ADF-11 Resource Allocation

Discussion Paper

ADF-11 Replenishment: Third Consultation
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Executive Summary

The PBA framework has been used since 1999 to allocate the bulk of ADF resources to eligible countries. Over the last three ADF cycles the share of resources allocated through the PBA framework has been broadly constant at around 80-85%. The share of total ADF resources allocated to the best performing quintile increased from 33% under ADF-8 to 40% under ADF-10. This demonstrates the effectiveness of the allocation mechanism in directing more resources to stronger performers.

The introduction of the DSF and MDRI adjustments has resulted in a partial de-linkage of actual allocations from performance indicators at the country level. Of the 18 completion-point RMCs that had qualified for the MDRI by end-June 2007, 16 saw their ADF allocation decrease due to the MDRI netting-out effect. In contrast, the seven pre-decision point and five non-HIPC beneficiaries had higher net allocations because no MDRI relief was deducted but they benefited from the reallocation of debt relief among all countries.

ADF-11 resources will ultimately be allocated across competing demands and in support of the strategic directions and funding priorities identified during this consultation. Management's core commitment remains that the bulk of newly available ADF resources will be allocated on the basis of performance as captured by the agreed PBA framework.

Assuming a 60% increase in the agreed level of resources under ADF-11[1], as well as Deputies' agreement to Management's proposals with respect to financing for Fragile States and Regional Operations, prospective allocation of ADF-11 resources will be as follows:

- Sixty eight percent (68%) of resources would be allocated directly through the PBA system for country programs compared to 80% under ADF-10, but with an expansion of PBA-linked allocations.
- Twenty two percent (22%) would be allocated for two key continent wide initiatives: a special set-aside for enhanced engagement in fragile states, and an increased earmark for regional operations. Both proposals provide a link to the PBA formula.
- Ten percent (10%) would not be PBA-derived; these resources would finance selected investments in regional public goods (RPGs), targeted support for fragile states not eligible for supplemental funding under the FSF proposal, and arrears clearance programs as detailed below.

During the course of the ADF-10 replenishment period, Bank staff and the MDBs PBA technical group have examined a variety of issues related to both the design and the application of the PBA formula. Management is proposing several adjustments to increase predictability and simplify the formula for greater transparency. These adjustments draw on proposals emerging from the PBA technical group discussions, but also address ADF-specific issues.

Increasing Predictability

- Changes in the timing of the allocation and DSF classification cycles to align with the ADF operational calendar year thereby eliminating mid-year changes to allocations;
- The use of single country-specific data points for population and income over the entire ADF-11 period to smooth year-over-year changes from these factors;
- Revision of the portfolio review factor (CPPR) by measuring projects at risk based on problem projects only, thereby excluding potential problem projects from the measurement to reduce volatility;

Simplification and Streamlining:

- Revision of the CPIA to include only the first three clusters of the current CPIA under ADF-10 to eliminate double counting of governance;
- Revision of the Governance Factor (GF) by eliminating the procurement element; and
- Elimination of the Post-Conflict Enhancement Factor upon approval of the proposed Fragile States Framework.

[1] For further details see Scenario 3 of "ADF-11 Financing Framework 2" ADF-11 Replenishment Third Consultation Meeting, September 2007, Bamako.

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ADF-11 RESOURCE ALLOCATION

1. Introduction

1.1 This paper presents a proposed framework for the allocation of ADF funds during the ADF-11 period. It briefly reviews experience to date under the Performance-Based-Allocation (PBA) system and sets out the prospective allocation of ADF-11 resources for different purposes. It also discusses specific issues regarding the application of the PBA system, and identifies a number of options to modify the system to improve its performance in the light of experience.

2. Country Eligibility

2.1 Eligibility for ADF resources is determined according to: (i) creditworthiness as determined by agreed World Bank criteria,[2] country needs as measured by population and Gross National Income per capita below a threshold[3], and country performance.

2.2 There are currently 38 ADF-only eligible borrowers and two blend countries (see Annex 1). Operations in ADF-only countries may also be financed by: (i) the private sector window of the Bank; and (ii) non-concessional resources for enclave projects, provided such private sector and enclave projects meet the relevant eligibility criteria. Several countries that are currently not active borrowers due to sanctions are expected to re-engage during the course of ADF-11, subject to clearance of their arrears with the Bank Group.

3. ADF-10 PBA Framework and Results

PBA System and Enhancements

3.1 The PBA framework has been used since 1999 to allocate the bulk of ADF resources to eligible countries. Over the last three ADF cycles the share of resources allocated through the PBA framework has been broadly constant at around 80-85%. During ADF-8 and 9, roughly 65% of resources were allocated directly through the PBA system. An additional 19% of resources were set aside for policy based loans (PBLs) and to “top up” resources for performing countries.[4] In addition, specific pools of resources were set aside from the PBA framework for the purpose of financing multinational operations. Under the ADF-10 agreement Deputies agreed to fold the PBL allotment into the standard PBA system, and to raise the proportion of resources earmarked for regional operations to 15%. As a result, the share of resources directly allocated through the PBA system increased to 80%. (See also Annex 2.).[5]

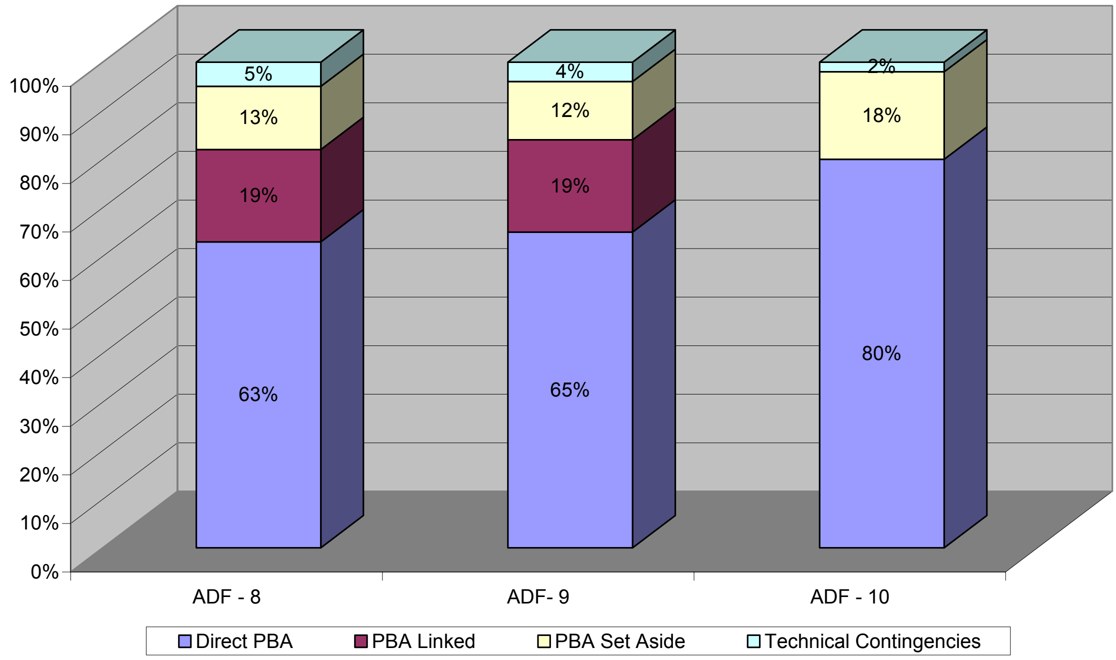
[2] See Resolution concerning the amended Bank Group Credit Policy, ref.: ADB/BD/WP/95/79, dated 8 May 1995.

[3] The operational cut-off (threshold) is GNI per capita of US$ 1,025 for IDA/ADF eligibility under the ADF-10 cycle. See World Bank, Operational Manual, OP.3.10, Annex D, archived January 2007. The thresholds and historical ceilings for IDA/ADF eligibility are revised regularly by IDA.

[4] Under this framework, an additional allocation of 50% of the standard PBA allocation was made available to high performing countries to finance PBLs.

[5] See ADF-10 Country Allocations for 2005, ref.: ADF/BD/WP/2005/116, dated 28 June 2005, paragraph 24 and footnote 10.

Figure 1: Share of PBA Resources from ADF-8 to ADF-10



3.2 The PBA system places country needs and performance at the center of the allocation process. (See Annex 3.) Country needs and absorptive capacity are assessed yearly on the basis of GNI per capita and population. Country performance is assessed each year according to the following criteria:

- the Country Policy and Institutional Assessment (CPIA), which tracks the performance of the country's policy and institutional framework to promote growth and reduce poverty;
- the Country Portfolio Performance Rating (CPPR), which assesses a country's portfolio implementation performance based on the percentage of projects at risk; and
- a Governance Factor (GF) made up of five criteria from the CPIA governance cluster and one procurement element from the CPPR.

3.3 ADF resources are then allocated on the basis of an agreed formula using these country performance assessments (CPA),[6] population, and GNI per capita indicators. As detailed in Annex 3, country performance is a primary driver of the formula. For example, if a country doubles its performance score, its allocation will quadruple. Ceteris paribus, an increase in the population factor results in a proportionate increase in allocation, while an increase in GNI per capita results in a lower allocation.

3.4 Under the ADF-10 agreement, and in line with similar arrangements agreed under the IDA-14 framework, five specific changes were introduced[7]:

- *Simplification of the CPIA*: The number of specific criteria included in the CPIA was reduced from 20 to 16. Criteria were grouped into 4 equally weighted clusters: (i) economic management; (ii) structural policies; (iii) policies for social inclusion and equity; and, (iv) public sector management. (See Annex 4.)
- *Integration of the IMF/World Bank Debt Sustainability Framework (DSF)*: The DSF employs an agreed analytical framework to assess a country's risk of debt distress. This assessment is used to determine whether a country is eligible for grants, loans or a 50/50 combination of loans and grants. It was also agreed that grant allocations would be

[6] Currently, the CPA also includes a factor to provide additional resources for designated post-conflict countries.
[7] For further details, see: Enhanced Performance-based Allocation Framework under ADF-10: ref.: ADF/BD/WP/2005/93/Rev.1, dated 05 July 2006, sections 3.1 - 3.8.

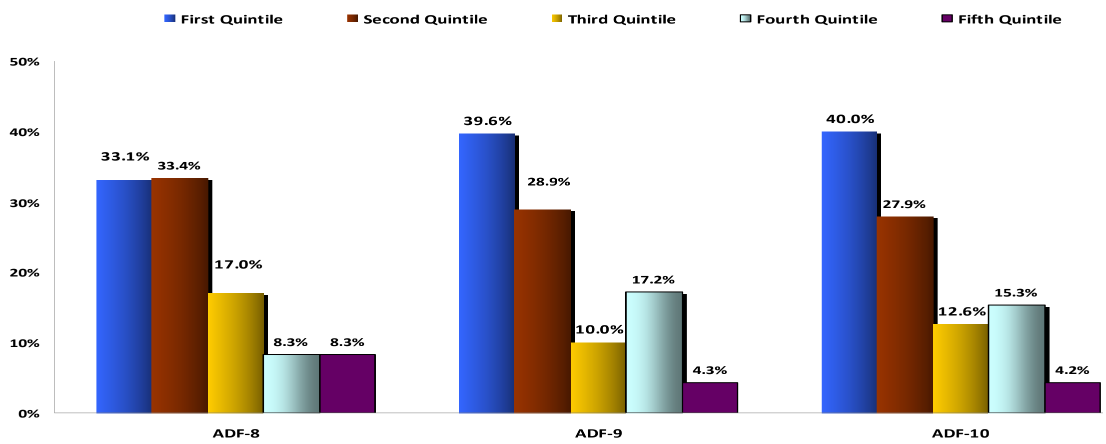
subject to a 20% upfront volume discount[8]. A portion of the discount (12%) is used to compensate the ADF for forgone loan repayments, and the remainder (8%) is reallocated across all ADF-only countries according to the PBA.

- *Netting-out of debt relief under the Multilateral Debt Relief Initiative (MDRI):* For MDRI recipient countries, the "netting-out" mechanism deducts the amount of forgone ADF debt service. Donor resources provided to ADF for foregone reflows are then reallocated to all ADF-only countries on the basis of the PBA system.
- *Operational flexibility within the ADF-10 period*: Some flexibility in the use of annual PBA-derived resources within the three-year ADF replenishment period is used to facilitate country planning and operations. Specifically, the possibility of front- or back-loading was introduced, under which a country may use more or less than its pro-rata annual PBA allocation in a given year. For example, first year ADF commitments may reach up to 50% of the total allocation amount for the three-year period.
- *Public disclosure of Ratings*: To enhance transparency CPIA and CPAs have been publicly disclosed on the Bank's website since 2005.

Allocation Results

3.5 As illustrated in Figure 2 below[9] top performers have gotten an increasingly bigger share of successive ADF replenishments. The share of total ADF resources allocated to the best performing quintile increased from 33% under ADF-8 to 40% under ADF-10. This demonstrates the effectiveness of the allocation mechanism in directing more resources to stronger performers.

Figure 2: Resource Allocation by Performance: ADF-8 to ADF-10

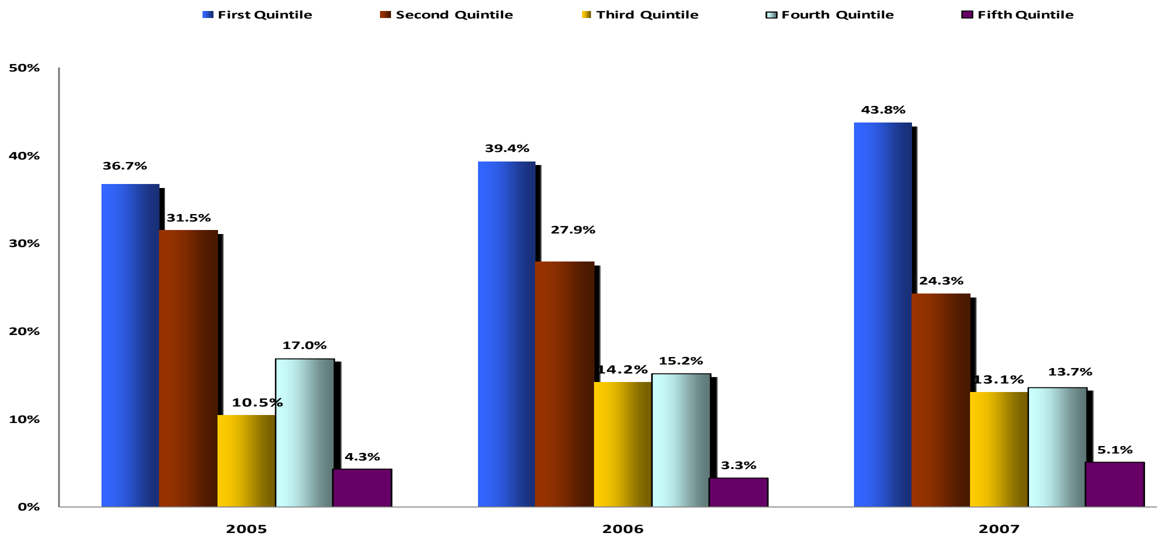


3.6 Figures 3 and 4 below show the continuation of this trend on an annual basis during the ADF-10 period; for example in 2007, the top quintile received 44% compared to 37% in 2005.

[8] The 20% discount is intended to address moral hazard concerns associated with providing soft terms to some of the poor performing countries and to transfer more resources to grant-eligible countries in present value terms.

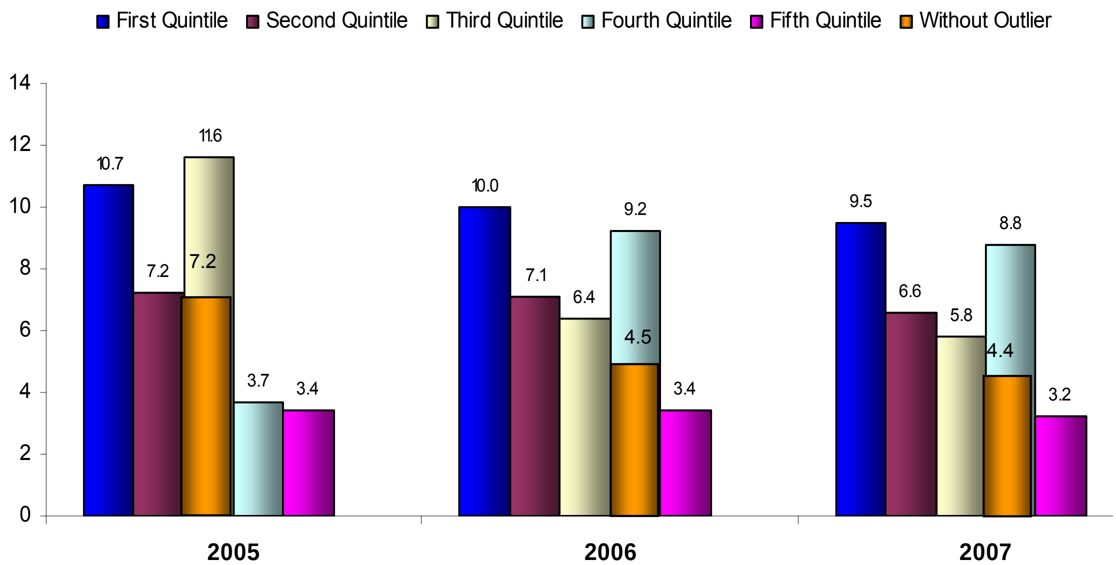
[9] The graphs show basic allocations under the ADF cycles, without adjustments for DSF and MDRI impacts under ADF-10.

Figure 3: ADF-10 Allocations by Performance



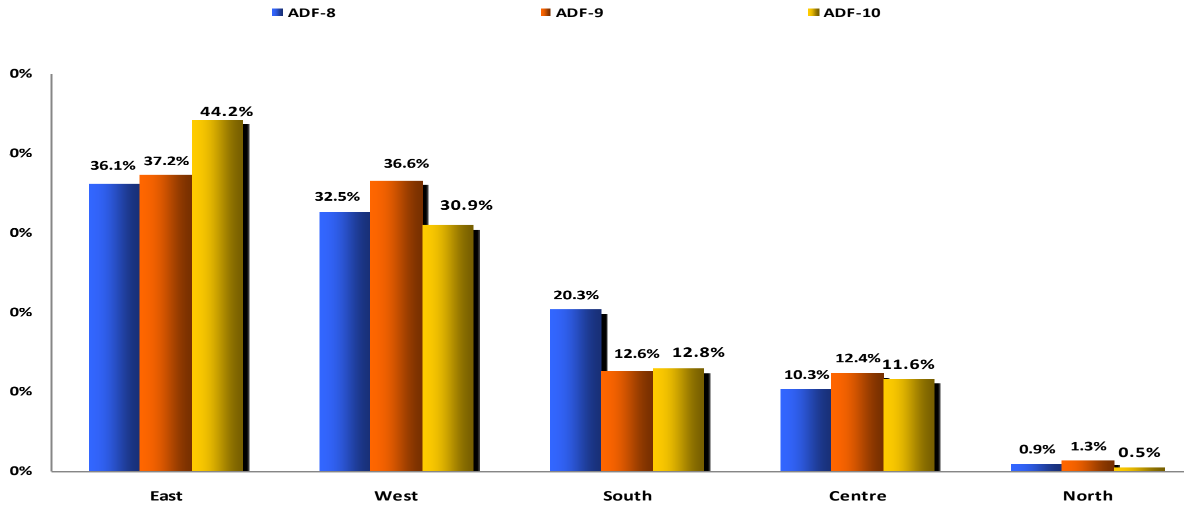
3.7 Figure 4 presents corresponding averages for per capita allocations by quintile, generally showing higher per capita allocations for higher quintiles and lower per capita allocations for the lowest quintiles. Because these data are for average per capita allocations, they can be vulnerable to the effect of outliers, as can be seen below. In particular, the relatively high (and non-trend)_per capita allocations for the third quintile in 2005 and the fourth quintiles in 2006 and 2007 reflect the inclusion of Sao Tome & Principe in each of these aggregates. If Sao Tome and Principe is taken out, the third quintile average for 2005 would be 7.16 and the fourth quintile average would be 4.52 and 4.35 in 2006 and 2007, respectively. Primarily as a result of the minimum ADF allocation, per capita allocations for this sparsely populated country have run at a level of four times the average of others in the same quintile, thereby pulling up the arithmetic average.

Figure 4: ADF-10 Average per Capita Allocations (UA) by Performance



3.8 Figure 5 below shows a broadly consistent distribution of ADF resources by geographical region over the past three ADF. The East and West sub-regions have been the largest beneficiaries receiving a growing portion of total resources. Combined the East and West regions were allocated 67% of total resources in ADF-8 increasing to 75% in ADF-10.

Figure 5: Geographical Allocation Resources: ADF-8 to ADF-10



3.9 The introduction of the DSF and MDRI adjustments has resulted in a partial de-linkage of actual allocations from performance indicators at the country level. When the DSF analysis points to an increased risk of debt distress, a country may receive a greater percentage of its allocation in the form of grants. Because grants are subject to a 20% upfront volume reduction, this leads to fewer total resources, albeit on better terms. (See Box 1.)

Box 1: Impact of DSF on selected country allocations

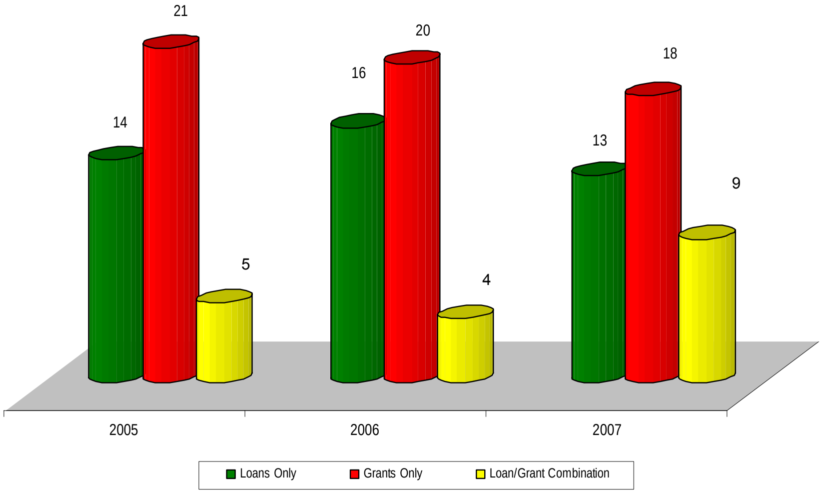
In 2006, both **Zambia** and **Niger** improved their overall performance score (CPA*) by 22% relative to 2005. However, Zambia's final allocation increased by 37% while Niger's allocation increased by only 6%. The main reason: Zambia's DSF classification changed from loan/grant combination to loan only, while Niger's DSF classification changed from loan only to grant only. Accordingly, no discount was applied to Zambia's allocation, but Niger's allocation was reduced by the 20% discount applicable to grants.

In 2007, **Burkina Faso** achieved a 2% increase in its CPA* over 2006, but its final allocation decreased by 27%. Again, the main reason was its DSF classification change from loan only to loan/grant combination, subjecting 50% of its allocation to 20% discount. Similarly, **Benin's** overall performance improved by 16% in 2007, but its final allocation fell by 6%. In this case as well, the main reason was the country's DSF classification, which changed from loan only to loan/grant combination, with the 20% discount applied to 50% of its allocation.

3.10 Based on the DSF country rankings carried out in connection with annual PBA exercises, the overall share of grants decreased from 44.5% in 2004, to 34.29% in 2005, and down to 28.4% in the recently completed 2007 DSF risk assessment.[10] The overall share of grants is determined endogenously, and the decrease in overall grant share has resulted from more countries having reduced their vulnerability to debt distress. The DSF classification over the ADF-10 period is shown in Figure 6 below.

[10] The 44.5% grant share for ADF-10 was the estimate presented at the final ADF-9 replenishment consultations in December 2004, while the share of grant in 2005 to 2007 was determined as part of the PBA exercise.

Figure 6: DSF Classification for Allocations



3.11 In certain cases, the introduction of the MDRI has also affected the link between performance and allocation. First, the "netting-out" mechanism directly deducts debt relief payments from the country allocation. Second, the debt relief is compensated by donors and reallocated to all ADF-only countries regardless of their MDRI eligibility. Of the 18 completion-point RMCs that had qualified for the MDRI by end-June 2007, 16 saw their ADF allocation decrease due to the MDRI netting-out effect. In contrast, the seven pre-decision point and five non-HIPC beneficiaries had higher net allocations because no MDRI relief was deducted but they benefited from the reallocation of debt relief among all countries.

Box 2: Impact of MDRI on selected country allocations

In 2007, Tanzania, an MDRI recipient, and Kenya, a non-MDRI recipient both improved their performance by over 23% compared to 2006. Tanzania's final allocation increased by 2% whereas Kenya's increased by 17%. A key difference in the size of the allocation increase arose from the MDRI impact on both countries.

For Tanzania, MDRI recipient country:

Step 1: MDRI debt relief to ADF is deducted from the PBA allocation:
Tanzania's allocation (UA 298.8 m) – MDRI debt relief (UA 5.5 m) = Net ADF (UA 293.3m)

Step 2: Reallocation of all MDRI debt relief to ADF-only countries based on PBA:
Net ADF allocation (UA 293.3 m) + Reallocated MDRI relief (UA 7.0 m) = **UA 300.3 m**

For Kenya, non-MDRI recipient country:

Step 1: As a non-recipient, no MDRI debt relief is deducted from the PBA allocation:
Kenya's allocation (UA 240.5 m) – MDRI debt relief (UA 0.0 m) = Net ADF (UA 240.5 m)

Step 2: Reallocation of all MDRI debt relief to ADF-only countries based on PBA:
Kenya's allocation (UA 240.5 m) + Reallocated MDRI relief (UA 6.3 m) = **UA 246.8 m**

4. Proposed ADF-11 Resource Allocation Framework

PBA- related Allocation and Set-asides

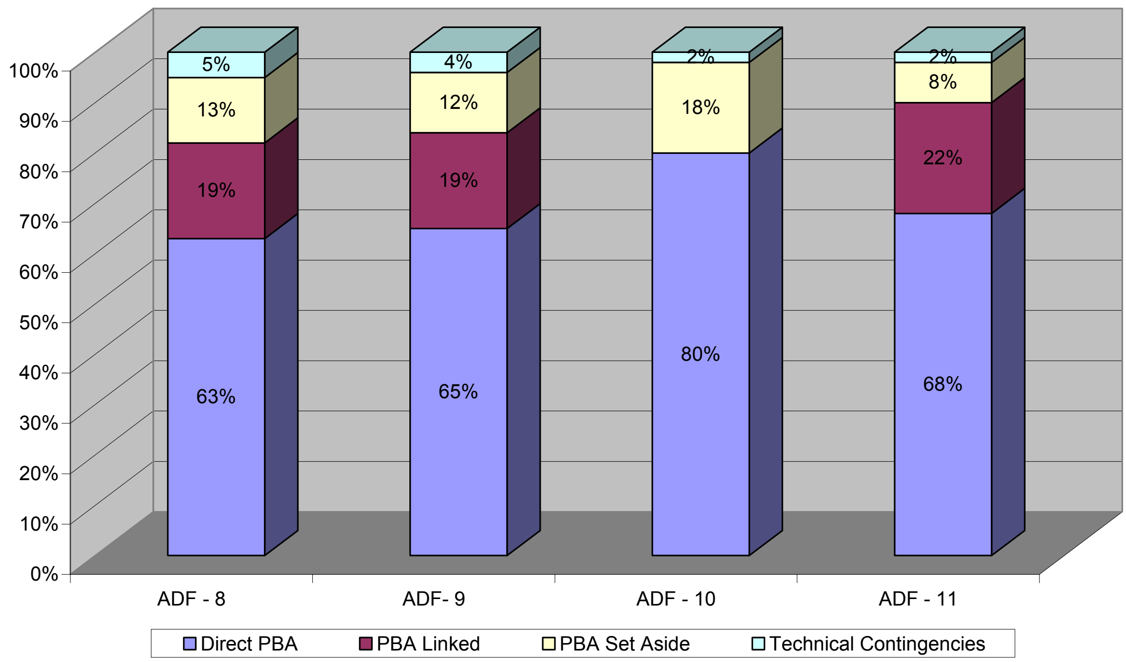
4.1 ADF-11 resources will ultimately be allocated across competing demands and in support of the strategic directions and funding priorities identified during this consultation.

Management's core commitment remains that the bulk of newly available ADF resources will be allocated on the basis of performance as captured by the agreed PBA framework.

4.2 Figures 7 and 8 below assume, for illustrative purposes, a 60% increase in the agreed level of resources under ADF-11[11], as well as Deputies' agreement to Management's proposals with respect to financing for Fragile States and Regional Operations. Key implications of these assumptions include the following.

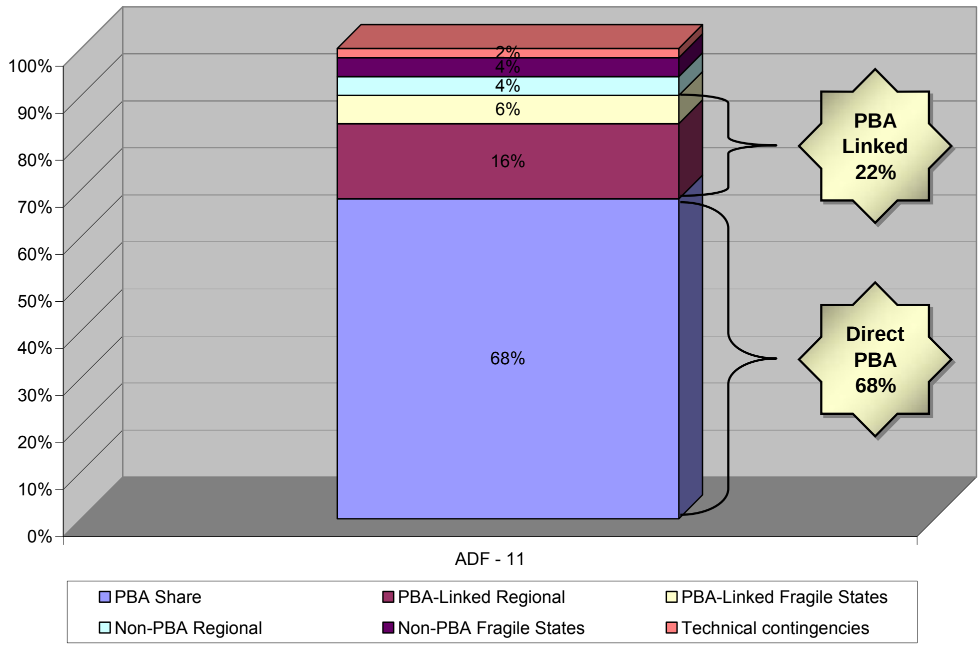
- Sixty eight percent (68%) of resources would be allocated directly through the PBA system for country programs compared to 80% under ADF-10, but with an expansion of PBA-linked allocations.
- Twenty two percent (22%) would be allocated for two key continent wide initiatives: a special set-aside for enhanced engagement in fragile states, and an increased earmark for regional operations. Both proposals provide a link to the PBA formula.
- Ten percent (10%) would not be PBA-derived; these resources would finance selected investments in regional public goods (RPGs), targeted support for fragile states not eligible for supplemental funding under the FSF proposal, and arrears clearance programs as detailed below. Board approval would be required prior to allocating these resources, providing an opportunity for additional oversight.

Figure 7: Allocation of ADF Resources from ADF-8 to ADF-11



[11] For further details see Scenario 3 of "ADF-11 Financing Framework 2" ADF-11 Replenishment Third Consultation Meeting, September 2007, Bamako

Figure 8: Proposed Allocation of ADF-11 Resources



4.3 ***Enhanced Engagement in Fragile States.*** Fragile states committed to transitioning from fragility to more stable political and economic development require resources beyond what is available under the PBA system. Deputies have given broad support to the idea of providing additional ADF funds on top of regular PBA allocations for fragile states, and Management's proposed Fragile States Facility[12] reflects this view.

- Supplementary allocations to countries in post crisis and transition situations would be provided in addition to the calculated PBA resources under the normal ADF-11 allocation process. However, the amount of these supplementary allocations would be, for each country, determined by previously calculated PBA allocations under ADF-10. Thus supplementary FSF allocations would be linked to the PBA though not directly driven by it. The separate Fragile States paper provides details.
- Resources would also be set aside to: (i) finance arrears clearance programs of countries re-engaging with the Fund (Cote d'Ivoire, Liberia, Sudan, Comoros and Togo) estimated at UA 200 million in aggregate[13]; and (ii) provide highly targeted technical assistance and capacity building support, totaling UA 38 million, across the fuller spectrum of fragile states.

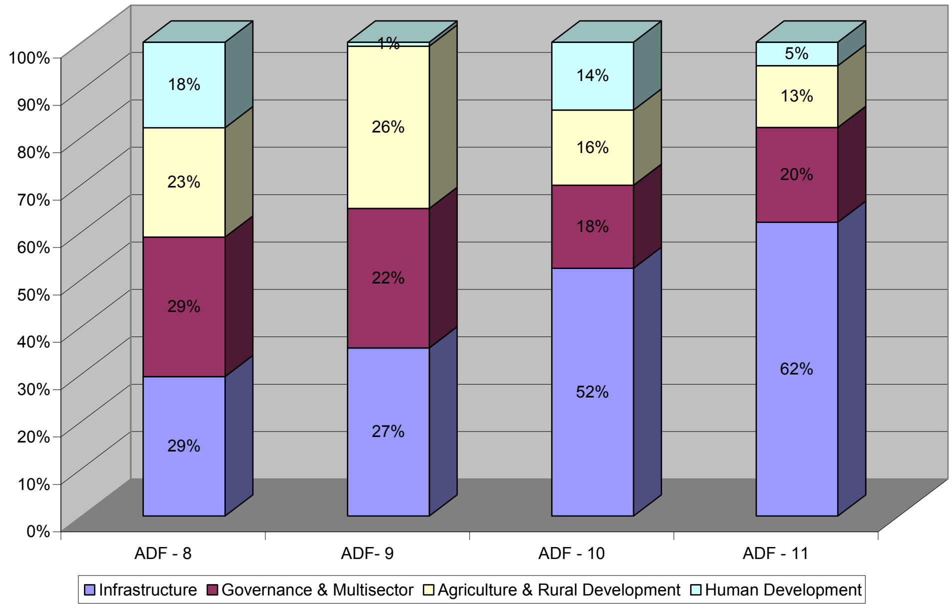
4.4 ***Increased Support for Regional Operations (ROs).*** With the Bank's clients increasingly recognizing the value of regional solutions to their development challenges, the demand for financing of ROs steadily increased resulting in a significant backlog of projects estimated at UA 1.1 billion at the close of ADF-10. Additional projects amounting to UA 1.3 billion have been identified, bringing the overall estimated amount of the current ROs pipeline to UA 2.4 billion. In order to better meet this demand, Management has proposed an increase in the RO share of the ADF-11 replenishment from 15% to 20%. To further leverage the Fund's resources, it is expected that the number of co-financed projects will increase from 47% to 76%. In addition, to provide a meaningful link between resource allocations to ROs and the performance and commitment of clients, countries will be required, subject to certain caps, to finance from their PBA allocation one third of the costs of regional operations attributable to them, whereas the other two thirds will come from the RO envelope. This PBA linked share of the RO envelope roughly represents 16% of the ADF-11 envelope, while the other 4% represents the share of the RO envelope used for financing RPGs, for which no contribution from client countries PBA allocations would be required.

[12] For further details see Board document: ADF/BD/WP/2007/74 "Enhancement Engagement in Fragile States"
[13] These programs would have been formerly eligible for financing from the PCCF)

Indicative Operational Focus

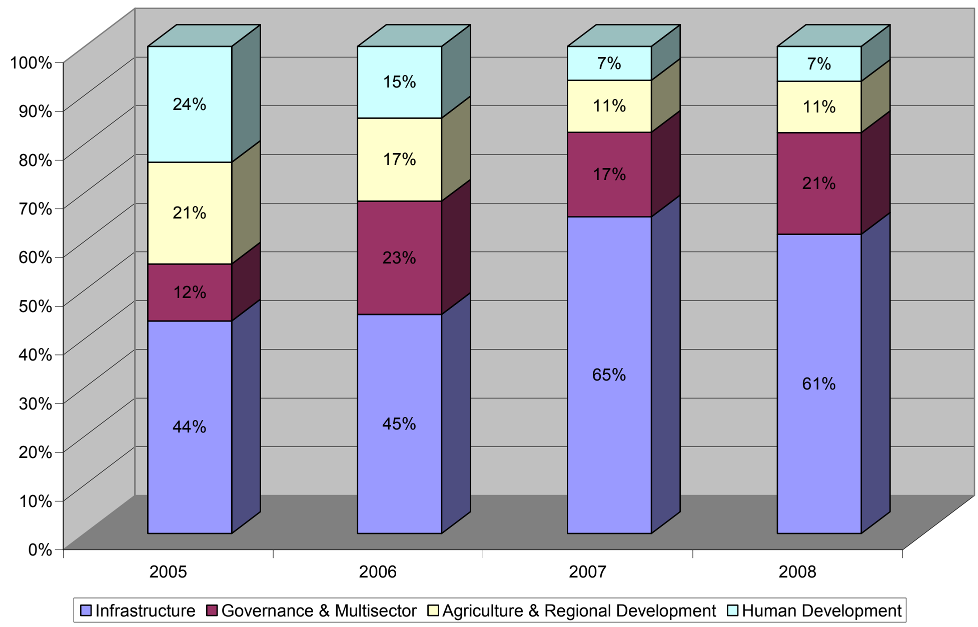
4.5 ADF-11 operations will build on and deepen the Bank's strategic orientations, reinforced delivery capacity and the sector expertise it has developed across replenishments. In order to focus on areas where the Fund can deliver the strongest results, it will be increasingly selective. Figure 9 below shows this sharper selectivity across replenishments with two main building blocks for the ADF-11 cycle: infrastructure and governance.

Figure 9: Sector Distribution from ADF-8 to ADF-11



4.6 The indicative operational program for 2008 shown below (Figure 10) illustrates very concretely the proposed ADF-11 sector orientations. In line with the 2007 operational program, a substantial proportion of 2008 resources will be devoted to infrastructure (62%) and governance (20%). The bulk of resources in infrastructure will finance both national and regional operations, in particular power supply (34%), transport (20%) and water and sanitation (7%). In governance the Bank will provide support to enhance transparency and accountability in the management of public resources at the country and regional level, primarily through PBLs and institutional strengthening projects.

Figure 10: Sector Distribution of Operations (2005-2008e)



5. PBA IMPLEMENTATION RELATED ISSUES

5.1 During the course of the ADF-10 replenishment period, Bank staff have identified and examined a variety of issues related to both the design and the application of the PBA formula. The MDBs PBA technical group has shared analysis and experience on a number of these issues and has identified possible technical adjustments within the existing PBA structure. For the most part, these issues are still under discussion at both the technical and the policy levels, including in the context of the ongoing IDA-15 replenishment consultations. They are therefore presented in summary form here for Deputies' consideration and guidance. This section reviews the current status of this work with respect to the ADF, highlighting issues and proposals to solve them as the case maybe.

Sequencing issues linked to availability of CPIA ratings and DSF classification

5.2 The ADF resource allocation process has been disadvantaged by sequencing problems resulting in a disconnect between its operations programming and processing work, on the one hand, and the identification and allocation of resources to support this work, on the other.

5.3 ***CPIA rating*****.** To date, the Bank's CPIA ratings process has been closely aligned with IDA. This has ensured a good overall degree of consistency and provided a valuable context for joint assessments, exchange of views and common understanding between both organizations. However, IDA's assessment follows the World Bank's fiscal year (July – June), which means that CPIA ratings are not available until the mid-point of the calendar year. ADF's process follows the Bank Group's calendar year. The result is that allocation figures are not known (to either operations staff or RMCs) until at the earliest halfway through the Bank Group's operational year.

5.4 ***DSF classification*****.** The sequencing problem has been reinforced by the agreed DSF country classification process. To date, the DSF classifications are prepared by IDA/IMF teams and are adopted directly by the ADF[14]. Such classifications for a given year are not available until May/June, which results in the Bank's operations teams only knowing with certainty the basic nature of ADF support (i.e., grant and/or loan and the associated impact on volumes due to the 20% volume discount on grants as explained above) until programming work is well advanced.

5.5 These sequencing issues have created considerable problems for the Fund and its clients. When revised CPIA and DSF data become available, often as late as September, there are frequently substantial changes to country allocations, both up and down. Where there are increases, this creates a rush to deploy resources before the end of the calendar year. Where there are decreases, it leads to wasted effort on projects for which resources are no longer available. It inhibits the Funds ability to work smoothly as part of multi-donor operations. Finally, it introduces considerable uncertainty for clients who must make complementary provisions in their own budgets.

5.6 In order to improve the predictability and timing of aid, Management proposes the following two adjustments to ensure that ADF's annual PBA process is carried out effectively on a calendar year cycle, with country allocations determined by end-January:

- Completion by the Fund of its CPIA exercise by December of the previous year, with final figures shared with operations departments and RMCs the following January. This means that the Fund would not wait until the IDA CPIA ratings are finalized. The Bank does not anticipate any significant problems due to this change, thanks to its active dialogue with IDA on country matters (including at the country office level), and the considerable consistency that these independent exercises have produced historically.
- Utilization of latest available DSF classifications (i.e., from the previous year) instead of waiting for the mid-year update. This does raise the risk of a temporary disconnect with IDA in cases of classification change. However, given that DSF classifications have not been very volatile (nearly 75% of ADF countries had constant DSF classifications

[14] A new agreement is under consideration in which ADF staff will participate in future joint IDA/IMF DSA missions, on a selective basis, for determining DSF country rankings on an annual basis.

throughout ADF-10), Management believes that the benefits of more effective programming from the proposed change clearly outweigh the possible inconveniences.

Swings in Income and Population Data

5.7 The impact of significant swings in GNI per capita and population data has been a matter of concern for both Bank Management and its RMCs. As experienced in 2006, large annual changes can occur in the standard GNI per capita data series[15] as a result of short-term factors such as swings in exchange rates and commodity price fluctuations, as well as revisions to baseline data series. In the short run, these factors can obfuscate the underlying poverty picture for which the GNI per capita is a proxy. Exceptional revisions have also been made to population data series, again during 2006, resulting in some very large one-time changes relative to previous published series.

5.8 To address these issues, Management proposes that the latest available GNI per capita and population data from agreed data sources be set at the beginning of the replenishment and held constant over the 3-year replenishment period.

Adjustment of CPA Components

5.9 ***Country Portfolio Performance Rating (CPPR).*** Substantial volatility in portfolio ratings has been a main source of volatility in country allocations during the ADF-10 period. Experience in ADF, IDA and AsDB, reveals that a high degree of the volatility in country performance ratings (CPPR) is driven mainly by the way the portfolio performance ratings are computed.[16]

5.10 To address this issue, the Bank will first continue to sharpen the quality and comprehensiveness of its portfolio supervision process. Building on the last year's experience, the 2007 CPPR ratings are based on supervision data generated for the entire portfolio qualifying for supervision in 2007. Field Offices are now fully involved in portfolio management and in improving the quality and consistency of supervision ratings. The creation of the Country Program Officer (CPO) position at Headquarters and in the field (for which recruitment has essentially been completed) will significantly increase the focus and scope of the supervision process.

5.11 Furthermore, two technical fixes to the calculation of portfolio performance ratings are proposed:

- Use of actual problem projects instead of actual plus potential problem projects (the inclusion of potential problem projects exacerbates volatility); and
- Use of average data on actual problem projects for the last four quarters (if this data exists) rather than a year-end snapshot.

5.12 In addition, for countries with very small number of projects, some MDBs have proposed using the average portfolio rating for all countries in the same region as a proxy to reduce extreme volatility. Management will examine further this option.

Double Counting of Governance

5.13 As indicated above, the adjusted country performance assessment score (CPA*) combines the CPIA, the CPPR, the GF and the PCEF. The CPIA includes four clusters of criteria or indicators, including governance indicators. (Cluster D, covering governance, includes the same indicators as the GF as well as a procurement indicator that is included in the CPPR.) These same indicators are also used in separate calculation of the GF. (In a similar fashion, procurement ratings are used in both in the CPPR and the GF). In effect, the CPA* double counts governance. (For more detail on the composition of the CPIA and the GF, see Annex 4.) This complicates the analysis of the impact of variations in the governance indicators on allocations and governance discussions between the Bank and RMCs.

[15] The standard GNI per capita series adopted by various agencies, including ADF, is issued by the World Bank's World Development Indicators data base.

[16] To calculate the CPPR in a country, all projects-at-risk are identified at the end of each calendar year. Projects at risk consist of *actual* problem projects as well as *potential* problem projects. The percentage of projects at risk in each country is corrected for age and is then converted into portfolio performance ratings using a conversion scale

5.14 In order to address this issue, the MDBs PBA technical group has proposed that the double counting of governance be eliminated by a revision of the components of the current CPIA and GF as follows:

- The CPIA would include only three clusters (economic management; structural policies; and, policies for social inclusion/equity); and
- The components of what is now CPIA Cluster D would become the GF, except for the procurement factor, which would be eliminated since it is already included in the CPPR;

5.15 The revised component parts of the CPIA (CPIArev) and GF (GFrev), incorporating these changes, are presented in Annex 5. The main benefit of eliminating the double counting of governance would be to reduce the annual volatility of the CPA*. This is illustrated in Box 3 below.

Box 3: Elimination of Double Counting of Governance

Over the ADF-10 period, with double counting of governance, and application of the old PBA formula **Kenya** and **Rwanda** experienced increases in overall performance assessment (CPA*) by 10.7% and 4.5% respectively, in 2006 over 2005. But if the double counting of governance had been eliminated, by applying the same old PBA formula, the variability would have been significantly reduced, as the revised performance assessment (CPA*rev) would have changed by only 0.5% and -0.6% respectively in 2006 over 2005.

Similarly, over the same ADF-10 period, **Mozambique's** overall performance assessment (CPA*), with double counting of governance, shows a systematic decrease of 3.0% in 2006 and 10.0% in 2007. On the other hand, if governance had not been counted twice, and the same old PBA formula had been applied, the variation would have been significantly reduced to a decrease of only 2.0% in 2006 and 6.0% in 2007.

Elimination of the PCEF

5.16 Starting with the ADF-9 agreement, Deputies agreed to revise the PBA formula to make available additional resources to support ADF operations in post-conflict countries. At present, a Post-Conflict Enhancement Factor (PCEF) is a stand-alone component of the CPA formula. However, experience to date shows only a limited net incremental effect of the PCEF on the nine beneficiary RMCs.[17] This was estimated at UA 68.5 million in 2006, and is equivalent to only about 2% of the total allocation for ADF-eligible countries. The proposed Fragile States Facility (FSF) under ADF-11 would, if approved, obviate the need for the PCEF. Management proposes that the PCEF be eliminated with the approval of the FSF.

Simplification of the PBA Formula

5.17 In addition to proposals to simplify the individual components of the PBA formula discussed above, the MDBs PBA technical group is currently reviewing proposals to simplify the structure of the PBA formula to ensure greater simplicity and clarity.

5.18 While the PBA formulas used by different institutions in the MDB system are substantially the same in their structure and components, there are nevertheless a number of differences in how individual components are weighted (through coefficients, in which case the formula is a linear one), or through exponents (in which case the formula is a geometric one). There are also some differences in the specific weights selected. Keeping weighs equal, a geometric formula results in an increased elasticity of outcomes for a given variation whereas a linear formula produces similar changes at all levels of performance.

5.19 The current ADF PBA formula for country (A_i) is linear, as shown below:

$$A_i = [(0.7*CPIA + 0.3*CPPR) * (GF) * PCEF]^{2.0} * P * (GNI/P)^{-0.125} \qquad (1)$$

- The performance component of this formula is linear in structure as its integral variables

[17] The 9 PCEF beneficiaries were: Angola, CAR, DRC, Congo Republic, Eritrea, Guinea Bissau, Liberia, Sierra Leone and Sudan.

(CPIA, CPPR and GF) each have a specified weighting coefficient; by agreement these are: 0.7 for the CPIA, 0.3 for the CPPR, and 1.0 for the Governance Factor (GF). The structure of IDA's formula is similar, but the coefficients are different. (See Annex 3B.)

5.20 By contrast, the Asian Development Fund employs a geometric approach, as given by its formula for a country (X_i) shown below:

$$X_i = [CPIArev^{0.7} * CPPR^{0.3} * GFrev]^{2.0} * P^{0.6} * (GNI/P)^{-0.25} \quad (2)$$

- In this case, the performance components are weighted through exponents, rather than coefficients, though their values are identical to those of the ADF formula.

5.21 The MDBs PBA technical group is currently reviewing both the linear and geometric simplified formulas for the overall performance rating (CPA*rev) and running simulations for different weighs. These issues are under discussion at both the technical and the policy levels. Proposals will be presented to Deputies upon completion of the review exercise.

5.22 The weight of the population factor in the PBA formula is also under discussion at the technical level. ADF and IDA use a weight of 1.0 for the population factor, which may advantage larger less-performing countries relative to smaller better performing countries. In the past both institutions have attempted to compensate for this "large country bias" through a fixed minimum or base allocation (SDR 3.3 million in IDA and SDR 5.0 million in ADF). IFAD and AsDB, on the other hand, address this issue through the use of lower weighs for the population factor of 0.45 and 0.6, respectively. In the absence of a consensus, the issue requires further examination by the MDBs technical group.

6. Conclusion and Recommendations

6.1 This report has presented the proposed ADF allocation framework for the ADF-11 cycle. It has reaffirmed the PBA system as the core allocation mechanism for ADF resources, set out some specific implications for overall ADF-11 allocations resulting from proposed set-asides for specific purposes, identified some implementation issues and concerns under the current system, and proposed a number of possible options to address some of these concerns.

6.2 Deputies' guidance is invited on the following issues:

- The proposed share of performance-driven allocations under ADF-11 in the light of proposals for specific set-asides;
- The proposed changes in the timing of the allocation and DSF classification cycles;
- The use of single country-specific data points for population and income over the entire ADF-11 period;
- Revision of the CPIA to include only the first three clusters of the current CPIA under ADF-10 to eliminate double counting of governance;
- Revision of the Governance Factor (GF) by eliminating the procurement element;
- Revision of the CPPR by measuring the percentage of projects at risk (PAR) based on problem projects (PP) only; and
- Elimination of the PCEF upon approval of the FSF.

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Annex 1: Classification of Regional Member Countries

A. ADFResources Only*

Angola
Benin
Burkina Faso
Burundi
Cameroon
Cape Verde
Central African Republic
Chad
Comoros
Congo
Congo, Democratic Republic
Côte d'Ivoire
Djibouti
Eritrea
Ethiopia
Gambia
Ghana
Guinea
Guinea-Bissau
Kenya
Lesotho
Liberia
Madagascar
Malawi
Mali
Mauritania
Mozambique
Niger
Rwanda
Sao Tomé and Principe
Senegal
Sierra Leone
Somalia
Sudan
Tanzania
Togo
Uganda
Zambia

B. Blend of ADB and ADF Resources

Nigeria
Zimbabwe

C. ADB Resources Only

Algeria
Botswana
Egypt
Equatorial Guinea
Gabon
Libya **
Mauritius
Morocco
Namibia
Seychelles
South Africa
Swaziland
Tunisia

* Except for limited ADB lending for enclave and private sector projects.
** Libya is not a borrowing member country.

Annex 2: Resource Allocation Under ADF-8 to ADF-10

ADF-10 Resources for Allocation Only			
	UA mill	Shares	
Total ADF-10 resources, including internally generated resources	**3,677.52**		**100%**
Less Deductions for Special Activities	**729.55**		**19.8%**
Exchange rate contingency	24.77		
Contingency for acceleration	49.55		
Allocation for PCCF	135.00		
Allocation for Regional Projects	520.23		
Total Resources for Allocation	**2,947.97**		**80.2%**
PBL	736.99	25.0%	20.0%
Loans and Grants	2,210.98	75.0%	60.1%

ADF-9 Resources for Allocation Only			
	UA mill	Shares	
Total ADF-9 resources, including internally generated resources	**2,370.00**		**100%**
Less Deductions for Special Activities	**382.85**		**16.2%**
Allocation for Regional Projects	233.35		
Contingencies	46.67		
DRC Arrears Clearance	36.50		
HIPC Initiative	25.50		
Cost of Grants	15.00		
Cost of Evaluation	0.50		
Research & Capacity Building	15.00		
Adjustment to attain min UA 5.0	10.33		
Total Resources for Allocation	**1,987.15**		**83.8%**
PBL	447.11	22.5%	18.9%
Loans and Grants	1540.04	77.5%	65.0%

ADF- 8 Resources for Allocation Only			
	UA mill	Shares	
Total ADF-8 resources, including internally generated resources	2,036.40		**100%**
Less Deductions for Special Activities	357.74		**17.6%**
Contribution to HIPC Initiative	49.00		
Allocation for Regional Projects	203.64		
Contingencies	105.08		
Total Resources for Allocation	1,678.68		**82.4%**
TAF (Grants)	125.9	7.5%	6.2%
PBL	377.7	22.5%	18.5%
Loans	1,175.07	70.0%	57.7%

Annex 3A: The Enhanced PBA Framework for ADF-10

The enhanced PBA model applied to determine country allocations for the current ADF-10 period is:[18]

$$A_i = (GNI/P)_i^{-\lambda} (CPA^*)_i^{\theta} (P)_i \qquad (1)$$

where: $(CPA^*) = (CPA)(GF)(PCEF);$ (2)

$(CPA)_i = \alpha\, CPIA_i + \beta\, CPPR_i;\ (\alpha + \beta) = 1.0$ (3)

$\alpha = 0.7;\ \beta = 0.3$

and,

- **A_i** is the allocation share for country *i*;
- **GNI/P** is gross national income per capita, a proxy for poverty level;
- **P** is the level of population;
- λ is a fixed exponential assigned to the poverty variable ($\lambda = 0.125$); and
- θ is the performance exponential, now fixed at $\theta = 2$[19]

CPA* is the adjusted Country Performance Assessment (CPA); CPIA is the Country Policy and Institutional Assessment; CPPR is the Country Portfolio Performance Rating; GF is the Governance Factor, composed of the weighted average of CPIA cluster D and a procurement factor, divided by 3.5; and PCEF is the Post Conflict Enhancement Factor.

The essential ingredients of the PBA system are in line with the directives of ADF Deputies and best practices in sister institutions such as IDA and the Asian Development Bank (AsDB).

Annex 3B: Current PBA Formulas for Key MDBs

African Development Fund	$\underbrace{[(0.7*CPIA + 0.3*CPPR) * (GF) * PCEF]^{2.0}}_{\text{Performance}} * \underbrace{P * (GNI/P)^{-0.125}}_{\text{Needs}}$
Asian Development Fund	$\underbrace{[CPIArev^{0.7} * CPPR^{0.3} * GFrev]^{2.0}}_{\text{Performance}} * \underbrace{P^{0.6} * (GNI/P)^{-0.25}}_{\text{Needs}}$
International Development Association (IDA)	$\underbrace{[(0.8*CPIA + 0.2*CPPR) * (GF)^{1.5}]^{2.0}}_{\text{Performance}} * \underbrace{P * (GNI/P)^{-0.125}}_{\text{Needs}}$

Notes: CPIArev is a revised CPIA composed of clusters A-C of the CPIA only ; GFrev is a revised Governance Factor, i.e., average rating from the 5 elements of Cluster D of the CPIA, divided by 3.5.

[18] For further details, see ref.: ADF/BD/WP/2005/93/Rev.1, dated 5 July 2006, Section III, pp.4-18.

[19] During the ADF-8 period, the performance exponential θ was set to 2 for CPA $\geq$3 and 1.75 for CPA<3, thus creating the kink. One of the enhancements approved for ADF-9 removed the kink.

Annex 4: CPIA Criteria and the Governance Factor Under ADF-10

CPIA Criteria

A. Economic Management

1. Macroeconomic Management
2. Fiscal Policy
3. Debt Policy

B. Structural Policies

4. Policies & Institutions for Economic Cooperation, Regional Integration & Trade
5. Financial Sector
6. Business Regulatory Environment

C. Policies for Social Inclusion/Equity

7. Gender Equality
8. Equity of Public Resource Use
9. Building Human Resources
10. Social Protection and Labor
11. Environmental Policies and Regulations

D. Public Sector Management and Institutions

12. Property Rights and Rule-based Governance
13. Quality of Budgetary and Financial Management
14. Efficiency of Revenue Mobilization
15. Quality of Public Administration
16. Transparency, Accountability, and Corruption in the Public Sector

Governance Factor

D. Public Sector Management and Institutions

1. Property Rights and Rule-based Governance
2. Quality of Budgetary and Financial Management
3. Efficiency of Revenue Mobilization
4. Quality of Public Administration
5. Transparency, Accountability, and Corruption in the Public Sector

Country Portfolio Performance Rating

6. Procurement of Goods and Services for Projects

Annex 5: Proposed CPIA Criteria and Governance Factor Under ADF-11

CPIA Criteria

A. Economic Management

1. Macroeconomic Management
2. Fiscal Policy
3. Debt Policy

B. Structural Policies

4. Policies and Institutions for Economic Cooperation, Regional Integration & Trade
5. Financial Sector
6. Business Regulatory Environment

C. Policies for Social Inclusion/Equity

7. Gender Equality
8. Equity of Public Resource Use
9. Building Human Resources
10. Social Protection and Labor
11. Environmental Policies and Regulations

Governance Factor

D. Public Sector Management and Institutions

1. Property Rights and Rule-based Governance
2. Quality of Budgetary and Financial Management
3. Efficiency of Revenue Mobilization
4. Quality of Public Administration
5. Transparency, Accountability, and Corruption in the Public Sector