IDA14

IDA's Performance-Based Allocation System:
IDA Rating Disclosure and Fine-tuning the Governance Factor

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Acronyms and Abbreviations

AfDB	African Development Bank
AsDB	Asian Development Bank
ARPP	Annual Review of Project Performance
CAS	Country Assistance Strategy
CPIA	Country Policy and Institutional Assessment
ICP	IDA Country Performance rating
IDA	International Development Association
MDB	Multilateral Development Bank
PBA	Performance-Based Allocation system

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I. Introduction

1. IDA's Performance-Based Allocation system (PBA) has formed the basis for distributing IDA's resources since 1977. Over time it has undergone significant changes reflecting new analytical insights and experience. The most recent set of enhancements were discussed last autumn at the time of the IDA13 Mid-Term Review,[1] and at the time of the first IDA14 Replenishment Meeting[2] in February 2004. At those meetings several significant modifications were agreed, including a stretching out of the special allocations to post-conflict countries, and a special provision for selected regional integration projects.[3] This note updates the Deputies on further progress made in the areas of: (i) the review and disclosure of the CPIA; and (ii) the governance factor.

II. CPIA Revision in Light of the Expert Panel Recommendations

2. Over the past year management has consulted with the Board on how to implement the IDA13 undertaking of moving towards disclosure of IDA Country Performance ratings (ICP). Some Executive Directors questioned the robustness of the ratings. At their request management assembled an external panel of experts to review CPIA process and methodology. The findings and recommendations of this review were presented in a report circulated in June.[4] After an informal Board discussion, management started to implement the key recommendations of the Expert Panel, including:

- *Simplification* - to consolidate the CPIA from 20 to 16 criteria (see Annex 1 Box 1 for the new set of criteria, and the June report for a detailed discussion of this simplification of the CPIA);

- *Weighting* - to undertake analytic work to inform the choice of the weights of the CPIA clusters and criteria;

- *Rating Scale* - to provide definitions for the full range of ratings from 1 to 6, and to allow for ratings of 1.5 and 5.5 and define all rating levels from 1 to 6 accordingly (see the draft 2004 CPIA questionnaire, which is distributed as a background paper);

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1 *IDA's Performance-Based Allocation System: Current and Emerging Issues*, IDA/R2003-0203, October 24, 2003.

2 *IDA's Performance-Based Allocation System: Update on Outstanding Issue,* IDA/SecM2004-0061, February 9, 2004.

3 See Additions to IDA Resources: Fourteenth Replenishment, Annex 3, Summary of the Performance-Based Allocation System for IDA14.

4 *Country Policy and Institutional Assessments: An External Panel Review – Panel Recommendations and Management Follow-Up*, SecM2004-0304, June 15, 2004.

- *Client Involvement* - to include a stronger involvement of country authorities, providing them with an opportunity for comment on assessments as part of a consultation process, not as a negotiation of the ratings;

- *Advisory Committee* - to establish an independent standing committee to undertake a formal review of the CPIA methodology and process every three years; and

- *Disclosure* - to incorporate proposed enhancements in time to disclose the numerical CPIA[5] and ICP ratings starting with the 2005 CPIA exercise for IDA-eligible borrowers, while continuing to disclose the ratings in quintile groups for the time being.

3. On September 7, 2004, the Board of Directors met to discuss management's proposed response to the recommendations of the Expert Panel (for ease of reference this paper has been posted for information with the IDA14 papers).[6] It reached a broad consensus in support of management's proposed response. As a result, full disclosure of the IDA CPIA and Country Performance Ratings will start with the 2005 ratings.

4. Beyond the CPIA criteria proper, the Panel recommended a review of the weight given to governance in the IDA allocation process, and the issue was the subject of comment from several chairs in the Board discussion of September 7. Management indicated that this issue had been discussed by the IDA Deputies at the Paris IDA14 Replenishment meeting in February, and would be taken up again at the time of the October meeting. This issue is discussed in the next section.

5. In addition to considering the conclusions of the Panel, and as requested by some of the Deputies, IDA staff have had further interactions with colleagues from other MDBs. A meeting is being planned for January 2005 in Manila to share experiences with PBA implementation and to identify opportunities for further harmonization. The latter should be facilitated by the move towards full CPIA disclosure starting in 2005.

III. Fine-Tuning the Governance Factor

6. During the February 2004 meeting in Paris, management proposed modifications to the governance factor in IDA's Performance-Based Allocation (PBA) system. The objective of these modifications was to make the governance factor less volatile and, if possible, simpler. The alternatives discussed involved varying degrees of moderation of the effective weight of governance in the PBA system. The discussion was not conclusive. Deputies broadly welcomed management's efforts to find ways to make the governance factor simpler and less volatile, but some expressed reservations if this would be at the cost of a significant reduction in the effective weight of governance. Subsequently, as reported above, the CPIA Expert Panel expressed the view that the current effective weight of governance might be excessive, and lacked a clear analytical justification.

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5 It was agreed that starting in 2005 the disclosed CPIA ratings be referred to as the IDA Resource Allocation Index.

6 *Disclosing IDA Country Performance Ratings*, IDA/R2004-0210, August 9, 2004.

7. The consolidation of the CPIA criteria mentioned in Section II will result in a modest reduction of the effective governance weight since it involves the elimination of the old criterion #4 (“*management and sustainability of the development program*”). Since this criterion was an element of the governance factor, the computation of the governance factor will now be based on six, rather than seven, criteria: five from the CPIA, and one from the ARPP. This has a marginal effect on the effective weight[7] of governance in the PBA system, reducing it from 68% to 66% (see Table 2).

8. With respect to the volatility of the governance factor, analysis of the year-to-year variability during the five-year period 1999-2003 of the seven[8] criteria that have made up the governance shows that the procurement flag (an element of the Annual Review of Project Performance - ARPP) is by far the most volatile element. This particularly affects countries with small programs in which a rating shift in a single project implies a large percentage change on the “procurement flag.” Table 1 shows that the standard deviation of the procurement flag is about three times that of the other six governance variables. Clearly this represents more of a statistical effect than an accurate measure of year-by-year substantive changes in the quality of governance.

Table 1. Standard Deviation, Governance Factor Components 1999-2003

	CPIA						
	A. Economic Management	D. Public Sector Management and Institutions					ARPP
	#4 Mgt. & sustain. of devel. program	#16 Property rights & govern.	#17 Quality of budg. & finan. mgt.	#18 Effic. of reven. mobil.	#19 Quality of public admin.	#20 Transpar. account. & corrup. in pub. sector	Procurem. Flag
Standard Deviation	0.29	0.24	0.27	0.23	0.25	0.30	0.85

9. One way to reduce the governance factor’s volatility would be to simply drop the procurement flag from its calculation. This would simplify the governance factor. It would also result in a reduction of the effective weight of governance in the overall IDA rating (from 68% to 61%). However, dropping the procurement flag from the governance factor would eliminate a significant yardstick of good governance.

10. A second way to reduce volatility would be to use a moving average of the *whole* governance factor. Using the 1999-2003 data, this would reduce volatility by 40%, but have the drawback of making the overall PBA system much less responsive to changes in either direction in governance performance.

11. A third, more promising, way would be to use a three-year moving average for the procurement flag component only. This would reduce the volatility of the IDA Country

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[7] For the methodology used to calculate the “effective weight,” see Annex 3.

[8] Note that criterion #4 (see Annex 1) will not be part of the new CPIA, see para 8.

Performance rating by 18%.[9] Under this approach most of the governance factor would remain fully responsive to year-to-year changes in governance performance, while smoothing out only its most volatile component.

Recommendation and Issues for Discussion

12. Management has reviewed the way the governance factor affects a country's ICP rating (and thus its IDA allocation) and the impact of consolidating the CPIA in accordance with recommendations made by the external Expert Panel. On balance it recommends a governance factor with five unchanged elements (the criteria that make up the new CPIA's governance cluster), plus one modified element (the three-year moving average of the procurement flag from the ARPP). The resulting effective weight of governance would be marginally reduced from 68% to 66%, thereby keeping governance as the dominant element in IDA's PBA system, while reducing volatility by 18%. There remain some IDA-specific aspects of the way it takes governance performance into account. Still, as shown in Table 2, the 66% weight of governance is broadly consistent with that in the AsDB and AfDB, which now have governance weights in the 50-60% range.

Table 2: Effective Governance Weights under Alternative Options

	Current IDA CPIA Formula Non-Linear Governance factor (1.5) and Procurement Flag	Options		Modified AsDB PBA System	AfDB PBA System
		I New IDA CPIA Formula with non-linear governance factor (1.5) and Procurement Flag (mov. av.)	II New IDA CPIA Formula with linear governance factor (1.0) and Procurement Flag (mov. av.)		
Effective Weight of Governance	68%	66%	59%	53%	59%

13. With respect to the weight of governance in the PBA system, and in light of the concern expressed by the CPIA Expert Panel, the question remains whether the Deputies would want to reconsider the elimination of the governance factor's exponent of 1.5. This option was discussed inconclusively in February in Paris. Its adoption would further reduce the effective weight of governance in the ICP rating from 66% to 59%, and, while further reducing the volatility of the ICP rating, would also significantly affect the resulting country allocations in favor of weaker performing countries.

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9 The standard deviation would drop from 0.33 to 0.27.

Annex 1

Box 1. Revised 2004 CPIA Criteria

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

B. Structural Policies

4. 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. Policies and Institutions for Environmental Sustainability

D. Public Sector Management and Institutions

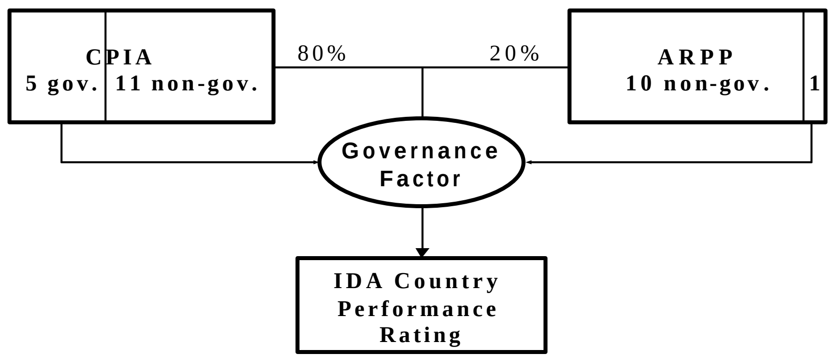
12. Property Rights and Rule-Based Governance
13. Quality of Budgetary and Financial Management
14. Efficiency of Revenue Mobilization
15. Quality of Public Administration
16. Transparency, Accountability, and Corruption in the Public Sector

Annex 2

Methodology for Calculating the Effective Weight of Governance in the ICP Rating

1. The IDA Country Performance rating (ICP), the dominant determinant of IDA's country allocations, is based on a two-step calculation (Figure 1): (i) the weighted average of the country's CPIA (80%) rating and its ARPP rating (20%); and (ii) the multiplication of this weighted average by the governance factor.

Figure 1
IDA Country Performance Rating



Accordingly, the relative importance of governance in the overall ICP rating has to reflect that governance appears in: (i) five of the 16 criteria in the new CPIA (cluster D, with a weight of 25%); (ii) one of the 11 criteria ("flags") of the ARPP; and (iii) the governance factor (derived from the average of these five CPIA governance criteria plus the one ARPP governance criterion).[10]

2. The calculation involves six steps:

- **Step 1a**. Start from a neutral score for all criteria of 3.5 - resulting in a 3.5 ICP rating. Calculate the % increase in the ICP rating resulting from a 10% increase in the rating of one CPIA governance criterion.
- **Step 1b**. Repeat this calculation, but now for a 10% increase in the rating of the one ARPP governance criterion.
- **Step 1c**. Calculate the weighted average x, taking into account that: (i) in the case of the governance criteria five come from the CPIA and one from the ARPP; and (ii)that the CPIA is weighted 80%, and the ARPP 20%.

[10] Governance factor = (average governance rating / 3.5)$^{1.5}$

- **Step 2a**. Starting from a neutral score[11] for all criteria of 3.5, calculate the % increase in the ICP rating resulting from a 10% drop in the rating of one non-governance CPIA criterion.
- **Step 2b**. Repeat this calculation, but now for a 10% increase in the rating of the one ARPP non-governance criterion.
- **Step 2c**. Calculate the weighted average y, taking into account that: (i) in the case of the non-governance criteria 11 come from the CPIA and 10 from the ARPP; and (ii) that the CPIA is weighted 80%, and the ARPP 20%.

- **Step 3**. Calculate the ratio x/y, showing how much more impact a governance rating change has than a non-governance rating change (about six times, see below).

- **Step 4**. Repeat steps 1-3 for rating increases of 20%, 30%, 40%, and 50%.

- **Step 5**. Calculate the average of these ratios, z.

- **Step 6**. Calculate the Effective Governance Weight (EGW) in the ICP rating calculation according to the formula specified below that reflects: (i) the extra impact (z) that governance criteria ratings have on the final ICP rating,[12] (ii) the number of those heavy-weighted criteria among the CPIA and ARPP criteria; and (iii) the CPIA and ARPP weights of 80% and 20%, respectively.

$$EGW = 0.8 * ((5*z /(5*z +11*1)) + 0.2 * ((1*z / (1*z + 10*1))$$

[11] The score of 3.5 is half way between the minimum score of 1 and the maximum score of 6.

[12] Note that to reflect this extra impact, governance criteria get credited with a weight of z, and non-governance criteria with a weight of 1.

3. Table 3 shows the ratio results which form the basis for the EGW calculation for the current governance factor with the new CPIA with 16 criteria.

Table 3: ICP Rating Changes as a Result of Governance and Non-Governance Rating Changes

Percentage Increase	Increase in Governance Criterion rating	Resulting Increase in ICP rating (x)	Increase in Non-Governance Criterion rating	Resulting Increase in ICP rating (y)	Ratio (x/y)
0%	3.50	0.0%	3.50	0.00%	
10%	3.60	2.9%	3.52	0.48%	5.99
20%	3.70	5.8%	3.53	0.96%	6.03
30%	3.81	8.8%	3.55	1.44%	6.07
40%	3.91	11.8%	3.57	1.93%	6.11
50%	4.02	14.8%	3.58	2.41%	6.15
Average					6.07

It shows that on average changes in governance criteria have 6.07 times as much impact on the overall ICP rating as changes in non-governance criteria.

Entering this result into the formula gives a EGW of 66%:

EGW = 0.8 * ((5*6.07 /(5*6.07 +11*1)) + 0.2 * ((1*6.07 / (1*6.07 + 10*1)) = 0.66