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Performance-based allocation (PBA) of foreign aid : still alive?

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Performance-based allocation is a principle for the allocation of development assistance between countries, governed by a simple formula for several decades and considered as accepted wisdom, at least at the multilateral level. An official of one of the major donors once even said: "the PBA is a global public good". In this chapter we explain first what is the meaning of this common principle, now declined in various formulas, second how it has generated major misunderstandings, undermining its legitimacy, third why the exceptions progressively brought to the principle have limited its impact, and finally which options are opened for the revision, the replacement, or the extension of the PBA.

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What is the PBA? A common principle and various formulas

Origin and dissemination: a "multilateral" need for a formula, a common wish to reward "good guys" through the CPIA

The origin of the PBA can be traced back to the late 1970s when it was first implemented at the World Bank, in 1977, for the allocation of the credits from its concessional window, the International Development Association (IDA). For the geographical allocation of development assistance by a multilateral institution, rather than to leave it governed by discretionary practices, it might be seen to be easier to find a consensus among donor members in the apparent simplicity of a mathematical formula, where roughly the amount of aid allocated to a country i is

$$A_i = f\,(\text{Performance, income per capita, population})$$

While today's practice, still relying on a formula, has become more complex, the core message of the PBA has remained the same for almost 40 years. The goal of the PBA is to reward countries that are performing well by allocating a larger amount of aid, according to a Country Policy and Institutional Assessment (CPIA) which represents the alleged quality of their public policy, that is, their commitment to development. Performance is measured from the CPIA and its components. So, since the beginning the PBA and a CPIA have been joint products. This vision of aid allocation quickly became popular among stakeholders and multilateral institutions, as it was supposed to enable accountability to public opinion, rewarding the "good guys" and providing incentives to the others.

Evolution of the PBA at the World Bank

The real debate about the PBA and its embedded vision of aid effectiveness has come under scrutiny essentially for the past 15 years with the release of the 1998 World Bank report Assessing Aid, reiterating the conclusions of a 1997 working paper by David Dollar and Craig Burnside (published in the American Economic Review in 2000), according to which aid is more effective in countries with better policies. It thus provided the first econometric evidence directly supporting the PBA, and propelled a renewed interest for the PBA as the right allocation methodology for the concessional windows of the multilateral development banks (MDBs). Soon after most of the MDBs, as well as some other multilateral agencies which had adopted the PBA, gathered in a kind of PBA club: 1999 for African Development Bank, 2000 for Caribbean Development Bank, 2001 for Asian Development Bank, 2002 for Inter-American Development Bank and 2005 for International Fund for Agricultural Development.

However, the PBA at the World Bank has not remained the same for all this time, which may be seen as a natural consequence of the shortcomings of such a restrictive formula. First the design of the formula has changed, either in the way by which the performance indicator is built or in the coefficients applied to the variables of the formula. Performance was initially (and until 1994) measured by the CPIA,[1] then by an average of the CPIA and of the quality of the World Bank portfolio in the country, although with a minor and fluctuating weight given to the portfolio assessment (20 percent in 1994, 10 percent in 1995-96, 7 percent in 1997, 20 percent again from 1998 to 2008, but in a peculiar formulation where governance was taken twice into account, and finally 8 percent since 2009). Since 2009 the CPIA was itself broken down in two parts, the average of its clusters A,B,C, with a minor weight of 24 percent, and the cluster D, related to the governance, with a major weight of 68%, the average of the three components being called the Country Policy Rating (CPR).[2] Second, the coefficients applied to the variables, that were exponents of multiplicative variables (except the performance measure) themselves

1. The CPIA is composed of 16 indicators grouped into 4 clusters:- A) macroeconomic management, B) structural policies, C) social policies, D) public sector management and institutions (D refers to the concept of governance).

2. Between 2009 and 1998 a more complicated formula gave a special weight to the governance factor, as measured by the cluster D of the CPIA, by multiplying the "performance" (= 0.8 CPIA + 0.2 Portfolio) by this factor (although already included in the CPIA).

changed over time: while population remained with the same unity level, the gross national income (GNI) per capita, initially set at -0.25, was reduced by half at -0.125 from 1997, and the exponent of the performance factor, set at 1.8 until 1997, was modulated according to the performance rating in 1997 (from 0.5 at the lower level to 1.95 at the higher level), and in 1998-2000 (from 1.75 to 2.0), then put at 2.0 between 2001 and 2008 (with the peculiar formula resulting in a double counting of governance),[3] set at 5 from 2009 to 2013, and more recently slightly reduced to 4. Except for this recent small change the general trend is that of an increasing impact of governance on allocation.

Moreover the PBA appeared to be not flexible enough to deal with some special attributes of recipient countries. Too small, too big, fragile, conflict-afflicted, or post-conflict countries to name a few, needed special treatment and tended to escape the general PBA. This led the World Bank to add an extended list of exceptions and special funds to the PBA to deal with those particular cases. Those amendments led to a diluted and highly non-linear version of the original PBA (see Guillaumont, et al., 2010).

Diversity of PBA among MDBs

While each MDB had to deal with the exceptions, their answers differed most of the time. Regarding smallness of population, for instance, the Asian Development Fund (ADF) chose to lower the exponent of population in the formula, while IDA, followed by the African Development Fund (AfDF) decided to increase country base allocations. Furthermore, as regional banks tend to focus more on the specificities of their own countries, their PBA started to diverge from the original. This is the case for AfDB which adopted a new formula in ADF13 (2014-2017) where a new variable was added to capture a need for aid resulting from a lack of basic infrastructures,[4] or for Caribbean Development Bank where the formula also includes an assessment of economic vulnerability, to capture a specific need of assistance. Another innovation brought to this new ADF was to introduce a new cluster (E) in the assessment of the performance factor to capture the efforts of the country to improve infrastructure and promote regional integration.

At the same time the coefficients or exponents given to the variables included in the PBA formula differ from one institution to another. The exponents of the performance factor have increased over time, as has been the case for the IDA, although they generally stayed at a lower level than for the IDA. For instance, at the AfDB this exponent, set at 1.75 or 2.0 (according to the performance factor) in 1999-2001, was unified at 2.0 between 2002 and 2007, then at 4 between 2008 and 2013, but slightly increased in 2014 (to balance the impact of the new infrastructure variable).[5]

The consequence of these various choices is that there are as many PBAs as there are MDBs.

Misunderstandings about PBA

As MDBs turned more and more towards the PBA system the civil society and the academic community started to question its political and economic foundations. Three main reasons for improving the present PBA have been identified, related to performance, effectiveness, and equity.

Is it really performance based?

Without doubt the success of the PBA has come from the word "performance". Everybody wishes developing countries to perform, and for aid to support performance. The problem lies in the ambiguity of the word "performance", or more precisely in the fact that the performance used in the PBA formula is far from the genuine meaning of performance. Performance normally refers to results or outcomes obtained (in this case by a country) in a given initial or external context. In performance-based allocation, performance refers to a subjective assessment of the country policy, which is indeed a different

3. See the previous footnote.
4. Called the African Infrastructure Development Index (AIDI) score.
5. The weight given to the new cluster E (6percent) in the performance rating was taken from that of the average of clusters ABC (lowered from 26 percent to 20 percent).

entity. The CPIA used by the World Bank, and in particular its fourth cluster, because it is not an index of development results and it is not assessed with respect to initial or external conditions, is not an index of performance in the real meaning of the word. Put simply, governance is not performance.

Does PBA promote effectiveness?

As explained above, the empirical validation of the theory of aid effectiveness depending on performance came from the World Bank and the famous study of Burnside and Dollar (2000) who argued, using a simple econometric model, that aid had a positive impact on gross domestic product (GDP) growth only if the quality of governance and public policies, proxied by the CPIA, was high enough. However, those results were proven to be at best fragile and many studies ended disavowing the work of Burnside and Dollar.

This controversy did not weaken the use of the PBA. Rather, it caused a shift in the rationale behind the PBA. More than a direct factor of current aid effectiveness, PBA was seen as an incentive to adopt better policies. It reflected the feeling that giving more help to those countries considered as "good guys" will push other countries to become more virtuous. This was a significant change compared to the initial Burnside and Dollar model where aid effectiveness was supposed to depend on policy, and policy not to depend on aid, and it might be seen as an ideological full circle operated at the IDA. However, as far as a better policy is good for growth, an incentive for better policy may become an indirect factor of growth, regardless of the ownership issue.

If it is admitted today that governance is a weak factor of aid effectiveness, an important amount of empirical studies fueled by this controversy have shown that other features of the receiving country are likely to influence aid effectiveness. Among these features, vulnerability to exogenous shocks has received increasing attention in the literature, although it is not always fully understood in policy circles (see a survey in Guillaumont and Wagner, 2014). Shocks and vulnerability are negative factors on development, whereas good governance is a positive factor, but both factors are likely to increase aid effectiveness. A major reason why aid can have a macroeconomic impact on growth and development is its stabilizing impact: aid dampens the negative impact of exogenous shocks on growth and development. As a consequence, taking into account vulnerability in aid allocation is likely to make it more effective.

Is PBA equitable?

International equity should be a priority concern in aid allocation. There are many views as to what is equity. Performance-based allocation is supposed to be equitable because it includes the level of income per capita as a criterion of aid allocation, but it is only one of the several factors that influence the level of opportunities and capabilities. A now commonly accepted meaning of equity is related to equal opportunities. Transposing the opportunity and capability perspective to the country level in order to determine aid allocation would involve taking into account the structural obstacles to growth each country faces. The present PBA formula, because it refers only to income per capita and to the quality of policies, fails to take into account any of the main structural handicaps to development, and so in reality fails to be equitable.

Furthermore the fact of considering only the quality of governance and policy as a criterion for aid allocation (alongside income per capita) has an unfair consequence. Populations suffering from bad government and policies are at the same time penalized by aid allocation, implying a double punishment introduced by aid donors. Thus, for equity reasons and to promote more equality of opportunity between nations and avoid double punishment, even more than for effectiveness reasons, it seems legitimate to include indicators of structural handicaps in aid allocation criteria.

When the rule becomes the exception

As mentioned above, the heterogeneous situations faced by IDA members made the strict implementation of the PBA not feasible and MDBs quickly had to implement a series of exceptions and special procedures to adapt the PBA and make it workable.

Fragile states treated separately

The main difficulty in the implementation of the PBA came from the special need of assistance to fragile states. The PBA allocates more aid to better performing countries, while fragile states are poor performers. More precisely the PBA allocates more aid to countries where the CPIA, and in particular its governance components, are higher, while the fragile states are most often identified by low CPIA, and by bad governance. So the strict application of the PBA would lead to fragile states being left behind, and marginalization of countries with low-quality governance. Fragile states are countries that have a big need for external support but where the quality of governance, because of chaos or civil conflict or deep state weakness prevents them from getting it.

To make the PBA consistent with the special need of fragile states, MDBs and notably the IDA had to set up various special funds and procedures to allow aid to flow into these countries, which were called by various and changing names: for instance at the IDA, "low income countries under stress (LICUS)", fragile states, post-conflict and re-engaging countries, fragile and conflict affected, and now turnaround countries. However, while the PBA formula is transparent, those procedures are not. They involve an arbitrary decision to consider a country as eligible for fragile state treatment. At the same time they introduce non-linearity in the allocation. More importantly they reflect only a curative approach to state fragility, when a preventive approach could prevent countries close to the eligibility threshold falling and experiencing dire internal turmoil. For instance Mali was not considered as a fragile state until the 2011 conflict erupted.

Furthermore, as recently evidenced, governance indicators are not purely endogenous to government decisions. They are determined by exogenous conditions as well (Guillaumont et al., 2013). An exogenous macroeconomic shock will ultimately have a negative impact on governance. As fragile states suffer from structural vulnerabilities, they are prone to experience such shocks lowering their governance even more. This enhances the need to have a preventive approach to state fragility, by taking structural vulnerability into account in aid allocation.

Small countries escaping the rule

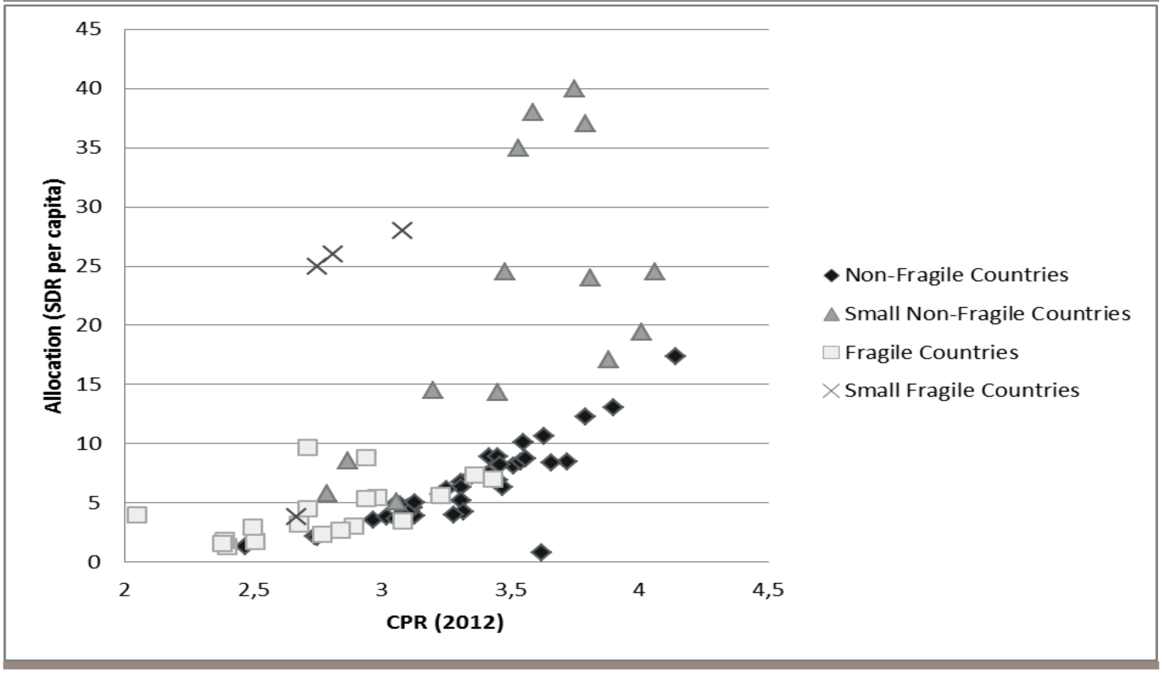
Another source of discontent with the PBA comes from the treatment of very large countries or, at the opposite of the distribution, very small countries. Since allocation shares in most MDBs increase proportionally with population, special treatments have been set up for capping the allocations to very large countries which otherwise would have attracted too much resources (for instance Pakistan and India at the IDA). Alternatively, since small countries tend to see their allocation share shrink with population size, leading to very small allocation shares, with incompressible management costs, most MDBs have set up a minimum allocation for each country. Since these minimum allocations have become quite large compared with the amount allocated through the PBA, it implies that the PBA in effect does not apply to those countries. Even a large variation in their governance does not lead to a significant change of a country's allocation.

With the recent increase of the minimum base allocation for the IDA and the ADF, and the growing number of countries benefitting from special treatment with regard to their state fragility, it seems that a minority of countries eligible to either the IDA or the ADF are really governed by the PBA. (Looking at per capita allocations illustrates the complexity for MDBs to balance the PBA formula and the exceptions; see Figure).

Parallel allocation through earmarked funds

Finally, a new trend has recently emerged in MDBs that may reduce even more the signifi-

Figure 1: IDA aid llocation *per capita* as a function of CPR in 2014



Source: Authors' calculations
Note: Original IDA performance based allocations excluding adjustments for front- and back-loading and regional and intra-regional reallocation. Tuvalu with an allocation of 240 SDR per capita in 2014 has been excluded from this figure for the sake of clarity.

cance of the PBA and threaten the equity and transparency of allocation procedures in those institutions. The development and proliferation of earmarked funds has driven upward the share of aid managed and disbursed through them. The procedures used within those funds to allocate resources are highly heterogeneous and often undisclosed. Furthermore, preliminary evidence shows that performance tends not to be used as a central criterion for allocation (Wagner, 2014). As the share of concessional public financing channeled through earmarked funds rises, the share of aid allocated through the strict PBA decreases. This trend results in more discretionary aid allocations by country. It also reflects some mistrust from bilateral donors with regard to the general allocation rules they are supposed to support.

Options for the future

There has been growing discontent among researchers and policy makers about the PBA formula, as it is presently designed, because of the various reasons explained above. All are linked to the need for assistance generated by critical handicaps to development ignored by the PBA, essentially structural economic vulnerability and low level of human capital. The detrimental consequences of the structural economic vulnerability of developing countries, notably of the least developed countries (LDCs), have been the object of much concern in the international community without being reflected in the PBA. In the following, we briefly examine how to address issues with and consequently how to improve the PBA formula. The PBA could be changed to better meet the principles of equity, effectiveness and transparency that should be the rule with aid allocation. It would then become more consistent with its original purpose.

An "augmented PBA"?

As emphasized above, the recurrence of exogenous shocks weakens policy and institutions. Econometric results show that governance is partly determined by structural economic vulnerability and to a lesser extent by low human capital. Moreover, as noted above, the governance indicators (in many cases, the World Bank's CPIA or its regional counterparts) are often pro-cyclical. So, adding indicators of economic vulnerability and of low human capital to the usual CPIA can simply be seen as a way of treating the endogeneity of the CPIA (that is, purging the CPIA from the impact of the structural handicaps of economic vulnerability and low level of human capital). In other words controlling for the structural handicaps makes the allocation more genuinely "performance based". At the same time it would allow a treatment of fragile states in a progressive and integrated framework, limiting discretionary allocations to the exceptional cases of fragility.

Moreover, in order to avoid caps and floors, it is possible to allow population to impact aid allocation in a less than proportional fashion, avoiding problems and threshold effects with very big or very small countries (for that the exponent of the population size should be lower than one, as it is already at the ADF).

Forgetting the acronym?

A simpler, although similar approach, would be to forget the "performance-based allocation" PBA acronym to avoid the related misunderstandings, but to keep the four criteria of income per capita, structural economic vulnerability, low level of human capital, and quality of policy as well. Population would be again introduced with a lower than one exponent. Such a reform of the current PBA would simply aim at balancing efficiency and equity criteria, in a transparent manner. It would again allow a treatment of fragile states in a progressive and integrated framework.

It is noticeable that this kind of allocation, relying on four corresponding criteria, has been used by the European Commission for its new cycle of development assistance (both for the European Development Fund and the Development Cooperation Instrument), showing its feasibility.

The reform also fits a recent resolution of the United Nations General Assembly, which "Invites development partners to consider least developed country indicators, gross national income per capita, the human assets index and the economic vulnerability index as part of their criteria for allocating official development assistance" (A/C.2/67/L.51, 3 December 2012).

The principle matters more than the indices, although the design of the indices may affect their impact on allocation (see Guillaumont, 2014). Each (multilateral) donor may choose indices of structural vulnerability, human capital, or policy, that it considers the most appropriate.

Global PBA: who needs a formula?

The previous recognition of principles for aid allocation relying on quantitative criteria invites consideration of which "development partners" are concerned by the use of a "formula". As seen above, the PBA formula emerged to express a kind of political consensus among those donors contributing to a multilateral agency. For bilateral assistance, the ex ante expression of the policy choice does not necessarily need the use of a formula. However, at the global level, a formula such as the PBA, revised or replaced, may express an international consensus on the optimal allocation of the total amount of aid among developing countries, helping to identify aid orphans and darlings. It would then be a way to monitor the new global agenda.

Integrated allocation: which PBA for the Sustainable Development Goals?

The post-2015 agenda will combine the previous Millenium Development Goals (MDGs) and the Sustainable Development Goals (SDGs). The allocation of concessional resources by multilateral agencies, as well as bilateral agencies, between countries will then include both usual development assistance, mainly focused on poverty reduction, and funds devoted to the protection of the environment, mainly the adaptation to climate change. For this second kind of external support, a PBA or another formula is also conceivable, combining effectiveness and equity criteria. For equity reasons, such a formula, besides income per capita and an indicator of "performance" or policy would include the country physical vulnerability to climate change among the criteria, as the structural economic vulnerability should be for development assistance. However, if the resources for development assistance and for adaptation were to be managed in common funds, the structural vulnerability to be considered would have to combine the components of the structural economic vulnerability and of the physical vulnerability to climate change (see Guillaumont 2013). Once again a similar principle, inherited from the PBA or replacing it, may be applied using the indices that donors feel are the most appropriate.

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