

**ASIAN DEVELOPMENT FUND (ADF)  
ADF IX DONORS' MEETING  
Seoul, 11-12 May 2004**

**INCREASING THE WEIGHT OF GOVERNANCE  
IN THE REVISED PBA SYSTEM**

**Asian Development Bank  
5 May 2004**

## ABBREVIATIONS

|      |   |  |
|------|---|--|
| ADB  | — | Asian Development Bank                       |
| ADF  | — | Asian Development Fund                       |
| AfDF | — | African Development Fund                     |
| CPIA | — | country policy and institutional assessments |
| CPA  | — | country policy assessments                   |
| IDA  | — | International Development Association        |
| PBA  | — | performance-based allocation                 |

## EXECUTIVE SUMMARY

Donors have expressed a strong interest in increasing the weight of governance in ADB's performance based allocation (PBA) system and in closer alignment of ADF with IDA and the African Development Fund (AfDF). This note affirms Management's commitment to increase substantially the weight of governance and to bring about closer alignment in the way that governance criteria influence country performance scores and allocations.

Two options are presented. The first option is to defer a decision on the treatment of governance in the revised PBA until such time that IDA 14 Deputies have had the opportunity to discuss World Bank Management proposals emerging from the conclusions of the World Bank's expert panel on country policy and institutional assessments (CPIA). Although this would guarantee close institutional alignment, it would delay ADB's PBA review and the determination of revised PBA allocations for the biennial period 2005-2006. For logistical and operational reasons, revisions to the measurement and treatment of governance might not be possible until 2006.

The second option is to move forward now with proposals to strengthen the weight given to governance criteria in country performance scores without waiting for a full resolution of issues in IDA 14. Nevertheless, the proposal described in the note attempts to anticipate future directions, by addressing questions that Deputies have raised in IDA 14 and in ADF IX. The modified performance scoring system described here would succeed in placing governance at the center of the ADF allocation process, achieve a much stronger performance-allocation nexus, and align outcomes in ADF more closely with those in the current IDA (and AfDF) system. The proposed system is transparent and may lead to increased public understanding of the rating and allocation system. Needed adjustments could take place at the time of the ADF IX midterm review.

Management requests ADF representatives' guidance on these options, but, on balance, favors the second option. Under either option, ADB would continue to coordinate closely with IDA and the African Development Fund on governance and other matters during the PBA policy review.

## **A. Donors' Views in the ADF IX Negotiations**

1. Donors in Lisbon observed that when compared to IDA there is less of a focus on governance in ADB's PBA system. Donors recommended that the revised PBA policy provide for a larger weight for governance. Donors urged also that there be greater alignment between the treatment of governance in ADB's PBA and in IDA, and that the PBA remain transparent and easy to understand. This paper briefly presents two options on how these objectives might be achieved. Annex A describes the current treatment of governance criteria in ADF, the African Development Fund (AfDF) and in IDA.

## **B. Option 1**

2. In the early part of 2004, the World Bank convened an expert panel to review its approach to country policy and institutional assessments (CPIAs). The expert panel has forwarded its views to World Bank Management and World Bank Management is currently considering the panel's findings. It seems unlikely that IDA Deputies will consider any proposed changes to IDA's PBA, including those affecting the treatment of governance criteria, until the IDA 14 replenishment meeting scheduled for October 2004.

3. Evidently, closest alignment of ADB and IDA systems would be achieved by waiting to see what decisions are made in IDA 14 about the measurement and treatment of governance. But deferring a decision until the fourth quarter of 2004 would present operational difficulties for ADB. There would not be enough lead-time for needed changes to guide allocations at the start of ADF IX. In such circumstances, adjustments to the biennial allocations (2005-2006) would be needed and could not take effect until 2006. Since the implied adjustments could be substantial for some countries this approach could prove operationally disruptive.

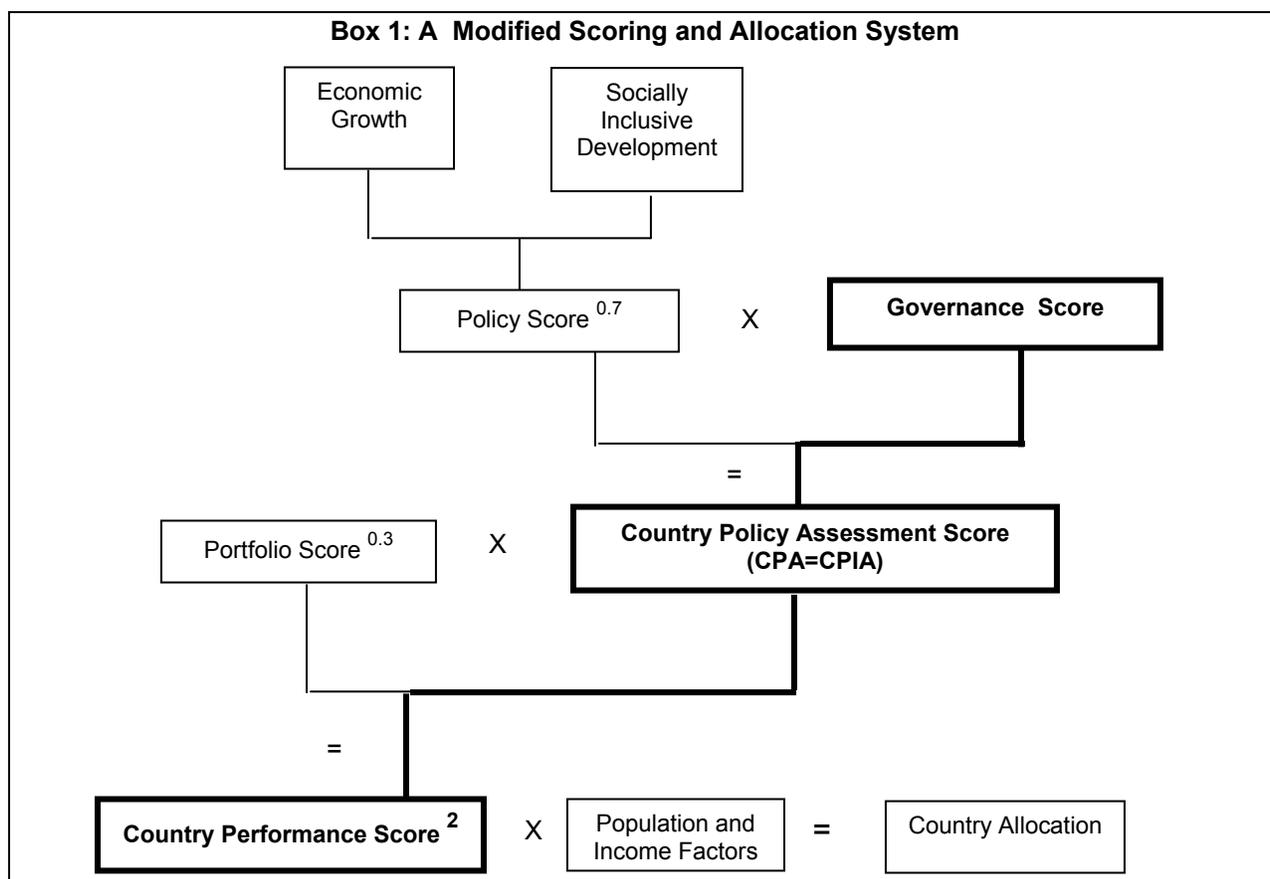
## **C. Option 2**

4. A second option is to modify the system ahead of decisions in IDA 14 to reflect the interests that have been expressed by ADF IX representatives and to address questions that have already been raised in IDA 14. The midterm review of ADF IX would present an opportunity to revisit the issues.

5. A modified scoring system that seeks to: (i) place governance at the center of ADB's PBA system; and (ii) strengthen the performance-allocation link is set out in Box 1. The modified system avoids double counting governance scores. This simplified country performance scoring system provides for a transparent role for governance.

6. In the modified scoring scheme of Box 1 primacy is given to governance through the selection of "aggregation" weights. Policy, governance and portfolio components of country performance are combined geometrically to generate a country performance score in a manner similar to the interplay of IDA's governance factor with IDA's policy and institutional and portfolio scores (see Annex A). With the proposed weights, a 1% increase in a score on a governance

criterion would result in a 1% increase in a country's performance score.<sup>1</sup> A 1% increase in other CPA (CPIA) criteria would increase the country performance score by 0.7% and a 1% increase in the portfolio score would increase the country performance score by 0.3%.



7. The simulated impact of the modified allocation system on country allocations is summarized in Table 1. For ease of comparison, the criteria used follow those presented in Table 2, p4 of IDA (2004).<sup>2</sup> The modified system is compared with the earlier ADF system (a governance weight of 30% and no governance factor), and the results reported by IDA for non-linear (1.5) and linear (1) governance factors. All calculations are based on the increased weight of 2.0 for the country performance score, as agreed in Lisbon. Simulations have been conducted using the country performance assessment for 2004.

8. The results of Table 1 confirm that governance exerts substantially greater leverage on ADF resource allocations in the modified allocation system than under current arrangements. The effective weight<sup>3</sup> of governance is 53%, compared to 30% in the current system. The “impact ratio” (line 4) also shows a strengthened governance link, comparable to IDA. The

<sup>1</sup> This modified scoring system is very similar to the application of a linear governance factor. However, double counting in IDA augments the governance impact by a value that is equal to 0.24 (the nominal governance weight) times the ratio of the governance to the country scores. This is equal to a difference of about 6.6%, which is very close to the difference (60%-53%) reported in Table 1 below.

<sup>2</sup> IDA's *Performance Based Allocation System: Update on Outstanding Issues*, February 2004, IDA, Washington D.C., Table 2, p4

<sup>3</sup> The “effective” weight measures the impact that a change in the governance score has on the total country score, measured relative to the impact of changes in other elements of the country performance scores.

impact of a unit reduction in a governance criterion score on allocations is substantially larger than in the present system (line 5), but it is less dramatic than with a non-linear governance factor. The modified system also substantially stretches the gap between allocations for the best and worst performers. Using 2004 performance data, and holding other factors equal, the best performer would receive a per capita allocation 10.6 times as large as that of the worst performer, compared to just 2.8 times in the current system.

9. In summary, this proposal would place governance at the center of ADF country performance scores, and achieves much closer alignment with IDA outcomes. Compared to the application of a non-linear governance factor, the modified system provides more continuity in the relationship between governance scores and allocations. Double counting of governance scores is avoided. Although there is no perfect system, these features are likely to contribute to an increased public understanding of the rating and allocation system.

**Table 1: The Impact of Option 2**

|   | Existing System | Modified PBA System | IDA with non-linear governance factor = 1.5 | IDA with linear governance factor = 1 |
|---|-----------------|---------------------|---|---------------------------------------|
| Double Counting of Governance                                 | n.a.            | No                  | Yes   | Yes                                   |
| Nominal Weight of each Governance Criterion in CPA/CPIA       | 6%              | 10%                 | 5%  | 5%                                    |
| “Effective” Weight of Governance (footnote 4)                 | 30%             | 53%                 | 68%   | 60%                                   |
| Governance to non-Governance Impact Ratio <sup>4</sup>        | 1.5             | 4.0                 | 6.2   | 4.5                                   |
| Allocation reduction from a one point reduction in governance | 4%              | 10% <sup>5</sup>    | 13.8%                                       | 10%                                   |

#### **D. Conclusions and Request for Guidance**

10. Option 1 has the advantage of ensuring close alignment with proposals that may emerge from IDA 14. The drawback of this option is that for reasons of timing and logistics it would likely delay the impact of revisions on allocations in ADF IX. Option 2 attempts to respond to donor concerns and seeks to address other questions that have been raised in IDA 14 discussions. Suggested modifications to the scoring system would give a much stronger role for governance in the country-scoring framework and provides for a strengthened performance-allocation link.

11. Donors are requested to provide guidance to the ADF Secretariat on the options in planning further work on the review of ADF’s PBA policy. To ensure expeditious progress with the review, Management, on balance, favors Option 2 but will remain fully engaged with IDA and the African Development Fund on governance and other PBA related issues.

<sup>4</sup> This is defined as the ratio of the impact on country scores of a 1point drop in a governance score (e.g. 3.5 to 2.5) compared to a 1point drop in a score on economic and social policy criteria.

<sup>5</sup> This is an average impact. Actual impacts vary by country and the distribution of policy, governance and portfolio scores. The maximum impact for any country is over 13% and the smallest impact close to 8%.

## Annex A: Governance Weights and the Governance Factor

1. ADB's assessment of a country's policy and institutional performance is based on 19 criteria that are weighted and aggregated to provide an average score. A separate assessment of portfolio performance conducted on a "projects at risk" basis is then combined with the policy and institutional performance score (with weights of 15% and 85%) to measure country performance. The nominal weight of governance in ADB's scoring system defined using the criteria in the Governance and Public Sector Management performance cluster is 30%.<sup>6</sup>

2. In IDA and in the African Development Fund, country performance is assessed on slightly different criteria with different nominal weights applied in aggregation.<sup>7</sup> An important feature of the IDA and AfDF assessment of performance is the use of a "governance factor". The governance factor operates in the multiplicative way shown in the Box A1.

|  |
|--|
| <p><b>Box A1:      Operation of the Governance Factor<sup>8</sup></b></p> $\begin{aligned} &\text{Country Performance Rating} \\ &= \\ &\text{Governance Factor} \\ &\quad \times \\ &(\text{Country Policy and Institutional Assessment (80\%)} + \text{Portfolio Performance Rating (20\%)}) \end{aligned}$ <p>where:</p> $\begin{aligned} &\text{Governance Factor} \\ &= \\ &(\text{Governance Score} \div 3.5)^w \end{aligned}$ <p>and where <math>w = 1.5</math> in IDA and <math>1.0</math> in AfDF. IDA uses a non-linear governance factor, while AfDF uses a linear governance factor. Implicitly, ADB's current PBA system has no governance factor (<math>w = 0</math>).</p> |
|--|

3. The governance factor is intended to amplify governance criteria in determining country performance and in this way to provide incentives for improved governance. Application of a governance factor reduces the country performance score and thus allocations for countries with weak governance and increases the performance score and allocations for countries with strong governance. The governance factor increases the effective weight of governance in the allocation system. Once the impact of the governance factor is taken into account, IDA report that the effective weight of governance in IDA is about 68%, compared to a nominal weight of 24%.<sup>9</sup> The application of a governance factor will also generally increase progressivity in allocations, measured as the ratio of what strong and weak performers receive.

<sup>6</sup> These criteria are: Rule of Law; Anticorruption and Accountability Institutions; Civil Service; Revenue Mobilization and Budget Management; Management and Efficiency of Public Expenditure. The review of PBA will consider in more detail the appropriate definition of "governance".

<sup>7</sup> See, Tables D1 and D2, pp60-61 Performance Based Allocation at ADB: Strengthening the Policy and its Implementation, November 2003). The nominal weight of governance in IDA is reported to be 24%. In the African Fund it is 21%.

<sup>8</sup> The weights in parenthesis are IDA weights. AfDF weights are 70% and 30%, respectively.

<sup>9</sup> As noted earlier, the "effective" weight measures the impact that a change in the governance score has on the total country score, measured relative to the impact of changes in other performance scores.

4. In comparing the current ADB approach with that taken in IDA, two points emerge. First, despite its larger nominal weight (30% v 24%), the effective weight given to governance criteria in ADB's PBA system is considerably lower than in IDA (30% v 68%). Second, as shown in the note on "*A Comparison of Performance Based Allocation Methods*" (Lisbon Meeting, March 2004) a governance factor generates a substantially stronger link between country performance and allocations under IDA than in ADF.<sup>10</sup> But in reviewing its allocation system, IDA has observed that, given the particularities of its approach, the use of a governance factor: (i) involves double counting governance scores (ii) generates sharp shifts in allocations for modest changes in governance scores and (iii) is not transparent.<sup>11</sup>

---

<sup>10</sup> Technically the reason for this is that the application of a governance factor in the IDA multiplicative way stretches the domain of the performance scores, giving performance more leverage on allocations.

<sup>11</sup> *IDA's Performance-Based Allocation System: Update on Outstanding Issues*, IDA, February 2004. IDA Deputies have underlined the need for a simple system in which the role of governance is transparent.