which limits their opportunities. They are more susceptible to shocks. Also, human and institutional constraints

¹ *Performance-Based Allocation at ADB: Strengthening the Policy and its Implementation*. Paper for Discussion, Asian Development Bank, November 2003. This paper was presented to representatives at their meeting in Tokyo, in December 2003.

² Monetary allocations have, however, fallen in some cases where performance improved. This is a result of a decline in the overall resources available for country programs.

³ *Policy on Performance-Based Allocation for Asian Development Fund Resources*, March 2001, Asian Development Bank, Manila, paragraph 36, p10.

⁴ *Op cit*, paragraph 40, p11.

are usually more acute in smaller countries. Most Group A countries, which include the poorest ADF borrowers, are small in size.

5. **Renewed focus on small countries.** To promote better alignment of the PBA with the broader strategic interests of ADB, Management supports modifications to the allocation system that will lead to a stronger focus on poor, small countries.⁵ Smaller countries do not have access to OCR and other resources that larger countries have, nor are they as favorably positioned to mobilize private sector resources for development. But, the weight of needs in larger countries ensures that they will continue to attract the largest share of ADF resources. To guard against the possibility that a strengthened focus on small countries undermines the efficiency of ADF allocation, the weight given to performance in the allocation formula will be increased. Options and specific recommendations will emerge from discussions with the Executive Board.

III. PROPOSED POLICY MODIFICATIONS

A. Realigning Countries

6. **Population distribution.** There are 24 ADF borrowing countries, with a combined population of close to 660 million. But this population is unevenly spread across countries. Ten countries have fewer than 0.5 million people, accounting for about 4% of the lending program. Among remaining countries, populations range in size from just under one million in Bhutan to 213 million in Indonesia.

7. **Country groupings.** Under current arrangements, a separate pool of resources is allocated to Pacific developing member countries (PDMCs). Per capita allocations of ADF resources to the PDMCs are, on average, over three times larger than for other countries. The size of the PDMC allocation is intended to account for the inherent vulnerability of the PDMCs. PNG, which is comparable in size to other Group A and B1 countries, benefits from special treatment. Management recommends that ADF IX incorporates these significant differences by (i) moving PNG to the larger Group A and B pool; and (ii) earmarking a pool of ADF IX resources for the remaining Pacific Island countries that would preserve their historical share in ADF. An attraction of this arrangement is that it would provide larger incremental rewards to PNG for improved performance and would not crowd-out allocations to smaller PDMCs. In this sense, the proposal increases the potential resources at the disposal of the Pacific. If PNG's performance deteriorated, it would lose resources, but allocations for smaller PDMCs would be protected.⁶

B. Increasing Flexibility

8. **PBA methods.** The PBA policy should be durable. The policy's objectives and the principles on which it rests should be capable of guiding allocations over the medium to long term. Under current arrangements, the formula and the formula weights; performance, needs and portfolio measurement criteria, and performance aggregation weights are all fixed by the policy. Modifications to measurement or allocation systems thus require Executive Board approval of a revised policy.

⁵ IDA caps allocations to larger countries, and both IDA and AfDF provide minimum guaranteed lending levels that favor small countries.

⁶ For small countries, with small programs, the management and regulation of the PBA entails heavy costs. Ways of reducing these costs deserve careful consideration. The inclusion of the Maldives and Bhutan in a "small country" grouping might merit consideration.

9. **Technical revisions.** IDA's experience underlines the importance of an evolutionary approach in which PBA methods respond to experience, improved knowledge, and shifts in the development paradigm. Management thus proposes that the policy be reformulated to allow periodic technical enhancements, without requiring formal revisions to the policy. Greater flexibility would also serve donors' interest in greater harmonization of PBA systems among MDB's. Technical proposals would be presented to the Development Effectiveness Committee for consideration and reported to the Executive Board in information papers. The Executive Board would retain the prerogative to request Management for formal recommendations.

C. Closing Strategic Gaps

10. **Strategic gaps.** The policy provides allocations to meet "exceptional circumstances." Exceptional circumstances include but are not limited to post-conflict countries; countries facing catastrophes and countries undertaking far-reaching reforms. Over the period 2002–2004, exceptional allocations absorbed between 2% (2002) and 13% (2003) of ADF commitments. The bulk of these allocations have been to support peace and post-conflict reconstruction needs, particularly in Afghanistan and Sri-Lanka.

11. **Post conflict allocations.** In determining lending allocations, post-conflict needs' assessments have been weighed against competing demands on ADF resources. The scope of the *Policy on Disaster and Emergency Assistance*,⁷ in preparation, covers conflict related assistance. This new policy will require the use of the *IDA 13 Framework for Conflict and Natural Disasters*. ADF allocations will also require a "Transitional Support Strategy" and an annual assessment of performance using IDA's "Post-Conflict Progress Indicators". Assistance will normally be for three years and for a maximum of five. ADF allocations to support post-conflict and emergency needs will be financed outside of the PBA.

12. **Sub-regional and regional cooperation.** Over the period 2002–2004, about 5% of ADF resources have been committed to support sub-regional and regional cooperation activities. ADF has helped reduce structural and institutional impediments to economic, physical and institutional integration, and supported growth in poor areas. In helping bring countries closer together, support for regional and sub-regional cooperation helps promote the stability needed for long-term growth and poverty reduction. Although the reasons for continuing ADF support for regional and sub-regional cooperation are compelling, the PBA policy does not expressly provide for such, nor does it specify eligibility or allocation criteria. Management proposes an allocation for regional and sub-regional cooperation of 5% of ADF resources over the period of ADF IX. In guiding allocations, key considerations will include whether proposed projects are part of an approved Regional Cooperation Strategy and Program (RCSPs); are consistent with country poverty reduction strategies; deliver substantial trans-boundary benefits; and there is demonstrated ownership of the project by participating countries. Performance as assessed within the framework of RCSPs will also be important. Specific criteria will be developed for Executive Board consideration as part of the revised policy.

13. **Weakly performing countries.** The PBA scales down ADF allocations for weak performers. But the policy does not explicitly address circumstances in which countries cannot support normal operations. A separate report to representatives outlines ADB's proposed approach to "weakly performing countries". The approach stresses the importance of continuing

⁷ *Policy on Disaster and Emergency Lending*, W-Paper, Asian Development Bank, Manila, October 2003. An R-paper is scheduled for presentation to the Executive Board in the second quarter of 2004.

engagement and strong partnerships. Management recommends that ADF allocations to assist weakly performing countries be decided outside the PBA. In cases where weak performance is a consequence of weak management, allocations may be reduced.

D. Broadening disclosure

14. **Disclosure policy.** Although there is a presumption in favor of public disclosure under ADB's *Policy on Confidentiality and Disclosure of Information*⁸, information that could be considered prejudicial to borrowers' interests may be classified as confidential. A review of the *Disclosure Policy* is under way.

15. **PBA disclosure.** To date, ADB has disclosed information only on aggregate performance quintile rankings in each year to the Executive Board. ADB practices on disclosure lag those of other MDBs. For example, the European Bank for Reconstruction and Development already publicly discloses all numerical scores. Management recognizes that donors favor greater public disclosure of information about borrower performance, including numerical performance scores. But disclosure is a sensitive issue for borrowers.

16. **Roadmap for broadened disclosure.** In principle, greater disclosure of performance scores can contribute to improved national ownership of the PBA policy, more informed policy debate, and strengthen the compact between ADB and the borrower. Disclosure is also important for accountability and sustaining public support for ADB. For these reasons, Management believes that broadened disclosure is needed. In full consultation with the Executive Board, Management will prepare a roadmap for disclosure. Specific proposals will be presented to the Executive Board as part of the revised PBA policy and following the report of the expert panel on IDA's Country Policy and Institutional Assessments (see paragraph 34 below). Action on panel recommendations that led to a more robust CPA scoring process would strengthen the case for public disclosure.

17. **First steps.** To move ADF practices broadly in to line with those of IDA, Management recommends that the following steps to greater disclosure are taken in 2004: disclosure of country ratings' scores at an aggregate and cluster level to each borrower, with benchmark average scores for all borrowers; (ii) on a confidential basis only, disclosure of aggregate and cluster scores to Executive Board members on completion of country programming missions; (iii) annual preparation and public disclosure of a report on the PBA modeled on the IDA format.

E. Triggers and Changes in Country Performance

18. **Incentives.** Country-specific performance criteria are agreed with borrowers annually. On the basis of these criteria, triggers are set that may lead to higher or lower lending levels. These criteria are intended to complement assessments on common country criteria through the CPA. Box 1 summarizes the impact of triggers.

19. **Issues.** Executive Board members have expressed a variety of concerns about triggers. Although these have tended to be country specific, they suggest more general doubts about the logic of triggers and consistency in their application. Triggers appear to represent a rather coarse form of program lending. Trigger conditions do not always seem commensurate with the relatively small resources at stake. From an administrative perspective, the cost of specifying and assessing triggers (for borrowers and ADB) has been disproportionate to the resources

⁸ *Policy on Confidentiality and Disclosure of Information*, Asian Development Bank, September 1994.

they have influenced. Last, as there is a fixed pool of ADF resources, and trigger assessments have increased demands, they have been financed through reductions of agreed baseline allocations for countries assessed as meeting base conditions. This has added to the difficulties of communicating PBA outcomes to borrowers.

Box 1: Country Specific Performance Criteria

Three rounds of assessments on the basis of country specific performance criteria have been conducted. In 2002, three countries qualified for the high lending scenario and were allocated a 20% increase over base case commitments. In 2003, six countries were considered to have partly met the conditions for the high lending scenario and were allocated 10% more. Two countries were adjudged not to have met base case conditions and had their lending reduced by 10%. For 2004, one country has been assessed as meeting the conditions for the high lending scenario and its lending commitment has been increased by 20%. Four countries have been assessed as partly meeting the high case criteria and have been given 10% more. Two countries were assessed as not fully meeting baseline criteria and had their allocations reduced by 10%. But, in aggregate terms, triggers based on country-specific performance criteria have redirected only about 3% of total ADF resources.

20. **Options.** There are technical solutions to some of the difficulties posed by trigger assessments. For example, performance scores on common and country specific performance criteria could be combined. This would allow allocations in one rather than two steps. Guidelines and quality control on the country-specific performance criteria could also be strengthened. An advantage of using (strengthened) country specific criteria is that they can be used to enhance the focus on ADB's development agenda in a country. However, given the mixed experience of triggers and the small amount of resources they have influenced, Management believes that scarce staff resources would be better expended in strengthening the country planning process and moving ahead with results-based CSPs. Options remain open and a final recommendation on triggers will follow consultations with the Executive Board and other stakeholders. If triggers are abandoned, other ways of providing incentives for improved performance could be considered (see paragraph 37 below).

IV. STRENGTHENING IMPLEMENTATION ARRANGEMENTS

A. PBA Focal Point

21. **Implementation responsibilities.** Under current arrangements, responsibility for PBA implementation rests with the five operational, regional departments. Regional departments rate countries on common and country specific performance criteria and recommend lending allocations, through Operational Vice Presidents, to Management. The role of non-operational departments is essentially advisory. They provide technical inputs to country performance rating process and provide an opinion on whether implementation conforms to the policy. These arrangements fragment responsibility and accountability for the policy. Also, they do not provide adequate separation between operational and resource allocation functions. Although country allocations are largely guided by the consistent application of rules, operational departments still exercise discretion over defining "set-asides".

22. **PBA focal point.** To clarify accountabilities and strengthen implementation, Management recommends that a PBA focal point be established outside operations' departments. The focal point would assume responsibility for recommendations to Management

on all ADF resource allocation matters. Operations departments would continue to conduct country performance assessments. The terms of reference of the focal point, its institutional location, staffing and lines of reporting will be decided after discussions with the Executive Board. Draft terms of reference are summarized in Box 2. Regional departments would continue to implement country performance assessments and be accountable for ratings. Membership of the PBA Working Group would be expanded to include sector and thematic experts from non-operational departments.

Box 2: Draft Terms of Reference for PBA Focal Point

- (a) Responsibility for recommendations to Management on all ADF resource allocation matters.
- (b) Tracking and monitoring of ADF resource use.
- (c) Monitoring implementation of the PBA policy and providing advice to Management on compliance.
- (d) Preparation of annual reports on PBA outcomes.
- (e) Conduct of periodic technical reviews of PBA allocation and measurement systems and recommend needed changes to Management.
- (f) Inter-agency coordination of all PBA related matters.
- (g) Providing support to the ADF IX mid-term review on PBA matters, as required.

B. Biennial Allocation Cycle

23. **Fixed period allocations.** The policy provides for a “three-years” rolling allocation system. In practice, allocations have been determined on a fixed annual cycle with commitments being aligned to approvals within each period. Recourse to rollovers of unutilized commitments has occurred only on an exceptional basis. Approvals that have exceeded commitments have been few and have been for small amounts. For PDMCs, however, there has been much greater flexibility in the application of the policy. In the PDMCs, matching commitments with loan approvals on a yearly basis has been impracticable because in some years there are no projects.

24. **Flexibility.** Experience suggests the need for greater operational flexibility. Shoehorning projects and programs to fit with commitments in each year poses risks to project quality and program coherence. The system should also provide enough flexibility to accommodate essential projects that happen to be large compared with annual allocations.

25. **Biennial allocation cycle.** Management recognizes that uncertainty about the ADF commitment authority must place constraints on flexibility. Thus, for non-PDMCs (other than PNG) Management recommends a move to a biennial PBA allocation cycle, commencing in 2005. Approvals would be constrained by commitments within each biennial period. In each year, limits might also be placed on how much of the biennial allocation can be used. In small countries where there are infrequent loan projects, approvals should be constrained by commitments within the replenishment period.

26. **Rolling allocations.** An alternative to a biennial cycle would be to retain an annual cycle, but allow some carryover and front-loading of commitments across periods. For example, rollovers and front loading of commitments up to some ceiling might be permitted in each year, with rollbacks in the following year ensuring that approvals are matched to allocations within each rolling two years interval. In the last year of the replenishment, commitments and

approvals, net of rollbacks, would be constrained by the expected commitment authority, and no conditional approvals would be permitted.

C. CPA Cycle

27. **Annual cycle.** Management favors retention of an annual CPA cycle for larger countries. Even if allocations are to be made on a biennial basis, annual CPAs will remain important for the annual country planning exercises, for monitoring, and dialogue. To allow country-programming missions to proceed unimpeded in the first quarter of the year, the CPA will be brought forward and completed by the end of the third quarter of the preceding year. Experience in earlier years suggests that delays in completing CPAs have hindered clear communications with borrowers about planned allocations. For small PDMCs, and possibly for other small countries, Management recommends a shift to a biennial CPA cycle.

28. **Trigger assessments.** If trigger assessments are to be retained (see paragraphs 19 and 20, above), and proposals to move to a biennial allocation cycle find acceptance, triggers should then be set and assessed biennially at the time of country programming. The current practice of assessing triggers during country confirmation missions means that lending programs are not resolved until the first quarter of the year in question. Country confirmation missions could discuss programs with greater conviction if trigger assessments were completed beforehand. Triggers would be set over a 2 years rather than eighteen months horizon.

V. REFINEMENT OF PBA METHODS

A. Background

29. **Issues.** The discussion paper presented to representatives in Tokyo,⁹ observes that there is no single, best PBA system. Alternative formulations entail trade-offs among different policy objectives and might reasonably embody different views about how best to measure needs and performance.

30. **Inter-agency review.** ADB Management is committed to strengthening PBA measurement and allocation methods. Management notes representatives' proposals that an inter-agency evaluation of PBA methods be conducted. An accompanying technical note illustrates the counterfactual impacts on ADF commitments for 2004 of African Development Fund (AfDF), IDA, and the Inter American Bank's Fund for Special Operations' performance measurement weights, and allocation rules. Management will study the conclusions of an inter-agency review and, on this basis, consider needed technical revisions. Meanwhile, there are several areas that representatives have suggested warrant closer attention.

B. Measurement of Needs

31. **Components of measured needs.** Following IDA's approach, "needs" are approximated by a geometric weighted average of population and per capita gross national income. But for given per capita income and population, countries where income distribution is

⁹ *Performance-Based Allocation at ADB: Strengthening the Policy and its Implementation, Paper for Discussion*, Asian Development Bank, November 2003. This paper was discussed with donor and borrower representatives in Tokyo, Japan on 8th December 2003.

more uneven will have more poor people. The severity of poverty is also likely to be greater the more unequally income is distributed.

32. **Poverty based measures of need.** In principle, direct measures of poverty would provide better indicators of country needs. One possible approach would be to replace the current population variable with a direct measure of numbers of poor.¹⁰ But internationally comparable data on numbers of poor are incomplete. The *World Bank Development Indicators* is missing poverty information for Cambodia and PNG, and for the small PDMCs. Data for other countries are only available infrequently.¹¹ There are also conceptual difficulties in comparing deprivation across countries and poverty data generated from household surveys are often thought unreliable. IDA has recently concluded that the poverty data available in most IDA countries do not provide the accuracy and cross-country comparability provided by population and gross national income figures.¹² Use of headcount data based on national poverty lines would provide better country coverage. But these data are problematic because poverty lines differ across countries.

33. **Non-income poverty.** Another drawback of the present approach to the measurement of needs is that it does not capture non-income dimensions of poverty. It is known that income and non-income measures of poverty can diverge. A useful perspective on important dimensions of human deprivation is, for example, given by the United Nation's human development index (HDI) (UNDP, 2003).¹³ Management will consider how the measurement of needs can be improved and augmented to better capture non-income dimensions of poverty.

C. Measurement of Performance

34. **Measuring performance.** The World Bank has convened an expert panel on country performance measurement. The terms of reference of the expert panel are broad and cover methods of performance scoring, associated processes, and disclosure. It is expected that the panel's preliminary conclusions will be known around mid-March. Consideration of the panel's conclusions will precede Management recommendations on revisions intended to streamline and enhance CPAs. Panel recommendations will also influence Management's views on how best to broaden disclosure.

D. Formula Weights

35. **Population.** So that PBA allocations better capture ADB's strategic interest in small countries, Management supports a reduced weight for the population variable in the PBA formula. This would increase per capita allocations for small countries but the weight of needs in large countries would still ensure they attract the largest share of ADF resources. Management will present options to the Executive Board.¹⁴

¹⁰ For comparable poverty lines, indicators of the depth of poverty might measure the severity of poverty.

¹¹ Independent estimates of poverty incidence based on PPP data also exist. These estimates do not always concur with those of *World Bank Development Indicators* and so would lead to a different distribution of ADF resources. One difficulty with independent estimates of PPP poverty incidence is that these data are not regularly maintained or updated.

¹² *IDA's Performance-Based Allocation System: Current and Emerging Issues*, IDA, Washington DC, October 2003.

¹³ *Human Development Report 2003*, UNDP, New York. HDI data would not be available for all countries in a small country grouping.

¹⁴ In IDA and AfDF the provision of minimum guaranteed allocations or capping allocations to larger countries favors small countries.

36. **Performance.** To guard against the possibility that a stronger emphasis on small countries dilutes the efficiency of allocation, Management supports an increase in the weight given to performance in the allocation formula. The current weight used by IDA and AfDF¹⁵ is a useful benchmark. Again, Management will present options to the Executive Board during the course of the review.

E. Changes in Performance

37. **Changes in Performance.** One way of encouraging improved performance would be to allow changes in performance on common country criteria to influence allocations. Improved performance could increase a country's allocation and a deterioration in performance could reduce it. This approach has several attractions. Most immediately, it would increase the leverage of performance on resource allocation. Incentive effects would be strongest for countries starting from a lower base. Moreover, the use of a change in performance variable would add a "results" dimension to the PBA. Unlike triggers, the approach would be almost costless to implement. Management supports further examination of the impact of a change in performance variable in a modified formula and will present options to the Executive Board. Box 3 illustrates the way in which such a proposal might work.

Box 4: Changes in Performance

A simple way to capture changes in performance would be to introduce a multiplicative term expressed as the ratio of the current country performance score to the same score a year earlier. Allocation shares would then be determined as follows:

$$A_i = \frac{\left(\frac{PER_{i,t}}{PER_{i,t-1}} \right)^I \cdot PER_i^{1.8} \cdot POP_i^{0.75} \cdot PCI_i^{-0.125}}{\sum_j \left(\frac{PER_{j,t}}{PER_{j,t-1}} \right)^I \cdot PER_j^{1.8} \cdot POP_j^{0.75} \cdot PCI_j^{-0.125}}$$

where A is the allocation share, PER is the country performance score, POP is country population size, and PCI is per capita gross national income. Subscripts i and j denote countries, and subscript t denotes time. To avoid the possibility of year-to-year gyrations in allocations caused by changes in measured performance, changes in performance might be measured by changes in the underlying trend of performance. I is the exponential weight given to the change in performance variable.

Simulations with this formula suggest that the impact of the exponential weight on allocations depends on whether average performance scores are stable through time, or drift up or down. For the modest improvement observed in ADB's average performance scores, an exponential weight of about 3 generates a 20% increased allocation for a median country whose performance score improves by 10% over the year, and would reduce allocations by just over 20% for a country whose performance score deteriorates by 5%. But, precise impacts depend on the share of ADF resources a country attracts. For a given improvement (deterioration) in performance, countries attracting a large share of ADF resources have their allocations increased (reduced) by a proportionately smaller amount (about $\pm 15\%$).

¹⁵ Both IDA and AfDF use a weight of 2. The ADF formula currently uses a weight of 1.8. Annex B of the PBA discussion paper presented in Tokyo explains the significance of these weights.

F. Formula Adjustments

38. **The collar.** Except where there are “exceptional circumstances”, country allocations are determined either by the PBA formula or by the “collar”. The collar places an upper and lower bound on allocations relative to their historical average. Actual allocations can be no less than 75% and no more than 125% of the (three-years) historical average. If formula allocations fall outside this band, actual allocations are set at the appropriate boundary. Otherwise, formula allocations apply.

39. **The collar’s impact.** The collar clearly attenuates the influence of the formula on allocations, but not necessarily the influence of performance. Actually, the main impact of the collar has been to moderate the influence of the population component of needs on allocations. In the transition to formula allocations, the collar has raised allocations for less populous countries and constrained allocations for more populous countries. Since most of these smaller countries happen to have better performance than the larger countries, the collar has (unintentionally) favored some of the better performers.

40. **The collar’s future.** At one level, it might be argued that abrupt changes in lending programs are costly (irrespective of allocation criteria) and that measures that buffer them are useful. The policy advocates this view. But while recognizing some merit in graduated adjustment, donors have suggested that a protracted adjustment would undermine the intent and integrity of the policy. In the context of the review, Management will recommend abandoning collar adjustments at the end of ADF VIII.

VI. SUMMARY AND NEXT STEPS

41. **Summary.** Table 1 summarizes the various recommendations of this paper. The table shows a timeframe for action and identifies if revisions to the policy will be needed to move forward. Issues requiring further examination and broader consultations are also identified. It is anticipated that the Executive Board will consider Management recommendations for a revised policy around the 3rd quarter of 2004. These changes would mostly take effect at the beginning of ADF IX, starting 2005. In developing a report for the Executive Board, prior consultations will take place with the Executive Board, and other stakeholders.

Table 1: Summary Proposals

Strategic focus	Recommendations	Policy Changes Required	Timeframe	Remarks
1. Small Country bias	Strengthened focus on small countries through increased per capita allocations. By weight of needs, large countries would still attract largest share of ADF resources.	Yes, as formula or other modifications required.	2005	Without mid-course correction, large countries will attract increasing share of ADF resources.
2. Country groupings	Reassignment of PNG to Group A and B. Possible creation of a separate resource pool for countries with fewer than 0.5 million persons.	Yes.	2005	Need to clarify basis for pool allocations
Scope of policy				
3. Technical revisions	Modify policy to provide the flexibility for periodic revisions to measurement systems or formula and formula weights	Yes, as all are set by policy.	2005	Oversight of proposed amendments provided by review by Development Effectiveness Committee.
4. Post conflict	Adoption of IDA 13 framework.	No.	Starting 2004	
5. Regional and sub-regional cooperation	The policy should provide a set-aside and specify eligibility and allocation criteria.	Yes. Not covered by policy as yet.	2005	
6. Weak performers	Integrate ADB's approach in revised PBA	Yes	2005	
7. Triggers	Possibly discontinue.	Yes	2006	If triggers set during country programming in 2004 they would have to be assessed.
Implementation				
8. PBA implementation	Set up a focal point responsible for resource allocation.	No	2004	Institutional arrangements to be worked out.
9. Allocation cycle	Move to biennial cycle to permit greater operational flexibility.	No	2005	Alternative would be to move to a two-years rolling cycle.
10. CPA cycle	Advance CPA's so that they are completed before end of 3 rd quarter.	No.	2004	
11. Disclosure	Prepare roadmap for broadened disclosure. Harmonization with current IDA practices	No	2004	
PBA Methods				
12. Needs measurement	Consider alternative measures of need. Meanwhile retain population and GNI variables.	No		Use of direct poverty indicators are possibly impractical at this time.
	Look at use of HDI to capture non-income dimensions of poverty.	Yes	2005	
13. Performance measurement	Await conclusions of WB expert panel.	Changes would require policy changes	2005	
14. Formula weights	Reduce population weight but increase performance weight.	Yes	2005	Changes in structure of formula, if needed, should await outcome of inter-agency review of PBA methods.
15. Structure of formula	Consider use of a change in performance variable.	Yes	2005	If triggers are retained, this proposal might not proceed.
16. Collar	Abandon collar adjustments.	No	end of ADF VIII	