



RE-376

*Evaluation of the Fund for Special
Operations during the Eighth Replenishment
(1994-2010) – Part I*

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TABLE OF CONTENTS

INTRODUCTION

I.	METHODOLOGIES TO ALLOCATE FSO RESOURCES.....	1
A.	The 1994-2001 period.....	2
B.	The 2002 adjustments to the allocation methodology	3
C.	The 2007-2010 allocation methodology	6
D.	On the distributive characteristics of the allocation methodologies.....	18
II.	LENDING.....	18
A.	Magnitude and utilization of FSO Resources.....	18
B.	Project cycle issues of FSO lending	20
C.	The poverty and social equity emphasis of FSO lending	22
D.	Sector distribution.....	23
III.	CLOSING REMARKS.....	24

ANNEXES

[Annex I](#) – Boxes

[Annex II](#) – Allocation Formulas

[Annex III](#) – Charts

[Annex IV](#) – Charts Without Haiti

[Annex V](#) – Algebraic Demonstrations

LIST OF ACRONYMS

AfDB	African Development Bank
CIPE	Country Institutional and Policy Performance Evaluation
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
EPBA	Enhanced Performance-Based Allocation
FSO	Fund for Special Operations
IDA	International Development Association
IFF	Intermediate Financing Facility
IMF	International Monetary Fund
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MIF	Multilateral Investment Fund
OC	Ordinary Capital
PPMR	Project Performance Monitoring Report
PTI	Poverty-Targeted Investment
SEQ	Social Equity

INTRODUCTION

The Inter-American Development Bank is unique among the multilateral banks in the sense that it has provided concessional funding for its member countries since its inception, with the institution of the Fund for Special Operations (FSO) in the 1959 Agreement that established the Bank.

The objective of this evaluation is to provide the Board of Executive Directors, when the Bank is engaging in a new increase of its capital, with an assessment of the performance of the Bank's concessional lending instrument, the FSO loan program during the period of the Eighth Replenishment (IDB-8: 1994-2010). In this sense, it does not discuss the Intermediate Financing Facility (IFF), nor the non-reimbursable technical cooperation financed with FSO resources.ⁱ

This is a timely exercise, for increases in the Bank's capital represent critical moments for replenishing the Fund. The concessional nature of the FSO, lower interest rates and longer amortization period, implies that its resources cannot be obtained from the capital markets, but rather have to come (mostly) from the contributions of member countries, and from the income that can be generated from its loans: from investment liquidity and from the interest collected.

This evaluation consists of two papers that, given their content and length, are presented separately. This first paper evaluates issues related to FSO allocation, approval and execution. The second document assesses financial and development results.

ⁱ IFF was essentially a financial instrument of interest-rate subsidy. OVE's "Oversight Note on the Performance Criteria for Allocating Concessional Resources." (RE-279, June 18, 2003), provides a discussion of IFF's methodology until 2002.

I. METHODOLOGIES TO ALLOCATE FSO RESOURCES

- 1.1 The limited amount of capital that can be supplied by the Bank's concessional funding sources, combined with the growing needs of the Region, have led, throughout the years, to a decline in the relative availability of concessional resources. Thus, because concessional resources are scarce, and because they represent a subsidy, the Bank has always felt it necessary to have some explicit criteria to be used in the allocation of these resources.
- 1.2 Initially, the IDB used two types of criteria for the allocation of concessional financing: sectoral and beneficiary criteria. Sectoral priorities were set in various concessional resource replenishment documents, and generally favored social sectors. Beneficiary criteria directed that the Bank should apply its concessional resources to the poor. However, as the availability of concessional resources decreased, the Bank gradually moved away from funding specific operations (in any country), to providing resources for a limited number of countries (for any operation) (see Box 1.1 in Annex I).¹
- 1.3 This process culminated during the period of the Eighth Replenishment when, due to its expected lack of concessional resources, only the five poorest countries in the Bank's Group D classification (the D2 countries) were assigned to receive FSO lending:² Bolivia, Guyana, Haiti, Honduras and Nicaragua.
- 1.4 As the country criteria displaced the sectoral and beneficiary criteria, the issue of how to allocate the resources of the FSO became fundamentally a debate about what constitutes a "just" distribution of the Bank's scarce concessional resources. Since the Bank has never engaged in any explicit and meaningful discussion of distributive justice, the problem of allocating FSO resources had to be addressed through alternative processes.
- 1.5 Four different methodological approaches have been used to determine the allocation of FSO resources during the IDB-8 period. Their main characteristics are briefly summarized in the table below.

¹ For accounts of the changes in the FSO see, for instance: GN-2101 (2000), GN-1856-40 (2003), CA-474 (2006), and GN-2442-16 (2009).

² These D2 countries were to receive exclusively FSO lending.

Table 1.1: FSO Allocation Methodologies During IDB-8

Period	Main Elements
1994-2001	FSO allocation determined by population and GNP per capita (needs-based approach).
2002-2006	Portfolio and country performance variables are incorporated to the methodology. Country allocations are determined by a linear formula that assigns more weight to the performance variables than the need ones (performance-based approach)
2007-2008	Country allocations are defined by the same elements as the previous period, but combine linear and exponential formulas. Loans are a blend of FSO and OC resources
2009-2010	Same as above, but country allocations are defined solely by an exponential formula. Final loan amounts continue to be determined by a blend of FSO and OC resources

Sources: RE-279, GN-1856, GN-1856-1, GN-1856-11, GN-1856-31, GN-1856-33, OP-203.

1.6 These modifications in methodology brought major changes to the structure of the Bank’s FSO lending and have generated benefits and reductions to the five Bank members eligible for concessional financing.

A. The 1994-2001 period

1.7 The FSO allocation methodology approved by the Board in 1994 used proxies to reflect the Bank’s two main concerns: a country’s need for concessional funding, and the equity in its distribution. The need issue was seen as best proxied by population: *“population has been considered as an indicator of a country’s estimated needs, in that more resources should go to a larger population.”*³ Even though the equity concern was partially addressed by the decision to limit eligibility to only the poorest countries, a second variable was introduced to measure relative poverty, which was expressed as follows: *“to reflect the principle of equity, it is proposed that more resources be authorized for countries with a lower per capita GNP.”*⁴ The resulting formula incorporated, with equal weights, the population and the GNP per capita of each eligible country (see Annex II).⁵ This approach is usually referred by Bank documents as “needs-based.”

1.8 Concessional resources were allocated by this formula for two-year cycle periods. If the projects approved or categorized as “A” in the pipeline for any given country during the two-year period did not use up the resources assigned to it, the remainder was to be distributed to the other countries. In light of this, it is important to note that the discussions in this chapter refer to the “notional” allocations of FSO resources, and not necessarily to amounts actually approved, which are discussed in the next chapter.

1.9 Table 1.2 displays the population and GNI per capita of the D2 countries eligible to receive FSO lending between 1994 and 2010. As will be shown in the next sections, the differences in these variables among the five countries played an important role in the distribution of resources.

³ “Distribution of FSO resources during the Eighth Replenishment Period,” (GN-1856, November 23, 1994).

⁴ Ibid.

⁵ The methodology was reiterated in GN-1856-1 (1995) and GN-1856-11 (1998).

Table 1.2: Population and GNI Per Capita, FSO Countries: 1994, 2008

Country	Population		GNI Per Capita (US\$)	
	1994	2008	1994	2008
Bolivia	7,315,414	9,684,093	830	1,460
Guyana	757,032	763,437	590	1,420
Haiti	7,689,405	9,780,064	230	660
Honduras	5,438,089	7,241,503	630	1,800
Nicaragua	4,561,169	5,677,771	400	1,080

Source: World Development Indicators.

- 1.10 As expected, given its relatively large population and low income level, Haiti received the largest allocation of FSO resources: its average share of the FSO resources distributed during the 1994-2001 period was approximately 28%. The fact that Guyana’s population is significantly smaller than any of the others had two consequences: it simultaneously generates the smallest share of FSO resources (10% on average between 1994 and 2001), and the largest per capita allocation: on average, more than five times greater than Bolivia, the country to receive the smallest allocation in per capita terms.

B. The 2002 adjustments to the allocation methodology⁶

- 1.11 In 2002 the allocation methodology was changed to introduce performance criteria. The interest in performance was not new, and was driven by three concerns. First, by the practical concern that a country might not actually make use of the resources allocated to it, thus depriving others of access to this scarce resource. Second, by the concern that poor institutional and policy performance might diminish or hamper the developmental impact of the investment. Third, by the concern that the existing criteria provided no incentive structure to encourage countries to improve their economic performance.⁷
- 1.12 The 2002 FSO allocation framework retained many of the features of the old “needs-based” allocation system, but added two new dimensions: one related to portfolio performance, and one related to country institutions and policies – the country institutional and policy performance evaluation (CIPE) indicators – that encompassed the following categories: economic management, structural policies, social inclusion and equity policies, and public sector management and institutions. Both of these new additions were heavily influenced by prevailing practice in other institutions, particularly the World Bank’s International Development Association (IDA). Box 1.2 in Annex I provides a more detailed description of the methodology, and the allocation formulas are shown in Annex II.⁸

⁶ For a more extensive assessment of the criteria for allocating concessional resources please refer to RE-279, from where much of the discussion that follows is based.

⁷ In 2000, Directors asked that the following paragraph be included in Management’s report on the allocation of concessional resources: “Because FSO resources are extremely scarce, it is important that they be allocated in a fashion designed to maximize their developmental impact. The present allocation framework is based on need. However, it is also important to account for the way resources are being used by individual countries. Therefore, Management shall submit a paper no later than September 30, 2000, which examines possible performance criteria that could be integrated into the FSO reallocation framework planned for 2001. In this regard, it is suggested that Management should seek performance indicators that are practical and based on data available to the Bank.” “Fund for Special Operations. Resource Allocation Proposal for the Period 2000-2003. Final Revised Version,” (GN-1856-18, July 10, 2000).

⁸ Box 1.4 in Annex I presents a brief discussion of IDA’s methodology, see also paragraph 1.30.

- 1.13 In 2003, the Directors requested OVE to assess the recently implemented performance-based methodology.⁹ OVE found four elements that were potentially problematic: unintended bias, incentive effects, transparency and objectivity, and developmental relevance (RE-279):
- a. **Unintended bias:** There were unanticipated biases in the distributions produced by the interaction of the various allocative criteria. Most importantly, it was found that there was a potential bias against countries with relatively higher levels of need, for these countries would benefit relatively less from improvements in CIPE scores.
 - b. **Transparency and objectivity:** The CIPE indicators were found to be highly subjective and to not rely on objective data. While the CIPE rankings were arrived at by an internal Bank process where individual subjectivity was checked by peer reviews, this checking was found to be not transparent to those outside of the review group. As a result, CIPE rankings exhibited high collective subjectivity, even though individual subjectivity might have been limited.
 - c. **Incentive effects:** The CIPE methodology distributed resources on the basis of a country's current level of performance, with high scoring countries getting greater allocations. While in theory this was a possible incentive for countries to improve their CIPE scores, this incentive effect was significantly weakened by the CIPE method itself: first, the lack of clarity present in the CIPE ratings process (discussed above), would make difficult a clear understanding of the evaluation criteria to the countries whose allocations were affected by it, thus limiting the possible incentive effects that might have arisen from the use of performance-based allocative criteria; second, to improve its resource allocation, a country must improve its CIPE score relative to all other countries in the pool. If all are improving somewhat, and the CIPE score gap is wide, it may be impossible for a country to improve its relative position over time, thus attenuating the incentive effects; finally, the levels-based approach of the CIPE process discriminated on the basis of circumstances and initial conditions, elements that were beyond the control of a country (e.g. its population).
 - d. **Developmental relevance:** The criteria used to rate country performance were based on inputs (adoption of policies seen as desirable), or efforts, rather than results, or actual performance, thus discarding the measurement of real outcomes in favor of measurement of compliance with current policy orthodoxy.¹⁰ In this sense, the term "performance-based allocation" was in fact an improper misrepresentation of the methodology implemented by the Bank and the other multilaterals.
- 1.14 The following recommendations proposed by OVE were directed at these four areas of concerns:
- a. Analytical work should be done on the interaction among allocative criteria to identify and eliminate any unforeseen and unintended bias among countries.

⁹ "Oversight Note on the Performance Criteria for Allocating Concessional Resources." (RE-279. June 18, 2003).

¹⁰ The policy instruments and institutions used to determine CIPE scores – for example monetary and fiscal policies, trade and commercial policies, institutions for environmental protection, activities in health prevention and social protection, etc. – are inputs to generate (as outputs) lower inflation, lower budget deficits, more exports, less pollution, more people vaccinated, greater access to pre-natal care, etc., and finally outcomes (in terms of higher growth, better income distribution (lower inequality), lower poverty rates, lower morbidity and mortality rates, improved literacy rates, etc.).

- b. Performance indicators should be made more data-based and objective, and the Bank should move towards full transparency in all judgments relating to scores used to influence resource allocation.
 - c. To enhance the incentive effects of the performance criteria, scores on performance variables should move in the direction of greater reliance on within-country changes over time, rather than cross-country level.
 - d. In order to establish a link between the resource allocation formula and the actual development results obtained from past Bank funding in eligible countries, a results-focused performance criteria ought to include data on the results obtained from past Bank projects in eligible countries, not simply data on overall country performance.¹¹
- 1.15 None of the recommendations were implemented, which implies that the main issues identified by RE-279 and summarized in 1.14.a-d are still valid. It should be noted, however, that as this document is being prepared, Management is reviewing its CIPE methodology, which moves in the direction of being more objective and data-driven.

1. Effects of the 2002-2006 allocation methodology

- 1.16 RE-279 had noted that the impact of the new performance-based methodology on the distribution of FSO resources would be considerable and not neutral. And, as the data analysis presented in this paper show, that was indeed the case.
- 1.17 While the introduction of the performance-based criteria reduced the dispersion of the shares allocated to each country (see Chart A-1.1 in Annex III),¹² it simultaneously increased the variation in the average per capita allocation across countries by approximately 86%, when comparing the average of the 1994-2001 period to the average of the 2002-2006 period,¹³ a result that can be largely attributed to the formula's bias to "over-allocate" resources to small population countries.
- 1.18 Thus, the most remarkable effect of the new methodology was the fact that it greatly benefitted Guyana, and negatively impacted Haiti's allocation. Controlling for changes in FSO availability, the new methodology increased the average per capita annual allocation to Guyana by 32% during 2002-2006, and reduced the per capita allocation to Haiti, the Bank's poorest member, by 40%, as shown in Chart 1.1 below.¹⁴

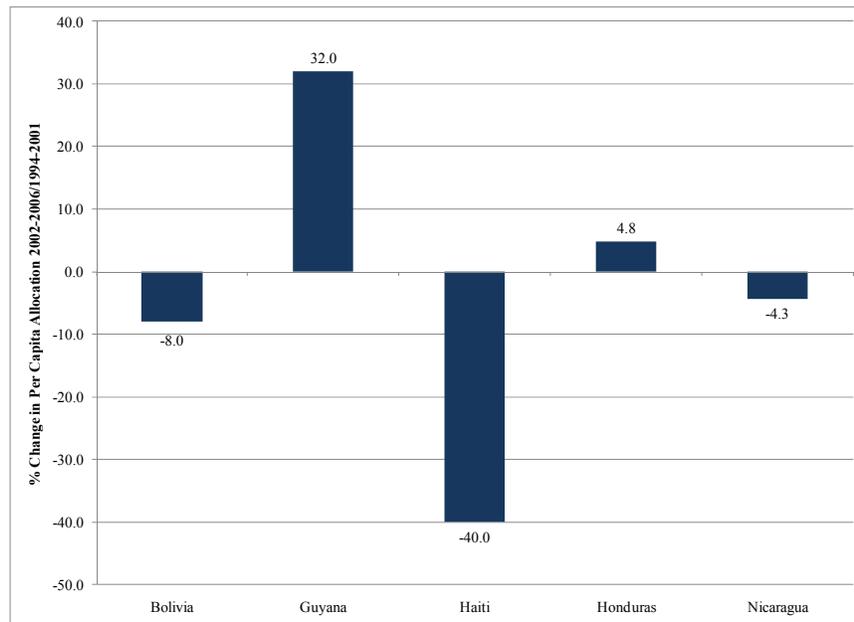
¹¹ In addition to these points, OVE also recommended that Management should consider incorporating elements to compensate for external shocks into the allocation framework, and the analysis of alternative models of distributive justice and their implications for resource allocation in its future methodological revisions.

¹² The difference between the country with the highest share of FSO resources and the country with the smallest share was reduced from approximately 174%, on average, during the 1994-2001 period, to an average of 66% during the period in which the performance-based methodology introduced in 2002 was in effect (2002-2006).

¹³ The percentage difference between the countries with the highest and lowest per capita allocations, increases from approximately 414% for the average of the 1994-2001 period, to 768% for the average of the 2002-2006 period.

¹⁴ When controlling for FSO availability, i.e. assuming a constant annual amount of concessional resources for the entire 1994-2006 period, the new performance-based methodology represented an average increase of 32% in the per capita allocation to Guyana during the 2002-2006, when compared to the average per capita allocation of the 1994-2001 period. Conversely, the methodology reduced the average per capita allocation to Haiti by 40%.

**Chart 1.1: % Change in Per Capita Allocation of FSO Resources
2002-2006 Average in Relation to 1994-2001 Average**



Source: OVE estimates based on data from CC-5325; GN-1856-11; GN-1856-18; GN-1856-33; GN-1856-43; GN-1856-48.

1.19 In summary, the data available show that the performance-based formula tended to “over-allocate” to countries with small populations and, most importantly, that the methodology had unintended bias against higher need countries, thus corroborating OVE’s findings in RE-279: not only the Region’s poorest country suffered the greatest negative impact, but also Bolivia (the most populous country) had the second greatest reduction in per capita allocation, and Nicaragua, the second poorest country, is the only country, other than Haiti, to observe reductions in per capita allocation in every year between 2002 and 2006 (Chart A-1.2 in Annex III), despite improvements in performance throughout the entire period.

C. The 2007-2010 allocation methodology

1.20 The process of analysis and discussion that led to the development of the next resource allocation methodology was a long one. It actually began in 2003 when the Board, prompted by OVE’s findings and recommendations presented in RE-279, requested a review of the Bank’s performance-based allocation system. In June of 2004 Management presented document GN-2314 containing a series of recommendations:¹⁵

- a. **Regarding the allocation formula:** the document made a strong argument for the maintenance of a linear formula, instead of replacing it with an exponential framework such as the one used by other multilaterals, particularly IDA: *“the [linear] formula’s main advantage, partly because of its clarity and simplicity, is that it reflects the intent of the Bank’s Board better than a[n] [exponential] formula that is difficult to grasp intuitively. Transparency and clarity are the cornerstones of the*

¹⁵ “Adjustments to the Methodology for the Allocation of Concessional Resources” (June 4, 2004). The analysis was supported by a study conducted by an external consultant.

Bank's concessional resource allocation methodology. The easier the formula is to understand, the more clearly its incentives and rationale are communicated to the eligible countries" (paragraph 2.8).

- b. **Regarding transparency:** as can be seen from above, Management seemed to recognize the importance of clarity and transparency in a performance-based scheme, as argued by OVE in RE-279. In fact, paragraph 2.10 essentially reproduced OVE's position: "*Disclosure of information about the concessional resource allocation system is important to its general credibility with member countries, and also important to the objective of providing an incentive to borrowers to improve their performance. Allocation results that are not clearly known and understood are hardly likely to lead to positive changes in performance.*"
- It appears however, that much of the emphasis on transparency remained at the discourse level. Despite the strong statements, the proposal that emerged in the document was a timid recommendation to disclose only the intermediate scores that comprise the overall CIPE rating – rather than the judgments that have determined country scores – for fear of the impact that greater transparency might have on public opinion and the financial community.¹⁶ The mere disclosure of intermediate CIPE scores, however, would maintain countries' performance assessment unclear, for it would not address the main transparency issue that exists in the performance-based methodology – it is the lack of clarity in the CIPE ratings process itself that makes difficult a clear understanding of the evaluation criteria – and therefore it is "*hardly likely to lead to positive changes in performance,*" as intended. Furthermore, it is hard to see how an economic argument could be sustained in favor of vagueness and lack of clarity.
- c. **Regarding the methodology's biases:** while the study recognized the bias present in the formula in favor of small population countries, thus recommending an "*increase to 75% [in] the weight assigned to population and correspondingly decrease to 25% the weight assigned to income per capita*" (paragraph 3.7), it did not discuss or assess the impact, if any, that such change would have on the anti higher-need country bias identified in RE-279. In fact, from the algebraic demonstrations presented by OVE in that document it can be seen that this proposed change would not solve this problem.
- d. **Regarding the performance variables:** the document recommended that the methodologies used to determine portfolio performance and countries' policy and institutional performance continue without modification. This means that Management would not be addressing the developmental relevance critique made by OVE that the criteria used to rate performance were based on inputs or efforts, rather than results (outcomes) (see paragraph 1.13(d) and footnote 10).
- e. **Regarding change in performance:** as already noted in the previous section, the document's proposal to introduce a variable measuring change in performance, which would capture one of OVE's recommendations, was never implemented.¹⁷

¹⁶ GN-2314, paragraph 2.10: "*the borrowing countries, whose policy/institutional performances are scored, are sensitive to public opinion and to the opinion of the financial community that might be influenced by the ratings.*"

¹⁷ In addition to these points, the document recommends that the allocation process continues to be bi-annual and that the use of the debt service ratio variable be removed from the IFF methodology.

- 1.21 Document GN-2314 prompted a series of questions from the Board over a period of more than 15 months after it was first discussed, i.e. until September 2005.¹⁸ Many, if not most, of these questions were related to “*Management’s recommendation to continue using the linear formula vs. the exponential formula preferred by other MDBs.*”¹⁹ Management’s defense of its proposal was presented in strong terms and rested on the main argument that the other multilaterals that used an exponential formula had other mechanisms to determine country allocation, particularly pre-allocations, since “*the amount allocated by the exponential formula alone would not be sufficient to maintain a lending program in small-population countries,*”²⁰ while the Bank’s allocation of concessional resources was determined exclusively by its performance-based formula. Thus, according to Management, a “*comparison of the two formulas as stand-alone drivers of final country allocations, while illustrative from a technical standpoint, does not present a fair assessment of the suitability of either formula to the IDB — since the IDB would have to adopt a pre-allocation system to sustain a program with its smaller population countries as well.*”^{21, 22}
- 1.22 While these debates were taking place, a new debt relief initiative emerged that drastically changed the nature of the discussions regarding concessional financing.
- 1.23 In mid-2005, the G8 countries proposed a new debt relief initiative with the aim of helping the so called Heavily Indebted Poor Countries (HIPC) reach the Millennium Development Goals (MDGs). This initiative involved the International Monetary Fund (IMF), IDA and the African Development Bank (AfDB), and was termed Multilateral Debt Relief Initiative (MDRI).²³
- 1.24 As the IDB was not originally envisioned to participate in the MDRI, no financial provisions or financing commitments had been made by the Bank. However, because “*certain IDB members requested that the Administration consider a proposal for the IDB’s provision of further debt relief to the IDB’s four HIPC-eligible countries and to Haiti,*”²⁴ the Bank began to assess the implication of its involvement in the MDRI.²⁵ It was found that the present value of the debt relief initiative, if applied to all five Bank countries, could amount to approximately US\$ 4 billion, to be financed in its entirety

¹⁸ See GN-2314-1, GN-2314-2, GN-2314-3, and GN-2314-4. The latter of this series of documents was discussed on September 26, 2005, while GN-2314 was discussed on June 4, 2004.

¹⁹ “Adjustments to the Methodology for the Allocation of Concessional Resources (Documents GN-2314 and GN-2314-1). Questions Presented by the Members of the Programming Committee of the Board of Executive Directors” (GN-2314-3. September 7, 2005).

²⁰ GN-2314-3, paragraph 2.

²¹ Ibid., paragraph 3.

²² Management also argued that the exponential formula could produce larger differentials in cross-country allocations due to changes in performance (GN-2314-3, paragraphs 1.3-1.5).

²³ In contrast with the “HIPC Initiative” of 1996 and the “Enhanced HIPC Initiative” of 1999, that involved all multilateral, official bilateral and commercial creditors, the MDRI was restricted to multilateral institutions.

²⁴ “Analysis of the Financial, Operational and Legal Considerations Related to a Debt Relief and Concessional Resource Proposal” (GN-2402. February 16, 2006). The four HIPC-eligible countries were Bolivia, Guyana, Honduras and Nicaragua. It was also thought that the exclusion of the Bank, and the other regional multilaterals, from the MDRI would put the Latin American and Caribbean countries at a disadvantage relative to the African countries, considering that the Bank was the main multilateral creditor of the these countries. In this sense, an “equitable” treatment of all HIPC countries would require the Bank’s participation in the MDRI (see “G8 Proposals for Extended Debt Relief: Implications for the IDB.” CS-3655, September 21, 2005).

²⁵ See CS-3655, CS-3675, GN-2402, GN-2402-1, and GN-2402-2.

from internal FSO resources.²⁶ Given the already constrained financial conditions of the FSO (see Box 1.3 in Annex I), the IDB's participation in another debt cancellation initiative (which was termed IDB-07 Relief) "*would require the Bank to restructure the manner in which concessional lending would be provided in the future*"²⁷.

- 1.25 The solution encountered to address the additional limitations imposed by the MDRI on the Bank's concessional resources was the implementation of a "parallel" or "blended" lending structure. In this scheme, the lower level of FSO financing is complemented with Ordinary Capital (OC) resources.²⁸ This arrangement would allow the Bank's concessional window to operate without a financial gap until 2015.²⁹ The proposed resolution that emerged from the November 2006 meeting of the Committee of the Board of Governors³⁰ established the general conditions for debt relief, and in relation to concessional resources it confirmed the parallel lending mechanism and called for "*measures to strengthen the FSO and IFF performance-based allocation systems*."³¹
- 1.26 The current allocation framework is the result of these instructions and consists of two basic elements aimed at combining "*financial conditions and lending levels consistent with the countries' borrowing capacity and absorption constraints*"³²: (i) the adoption of the debt sustainability framework (DSF) developed by the World Bank and the IMF as part of the MDRI; and (ii) an "enhanced performance-based allocation" (EPBA) formula.
- 1.27 The DSF functions as a coordination mechanism between the multilateral institutions, and aims at reducing the risk of debt distress through debt assessments and the definition of borrowing and lending strategies that are consistent with the countries absorption capacity.³³
- 1.28 In this new framework, the debt distress assessment defines a country's degree of concessionality – i.e. the FSO/OC ratio for the parallel or blended lending – with countries with higher risk of debt distress receiving higher levels of concessionality;³⁴

²⁶ It is well beyond the scope of this document to analyze the Bank's debt relief initiatives. The present discussion focuses on the relationship and impact of the debt relief initiatives on the FSO.

²⁷ GN-2402, paragraph 3.8.

²⁸ "*The IDB designed the parallel lending proposal to allow for maximum debt relief while ensuring the financial sustainability of the concessional window.*" "Implementation of Multilateral Debt Relief and Concessional Finance Reform at the IDB. Proposal for the Implementation of a Debt Sustainability (DSF) and Enhanced Performance-Based Allocation (PBA) Framework." GN-2442. February 7, 2007.

²⁹ The main elements of the new financing modality were discussed and defined throughout 2006 and early 2007 in the following documents: GN-2402, GN-2402-1, GN-2402-2, CA-474, CA-474-1, CA-474-2, CA-474-3, CA-474-4, AB-2504, AG-09/06, AB-2508, AB-2508-1.

³⁰ "Agreement on the Bank's Concessional Resources." AB-2504. November 22, 2006.

³¹ AB-2504, paragraph 3(f).

³² GN-2442. This is the main document produced by Management that details the new allocation framework.

³³ The DSF debt distress assessment uses "*(i) indicative thresholds to benchmark external debt-burden indicators and (ii) Debt Sustainability Analysis (DSA) and associated stress tests*" to assess a country's vulnerability to shocks. GN-2442, paragraph 18.

³⁴ Within the DSF, the risk of debt distress is classified in three categories: low ("*all debt indicators are well below the relevant indicative thresholds. Alternative scenarios and stress tests do not result in indicators significantly breaching thresholds*"); moderate ("*the baseline scenario does not indicate a breach of thresholds. Alternative scenarios and stress tests show a substantial rise in the debt service ratio over the projection period. As a consequence, the debt service ratio may reach its indicative threshold, while debt stock ratios may breach them*"); and high ("*the baseline scenario indicates a breach of debt stock and/or service ratios over the projection period. This is exacerbated by the alternative scenarios/stress tests*"). All quotes from GN-2442, paragraph 22.

while the EPBA formula defines the level of lending, with better performing countries receiving more resources. These two components delineate the lending matrix:

Table 1.3: FSO Lending Matrix 2007-2010

Debt Risk	Enhanced Performance-Based Allocation		
	Strong	Medium	Weak
Low e.g. Bolivia and Honduras	Low concessionality High lending	Low concessionality Medium lending	Low concessionality Low lending
Moderate e.g. Guyana and Nicaragua	Moderate concessionality High lending	Moderate concessionality Medium lending	Moderate concessionality Low lending
High e.g. Haiti	High concessionality High lending	High concessionality Medium lending	High concessionality Low lending

Source: GN-2442.

- 1.29 The 2007-2010 debt analyses have classified Bolivia and Honduras as countries with low-risk of debt distress, thus defining a lending structure composed of 30% of FSO and 70% of OC resources; Guyana and Nicaragua were classified as moderate debt risk countries, thus accessing a lending structure with higher level of concessionality (50% FSO/50% OC). Haiti’s particular circumstances and high risk of debt distress have led the Bank to assign only grant financing during the entire 2007-2010 period.³⁵
- 1.30 The EPBA formula contains the same elements as the 2002-2006 framework – (i) population (as a proxy for overall need); (ii) GNI per capita (as a proxy for economic strength); (iii) portfolio performance (as an indicator of the country’s disbursement capacity); and (iv) CIPE scores (as indicator of the quality of the country’s institutional and economic policies) – but adopts an exponential specification (instead of the linear formula introduced in 2002) – similar to the one then used by IDA and the other multilaterals – to determine the allocation of resources. The equations defined by EPBA methodology are presented in Annex II, and Box 1.4 in Annex I presents a summary of IDA’s methodology.
- 1.31 In line with the principle that the new performance-based allocation mechanism should “*strengthen the link between country performance and the allocation of concessional resources,*”³⁶ the exponential formula raises the country performance indicator – the weighted combination of portfolio performance (30% weight) and CIPE score (70% weight) – to the power of two, thus assigning to it a more than proportional impact in the allocation of FSO resources. The country’s income per capita, on the other hand, enters in the formula as its inverse, i.e. it is raised to the power of minus one, thus privileging poorer countries, but in a nonlinear manner; while the country’s population has a less than proportional impact in the allocation of resources, as it is raised to the power of one-half.

³⁵ In the DSF/EPBA framework, the IFF mechanism of interest-rate subsidies was substituted for a blending of FSO (20%) and OC (80%) resources. During 2007 and 2008, Ecuador, El Salvador, Guatemala, Paraguay and Suriname were eligible to receive FSO resources and were allocated an annual (total) amount of US\$50 million. Only Guatemala and Paraguay were designated FSO-eligible among the C and D1 countries during 2009 and 2010.

³⁶ “Implementing Multilateral Debt Relief and Concessional Finance Reform at the Inter-American Development Bank.” CA-474-2. December 22, 2006.

1.32 The new framework also ends with the carry-overs and reallocations within the two-year period in which FSO allocations are programmed. This measure implies that the FSO resources that are not programmed and approved by year's end are "lost" and return to the overall FSO pool, and aims at eliminating "*the notion of historic entitlements.*"³⁷ Although the latter might be considered correct in its intent, it may generate the "perverse incentive" of further inducing project approval in order to exhaust the concessional resources allocated for the year (see the next chapter).

1. The justification for the exponential formula

1.33 The adoption of the exponential formula means that the Bank decided in 2007 to go against its own recommendation made a few years earlier in GN-2314 (see paragraphs 1.20 and 1.21). However, Management does not seem to be able to present convincing arguments to justify the change in the formula.

1.34 In fact, it is quite interesting to note that the main arguments of simplicity and clarity that were used in 2004 to justify the preference for a linear equation against an exponential specification, are used three years later to support the exponential formula: "*This [exponential] formula has several advantages, namely, it is transparent, simple and appropriate to include country performance as one of the main criteria to allocate concessional resources.*"³⁸ Even though the formula in itself may be considered simple and transparent, its interpretation, particularly regarding changes in FSO allocation shares brought by variations in the elements of the formula, is not intuitive and may be difficult to interpret or isolate.³⁹ In this sense, the transparency problem noted by OVE in RE-279 may have actually increased.

1.35 Management also claims that the new performance-based formula would: (a) provide access to higher levels of lending based on risk and performance criteria; (b) create incentives to reduce debt risks and strengthen performance in order to access more resources; and (c) allow the Bank to increase the size of the overall lending program based on performance and debt-carrying capacity.⁴⁰ All these assertions are true due to the introduction of debt risk elements into the Bank's FSO allocation framework, but there is nothing in them that relates specifically to the exponential formula, in fact they would also apply had the Bank kept the linear specification.

1.36 Finally, it must be noted that the Bank has never explained how the exponents in the formula were derived, i.e. it has not presented a justification for the chosen parameters. In this sense, the Bank has never demonstrated that this particular specification provides the best or "more just" distribution of its concessional resources. It is interesting to note

³⁷ GN-2442, paragraph 40.

³⁸ GN-2442, paragraph 34.

³⁹ It must be remembered that two steps are required to determine each country's allocation of FSO shares (see the description of the formula in Annex II): the allocation number is calculated first, and then a country's allocation share is determined by the relative value of its allocation number in relation to those of the other countries. Thus for example, while each 1% increase in performance generates a 2.01% increase in the allocation number (using the countries' parameters for 2007-2008), this entire change does not get necessarily translated into increases in a country's share of FSO resources. This will depend on all the elements of the formula: the value of the need parameters, i.e. GNI per capita and population, as will be shown in the next subsection; and the absolute value of the performance score in itself, for the impact that improvements in performance has on a country's share decreases as the performance score gets higher.

⁴⁰ GN-2442, paragraph 40.

that while the Bank was implementing its exponential formula, IDA was changing its methodology. This included an increase in the performance exponent from 2 to 5, in order to maintain constant the dispersion of IDA's resources, a concern that does not seem to have been part of the Bank's agenda, as it will be seen below.

2. Effects of the 2007-2010 allocation methodology

a) Effects of the exponential formula

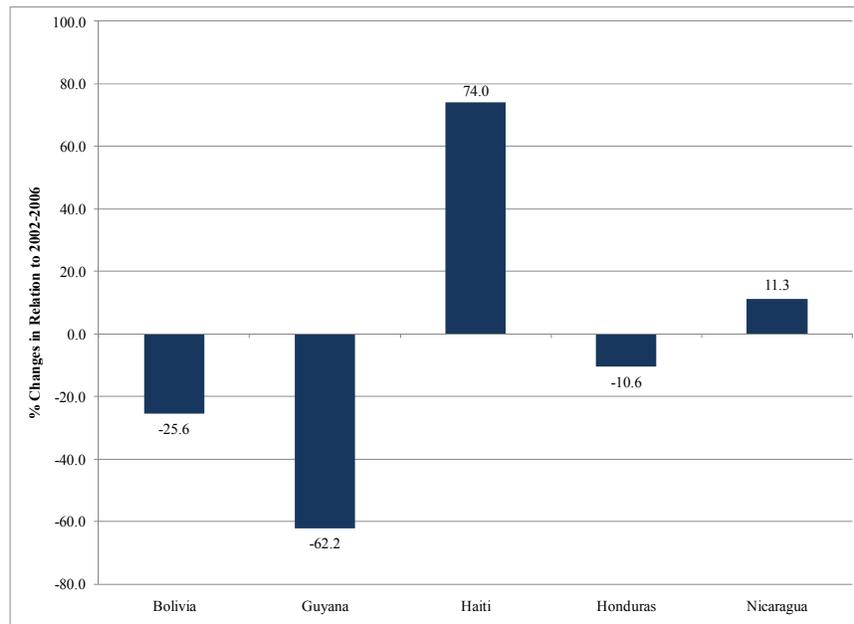
- 1.37 As the reader will note, the discussion that follows maintain Haiti as part of the analysis, despite the fact that the resources allocated to the country during the 2007-2010 period were not defined by the allocation formula. The decision to include Haiti was made because the country was considered an FSO beneficiary when the 2007 methodology was conceived.⁴¹ Moreover, the inclusion of Haiti allows for comparisons between all the allocation methodologies adopted by the Bank during IDB-8.
- 1.38 In order to ensure a thorough analysis, OVE has re-estimated the allocation results for the entire 1994-2010 period without Haiti. We found that, unless otherwise noted, the main conclusions discussed below remain valid. The charts that correspond to the ones discussed in the remaining of this chapter, but display the data without Haiti, are presented in Annex IV. These graphs replicate the same numbering structure presented in the next paragraphs.
- 1.39 In order to better understand the effects of the new methodology, OVE has in its calculations and simulations isolated the impact of the exponential formula from the blending of FSO and OC resources. The analysis shows that if the exponential formula were to be applied by itself – i.e. without the use of the different lending structures defined by the debt distress analysis – the major changes made by the 2002 linear formula in the distribution of FSO resources would be reversed, i.e. the exponential formula would have benefited Haiti and negatively affected Guyana.⁴² The exponential formula would raise Haiti's share of FSO resources by an average of 74% during 2007-2010, relative to the average of the preceding period (2002-2006), and would reduce Guyana's share by 62% (Chart 1.2, below).⁴³

⁴¹ For instance, in GN-2442, Haiti's case is viewed as the result of "special circumstances." "*Haiti would receive initially grants given its high risk of debt distress*" (GN-2442 paragraph 28, emphasis added). Haiti was expected to be able to receive a mix of grants and FSO loans after 2009 ("Multilateral Debt Relief and Concessional Finance Reform at the Inter-American Development Bank." AB-2508, January 30, 2007).

⁴² As noted before, because Haiti was assigned fixed grant amounts for the 2007-2010 period, it was not part of the Bank's calculations during the estimation of FSO shares for those years. In order to obtain consistent series for inter-temporal comparisons, OVE has re-estimated the entire 1994-2010 series with actual parameters, creating two different sets of data: one with Haiti in the entire period, and another excluding Haiti. During the 2007-2010 period, we have classified Haiti as a high-risk country for debt distress, thus assigning it only FSO resources.

⁴³ Similar impacts are seen in terms of average per capita allocation: Haiti's is increased by approximately 71%, and Guyana's is reduced by 62%.

**Chart 1.2: % Change in the Allocation of FSO Shares
2007-2010 Exponential Formula Average in Relation to 2002-2006 Average**



Source: OVE estimates based on data from GN-1856-33; GN-1856-43; GN-1856-48; GN-2442-16; GN-2442-20.

Note: 2007-2010 data refer to results derived from the use of the exponential formula by itself, i.e. they do not include the blending of FSO and OC resources.

- 1.40 The significant negative effect on the allocation of FSO resources to Guyana was to be expected, and is due to its small population size. In fact, as already discussed (see paragraph 1.21), this potential impact was noted in 2004 in GN-2314 and was then used as part of the justification for the maintenance of the linear formula. Thus, even though never explicitly stated, the impact of the new allocation formula on Guyana was likely to have been the major driving force for the adoption of a transition period in the allocation methodology during 2007 and 2008: in these two years, the previous linear allocation framework was applied to half of the FSO resources available, and the exponential formula to the other half “[to] smooth out and contain the volatility deriving from a complete shift in the allocation system.”⁴⁴ The combination of both formulas during the transition period indeed smoothes the reduction in Guyana’s share of the FSO allocation: from the 62% that would result from the application of the exponential formula alone, to approximately 30%.
- 1.41 The increase in Haiti’s share is explained by the combination of its larger population and (particularly) lower income per capita. It is interesting, however, that despite Haiti’s low performance scores – it had the lowest performance scores in every year since 2002 – the new exponential formula, which was supposed to be better aligned with country performance almost doubles Haiti’s share of FSO resources. This result can be explained by the fact that the differences in performance scores across countries (even when these

⁴⁴ GN-2442, paragraph 41.

scores are squared), are not as large as the differences that exist between relative population sizes and relative levels of income per capita.⁴⁵

- 1.42 These impacts on Haiti and Guyana would also cause a significant increase in the dispersion of the FSO shares (Chart A-1.3 in Annex III). In fact the exponential specification creates the largest “range” of FSO shares of all the three formulas that have been adopted by the Bank, as it is clear in Chart A-1.4 in Annex III, which displays the evolution of the countries’ shares throughout the entire 1994-2010 period.⁴⁶
- 1.43 It must be noted, however, that the new formula has the opposite effect on the dispersion of the per capita allocation of FSO resources. While the range is still very large – during 2007-2010, the percentage difference between the country with the highest per capita allocation and the country with the lowest was, on average, 307% – it is the closest distribution of FSO resources in per capita terms of the three formulas that have been used by the Bank.^{47, 48}
- 1.44 While Bank member countries might be concerned with the distribution of shares and the resulting per capita allocation of FSO resources generated by any given methodology, they might also be concerned with the impact that the different methodologies could have on the relative position of the beneficiary countries. In this respect, the following main results can be observed (see Charts A-1.5 and A-1.6 in Annex III):⁴⁹
- a. despite the fact that the different methodologies have had significant impacts on the allocation of FSO resources to Guyana, the country ranks last in all three methodological frameworks in terms of the size of its share, and first in terms of per capita allocation. Both results are explained by the very small size of its population in relation to the other FSO countries.
 - b. Nicaragua’s relative position also remains stable: all three methodologies would allot to Nicaragua the second highest share and per capita allocation of FSO resources.
 - c. While the exponential formula would benefit Haiti (because of its lower income per capita and larger population size), it would also worsen the relative positions of Bolivia and Honduras.⁵⁰ The negative impact on Bolivia can be explained by its

⁴⁵ It must be remembered that a country’s share is defined by its allocation number in relation to that of all the others. Haiti’s population is the second largest among the FSO countries, and because population values are square rooted, its difference from Bolivia (the most populous country) is substantially reduced. Also, the inverse of Haiti’s GNI per capita, is three times larger than Honduras’ (the country with the highest GNI per capita), and also significantly greater than any of the others. On the other hand, the ratio between the squared performance scores of Honduras and Haiti (the largest and the smallest, respectively) is only 1.8.

⁴⁶ While there is nothing intrinsically problematic in having large dispersions in the allocation of FSO resources, the methodological changes that have occurred through time have generated significant variations in the range in which FSO shares are distributed, and these changes might be of concern to Bank member countries.

⁴⁷ The 2007-2010 (average) dispersion of the per capita allocation of FSO resources is 60% smaller than the average dispersion of the previous period. This difference is also 25% smaller than the average for the period between 1994 and 2001. These results are due to the very large negative impact that the exponential formula has on Guyana.

⁴⁸ It is interesting to note that, once again, the effects introduced by the exponential formula go in the opposite direction of those generated by the linear performance-based framework introduced in 2002: as discussed in paragraph 1.17, the linear formula had decreased the dispersion of shares and increased the dispersion of the per capita allocation of FSO resources.

⁴⁹ The comparisons refer to the averages for each of the three periods defined by the methodological adjustments that have taken place during the period of analysis: 1994-2001, 2002-2006, and 2007-2010.

⁵⁰ Without Haiti in the series, the worsening in the ranking of Bolivia and Honduras only occurs in terms of share size and not in per capita terms (see Charts A-1.5A and A-1.6A in Annex IV).

relatively high GNI per capita and relatively low performance scores (Bolivia presents the second worst performance scores during the entire 2007-2010 period). The case of Honduras, however, is more difficult to understand, for even though the country has the largest GNI per capita, it has a relatively large population, and had the best performance scores in every year between 2007 and 2010. The negative impact of the exponential formula on Honduras' relative position might be the result of the fact that the differences in country performance scores, even when squared, are not very large (as discussed in footnote 45). It should be stressed, however, that it is surprising to see Honduras' ranking worsen with the implementation of a specification that was supposed to be clearly rewarding country performance.

- 1.45 The fact that the use of the exponential formula would generate a significant increase in Haiti's shares (paragraph 1.41), the country with the lowest performance scores, and worsen the relative ranking of Honduras, the country with the best performance scores, suggests that the formula, in its present specification, is not effectively emphasizing country performance. An even higher exponent for the performance indicator would be required to compensate for the large differences that exist in population and income per capita. However, the subjectivity and lack of transparency that exist in the determination of the performance scores noted in RE-279 and again in this evaluation, combined with the fact that this would further reduce the importance of the more objective needs-related variables, caution against such measure.

b) Unintended bias

- 1.46 OVE has found that the exponential formula contains an unintended bias against higher-need countries similar to the one observed in the linear specification: holding everything else constant, improvements in performance result in relatively smaller percentage increases in the share of lower income and/or larger population countries than they would in richer or less populous countries.
- 1.47 These results appear in simulations using actual data from the five FSO countries, and are demonstrated algebraically in Annex V, where it is shown that for equal improvements in performance:
- a. A country with a smaller population and higher per capita income, i.e. a lower-need country, would have a greater percentage increase in its FSO share than a higher-need country (i.e. a country with a larger population and lower per capita income).
 - b. A country with a higher per capita income would see a greater percentage increase in its share than a poorer country with the same population size.
 - c. A small population country would observe a larger percentage increase in its FSO share than one with a larger population and same level of income.⁵¹
- 1.48 The explanation for these outcomes lies in the fact that the formula's static results are different from its dynamic effects. While the formula does assign larger shares for lower income or larger population countries, because it presents decreasing marginal returns in all of its elements, share increases decline as the formula components increase.

⁵¹ The comparison of a country with a larger population and higher income with a country with a smaller population and lower income, does not provide an unambiguous result.

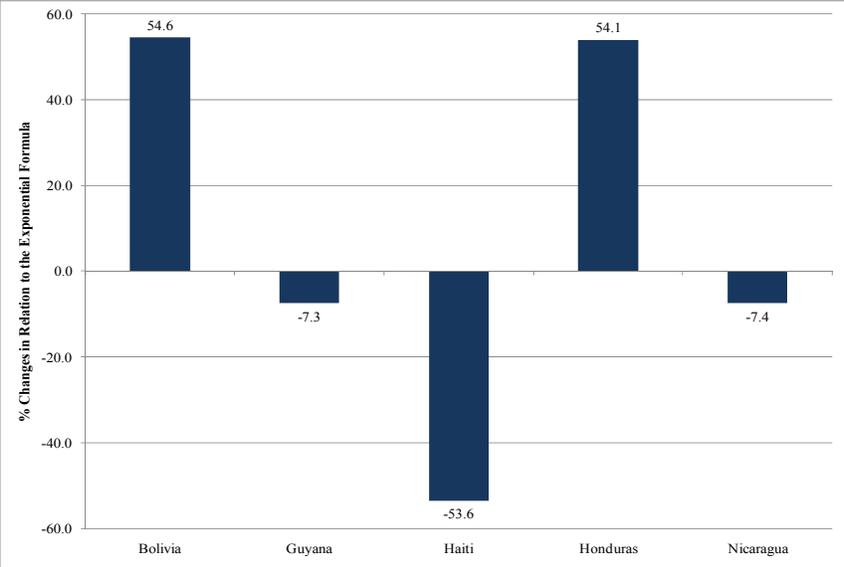
1.49 This characteristic conflicts with the framework’s intended goal of providing an incentive for improvements in performance, and penalizes countries for characteristics that are inherent and/or cannot be changed in the short to medium term, i.e. their relative population size and per capita income. These results reinforce OVE’s recommendation presented in RE-279 that the Bank should consider variables that incorporate within-country changes over time into its allocation methodology.

c) The effect of blending FSO and OC resources

1.50 In this subsection we analyze the effects of adopting the full DSF/EPBA framework by incorporating the blending of FSO and OC resources to the allocation results generated by the exponential formula. The designation of different proportions of FSO and OC resources according to a country’s debt risk has significant impacts on the allocation of concessional resources. As expected, a country’s final allocation share will increase as it has more access to the Bank’s Ordinary Capital, since the constraint imposed by the very limited availability of FSO resources observed since 2007 is reduced.

1.51 In this sense, Bolivia and Honduras, with blending ratios of 30% FSO and 70% OC – a result of their better debt risk profile – have their shares (now considering FSO and OC resources) increased by more than 54% in relation to what they would have been assigned by the exponential formula alone. Haiti, if it were to be part of the allocation exercise, would be on the other extreme, its shares of concessional resources would be almost 54% smaller than the exponential formula would have dictated: a result of the fact that it would be funded exclusively with FSO resources.⁵² Guyana and Nicaragua also see their shares decline because of their lower access to OC resources, but to a smaller extent (Chart 1.3 below). A similar pattern occurs in terms of the per capita allocation.

Chart 1.3: % Change in the Allocation of Shares (FSO and OC): 2007-2010 Full DSF/EPBA Framework in Relation to Exponential Formula Alone



Source: OVE estimates based on data from GN-2442-16; GN-2442-20.

⁵² These results do not incorporate the transition formula of 2007-2008, but rather simulates the use of the blending structure throughout the entire 2007-2010 period. They also incorporate Haiti.

- 1.52 In fact, in terms of access to funding, Honduras is the country that benefits the most with the adoption of the full DSF/EPBA framework. Not only it obtains the greatest increases in shares during 2007-2010 – whether in comparison to the average of the 1994-2001 need-based framework, or to the average of the 2002-2006 linear specification – but it is also the only country to see increases in its average per capita allocation relative to the other two methodologies (Charts A-1.7 and A-1.8 in Annex III).
- 1.53 These results imply that the introduction of the blending structure also brings significant shifts in the ranking of the countries in terms of shares allocated. As expected, the ranking of Honduras improves: while the exponential formula alone would assign it the third largest share of resources, with the introduction of the blending of FSO and OC resources, Honduras becomes the country to receive the largest share of resources. Haiti, on the other hand, moves from being the country to be allocated the largest share of concessional resources according to the exponential formula, to receiving the second smallest share. The case of Guyana is interesting, for the fact that its debt risk is moderate – which implies doubling the FSO allocation with an equal share of OC resources – is not enough to counterbalance the impact of its small population size on resource allocation: Guyana remains the country to receive the smallest share of concessional resources (Chart A-1.9 in Annex III). It must be noted, however, that Guyana continues to have the largest per capita allocation of concessional resources, but the DSF/EPBA framework reduces this amount by approximately 7% in relation to the allocation that would result from the adoption of the exponential formula alone.
- 1.54 Finally, it is worth mentioning that, despite the changes noted above, the blending structure does not significantly affect the dispersion of the shares and of the per capita allocation. In comparison to the results derived from the adoption of the exponential formula, the additional introduction of the parallel blending structure increases the dispersion of the shares designated for the countries by 3% and reduces the dispersion of the per capita allocation of concessional resources by approximately 7%.

d) (Lack of) transparency and subjectivity

- 1.55 OVE has called attention in RE-279, and reiterated in this evaluation, to the fact that the process that leads to the definition of country performance ratings lacks transparency and is marked by a high degree of subjectivity. This critique was corroborated in the previous document by the large differences that existed between the IDB and IDA regarding the policy and institutional performance classification of the five Bank member countries.⁵³ This problem seems to persist: the data available for 2005-2008 indicate that CIPE scores are in 90% of the cases lower than IDA's, and in 12 of the 20 observations the percentage difference is of two digits, ranging from 10% to 26%. In absolute terms the difference reaches 0.73, in a 1-6 scale. The significance of these disparities can be seen from the fact that if the CIPE scores were to be applied in the IDA context, Bolivia would move from the second quintile of performance, i.e. being among the 40% best countries, to the fourth quintile, and Guyana from the second or third quintile, to being amongst the 20% of the IDA countries with worst performance scores.

⁵³ RE-279 paragraph 3.12.

D. On the distributive characteristics of the allocation methodologies

- 1.56 In an attempt to capture some of the distributive characteristics of the different methodologies employed by the Bank since 1994, OVE has constructed concentration curves and concentration indexes based on the three elements that determine the Bank's allocation of FSO resources: per capita income, population, and country performance (see Charts A-1.10-A.1.12 in Annex III. Box 1.5 in Annex I provides further explanation of these curves).
- 1.57 The following general results can be observed from the data in the charts: the needs-based formula indeed presents a distributive pattern that tends to be "pro-poor" and "pro-large populations,"⁵⁴ the same could be said with respect to the exponential formula if it were to be implemented alone, for the introduction of the blended lending structure, i.e. the adoption of the full DSF/EPBA methodology,⁵⁵ has generated the opposite distributive impact: it has "privileged" the less poor and not-so-populous FSO countries. On the other hand, the full DSF/EPBA methodology has produced a distribution of resources that favors countries with higher performance scores (as performance is defined in the FSO allocation context). Finally, it is interesting to note that the linear formula has provided a more performance-consistent distribution of shares than the exponential formula.

II. LENDING

A. Magnitude and utilization of FSO Resources

- 2.1 Between 1994 and 2009, the Bank approved 276 projects financed with concessional resources to the five FSO countries, totaling US\$7.3 billion (or US\$8.9 billion in real terms).⁵⁶ These figures correspond to 23% of the number and 6% of the total amount approved by the Bank during the same period,⁵⁷ and show that the average FSO loan is approximately 26.5% of the size of the average Bank operation.⁵⁸
- 2.2 Project approval data also show that the IDB is the major source of concessional financing to the five poorest Bank member countries. Between 1994 and 2009 IDA

⁵⁴ Two curves lie above the equality line in Chart A-1.10: with a concentration index of -0.14, the one farther above the line is the concentration curve that would be generated by the exponential formula without the blended lending structure; the other curve is, as expected, the one showing the average allocation of the needs-based formula of the 1994-2001 period (concentration index of -0.09). It is interesting to see that the adoption of the full DSF/EPBA framework, i.e. adding the blended lending structure, shifts the concentration curve to below the equality line, thus generating a concentration index of 0.14, indicating that this methodology has "privileged" the richer countries. The linear performance-based formula shows a distribution that is generally close to the equality line, which is reflected in a concentration index close to zero (0.03). When countries are ordered by population size, from more populous to less populous in order to reflect the concept of need, as in Chart A-1.11, we see that even though all curves tend to lie above the equality line – thus the four negative concentration indexes – only the need and exponential methodologies have a significant distributive effect towards the countries with larger population (those ranked as 1 and 2 in the chart), while the full DSF/EPBA framework, in particular, has had a bias towards less populous countries.

⁵⁵ It must be remembered that the full DSF/EPBA curve is essentially the exponential curve plus the blended lending structure.

⁵⁶ In US dollars of 2009, adjusted by the US Consumer Price Index (CPI). The period ends in 2009 because this is the last full year for which data are available. These amounts include the OC part of blended projects approved between 2007 and 2009.

⁵⁷ For consistency, all comparisons exclude private sector and Multilateral Investment Fund (MIF) operations.

⁵⁸ The distinction between FSO and FSO+OC financing is not relevant for the discussion of this chapter. For this reason, we are referring to any of the lending operations approved to the five FSO countries as an FSO operation or FSO loan, whether it has been financed exclusively with FSO resources, or with FSO and OC resources, i.e. a blended loan.

approved 189 operations for the same five D2 countries, i.e. 68% of the number of operations approved by the IDB, totaling approximately US\$4.4 billion (US\$5.4 billion in real terms), which roughly corresponds to 60% of the Bank's approvals during the same period.⁵⁹

- 2.3 It is interesting to note that while FSO and IDA approvals had been highly correlated until the end of the nineties, this tendency is reversed in the early 2000's, with the correlation between FSO and IDA approvals becoming negative.⁶⁰ In fact, from the data it appears that the "volatility" of total concessional financing, i.e. FSO plus IDA, has been reduced since early 2000's (see Chart A-2.1 in Annex III).⁶¹ It is not clear, however, whether this is the result of a strategic behavior of the countries or of the two institutions, or whether it has occurred by chance, for this issue is not discussed in the Bank's country strategies or in the FSO allocation documents.
- 2.4 Given IDB's importance as a source of concessional financing, the decline in the availability of these resources that occurred during the period of IDB-8 is of particular concern, as explicitly recognized during the discussions of the Bank's new capital increase: "*Resources available for concessional lending have (...) decreased substantially between 1994 and 2008. The decrease is more marked after implementation of the debt relief initiatives.*"⁶²
- 2.5 It is not clear, however, whether this decline generated a supply-side constraint, or whether absorption capacity problems constitute the binding constraints. The question of "optimal" size lending – "optimal" in the sense of incorporating issues related to demand and absorptive capacity, pipeline size and quality, as well as debt and debt sustainability analyses – is beyond the scope of this evaluation, and more akin to the discussions of the Bank's General Capital Increase. Nevertheless, some of these matters are discussed in the next few paragraphs as they relate to the Bank's FSO lending and its characteristics.
- 2.6 The Bank's project approval data for the 1994-2009 period indeed suggest that there might have been a supply-side problem. There was a substantial 80% difference between the total amount approved to the five FSO countries and the five Bank member countries that can be seen as their closest comparators, the D1 countries: Dominican Republic, Ecuador, El Salvador, Guatemala, and Paraguay.^{63, 64} Even when we restrict the analysis

⁵⁹ Except otherwise noted, all monetary figures and comparisons are in real terms.

⁶⁰ The correlation coefficient of FSO and IDA approvals for the period between 1994 and 2000 was 0.73, and although the -0.32 correlation coefficient for the 2001-2009 period is not high (in absolute terms), the shift from the previous period is substantial.

⁶¹ The coefficient of variation of FSO+IDA approvals, for instance, reduces substantially from the 1994-2000 period to the 2001-2009 period: from 0.47 to 0.19.

⁶² "Report on the Ninth General Increase in the Resources of the Inter-American Development Bank." CA-511. February 18, 2010.

⁶³ In order to facilitate the comparisons, we have maintained the two groups with the same number of countries. To do that we have excluded the sixth D1 country, Belize, from our comparison group. The decision to exclude Belize, was based on its relatively high per capita income – it has the highest 2008 GDP per capita of the D1 countries (measured in US dollars. Latest year for which data are available) – and limited relationship with the Bank: between 1994 and 2009 the Bank has approved only 16 projects for Belize (an average of one lending operation per year).

⁶⁴ It should be noted that there are significant differences between the income per capita of the Dominican Republic, Ecuador and El Salvador, which range between US\$3,500 and US\$4,300 (2008 figures), and the FSO countries, which as shown in Table 1.2 reach a maximum of approximately US\$1,800.

to the poorest D1 countries, Guatemala and Paraguay,⁶⁵ the average per country approval for these two countries was 60% greater than the average per country approval of the five FSO countries.⁶⁶

- 2.7 Comparisons of supply and demand figures also indicate insufficiency of funds. Because the dimensioning of the countries' past demand for concessional financing is very difficult – as this type of analysis was not central to the discussions leading to the allocation exercises – we have used future demand estimates as proxies for the past. Management's calculations made for the Ninth Replenishment place the annual demand for concessional resources by the five FSO countries at US\$1 billion for the next ten years.⁶⁷ This amount is 70% greater than the average annual allocation of the 1994-2009 period, which was of US\$587 million. It is also 70% greater than the US\$585 million allocated for 2009, which already included OC resources and supplemental funds to help the countries face the world financial crisis. Assuming that past demand is not substantially different from the demand projected for the next ten years, or at least not almost half the size, it seems that the Bank's concessional window has been underfunded.
- 2.8 Despite the figures suggesting the presence of supply constraints, the data also indicate that utilization and absorption capacity have also been problematic, particularly in the cases of Guyana and Haiti. Although 96% of the total resources allocated to the five FSO countries between 1994 and 2009 have been used, country specific data show that Haiti and Guyana have had difficulty in using their shares of allocated FSO resources. Only 63% and 88% of the resources allocated to Haiti and Guyana, respectively, were actually approved, thus suggesting that these two countries, particularly Haiti, may not have faced supply constraints, but rather problems related to absorptive capacity. Bolivia, Honduras and Nicaragua, on the other hand, have overspent their shares by 9%, 2%, and 15%, respectively.⁶⁸

B. Project cycle issues of FSO lending

- 2.9 Considering the weaker technical capacity of the FSO countries, it was to be expected that project preparation would take longer in these countries than in the rest of the Bank. However, the data for 1994-2009 show that the average preparation time for an FSO investment project (17 months),⁶⁹ was shorter than for a project in the D1 comparators and the A, B and C countries as a whole (20 months and 19 months, respectively). This

⁶⁵ Guatemala and Paraguay are, in fact, currently eligible for FSO borrowing.

⁶⁶ If Haiti is excluded from the calculations because of its low approvals (see paragraph 2.8), the difference between the average per country approval of Guatemala and Paraguay and the four remaining FSO countries is almost 50%. If Guyana and Haiti are excluded, the difference is of approximately 24%.

⁶⁷ According to Management, these estimates take into account the country's absorptive capacity and debt conditions. See for instance: "Review of the Need for an Increase of the Ordinary Capital and Replenishment of the Fund for Special Operations: FSO Financial Analysis." GN-2518-11. August, 6, 2009; "Review of the need for a General Capital Increase of the Ordinary Capital and Replenishment of the Fund for Special Operations. Second Working Paper: Main Findings and Options from the Technical Analysis. Revised Version." GN-2518-16, September 20, 2009; and "Report on the Ninth General Increase in the Resources of the Inter-American Development Bank." CA-511. February 18, 2010.

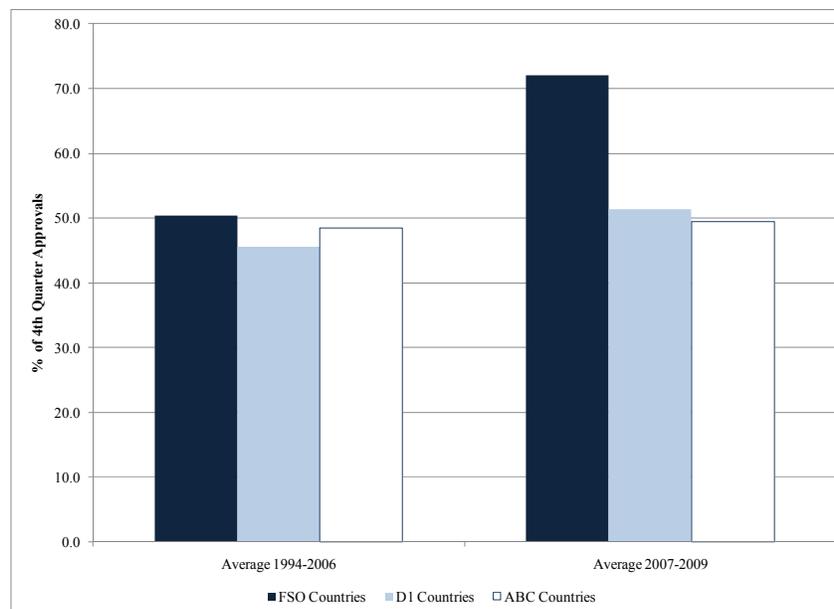
⁶⁸ As discussed in the previous chapter, the distribution of concessional resources defined by the allocation methodology is notional, i.e. the amounts used by each country through project approvals are not necessarily equal to the amounts allocated.

⁶⁹ Preparation time is measured as the number of months elapsed between the moment the project appears on the Bank's pipeline, until its approval.

unexpected result could be explained by the incentives generated by the allocation cycles that cut unused resources once the allocation round is over. Even though this hypothesis cannot be directly proven, intra-annual approval data and cancellation figures indicate that the incentives present in the Bank’s FSO lending may constitute important determinants of behavior.

- 2.10 The intra-annual pattern of approvals indicates that FSO countries have a relatively higher greater concentration of approvals in the fourth quarter of the year: about 54% of the projects approved for the five FSO countries were approved in the fourth quarter of each year between 1994 and 2009, as compared to 47% of the D1 countries and 49% of the group of A, B and C countries. Furthermore, the fourth-quarter bunching among the FSO countries is even more pronounced in the final year of the two-year allocation cycle.⁷⁰
- 2.11 Most importantly, this difference was dramatically accentuated with the 2007 elimination of carry-overs when, on average, 72% of the FSO projects were approved in the fourth quarter of each of the years of the 2007-2009 period, while it remained relative stable with the other groups of countries (see Chart 2.1, below). In this sense, the concern expressed in paragraph 1.32 that the new rule may generate the “perverse incentive” of inducing project approval – with the goal of exhausting the allocation made for the year – may have been realized.⁷¹

Chart 2.1: % Average of FSO-Financed Projects Approved in the Fourth Quarter of the Year: 1994-2006 and 2007-2009



Source: OVE estimates from Oveda data.

⁷⁰ Thus, the proportion of FSO projects approved in the fourth quarter were as follows: 1996 (50%) – 1997 (56%); 1998 (44%) – 1999 (53%); 2000 (42%) – 2001 (56%); 2002 (45%) – 2003 (58%); 2004 (30%) – 2005 (38%). The exception to this pattern is the 1994-1995 cycle, in which almost 82% of the FSO projects were approved in the fourth quarter of 1994 and 47% in 1995.

⁷¹ The very good approval/pattern of the 2007-2009 period; with 93%, 100%, and 99% of allocated resources used, may be seen as a corollary of this phenomenon.

- 2.12 Given the financial and structural characteristics of the FSO countries – e.g. severe budgetary constraints, limited technical capacity and weak institutions – it was also to be expected that projects in these nations would present slower disbursement patterns. In fact this was one of the assumptions that were incorporated into the establishment of the FSO during the Eighth Replenishment: “*Due to domestic resource and institutional constraints, projects in the less developed countries generally experience relatively longer [implementation] periods.*”⁷² However, as with preparation times, the data available display a different scenario.
- 2.13 The average total execution time of the investment projects approved for the FSO countries between 1994 and 2009, measured by the time elapsed from eligibility to total disbursement (including extensions), is quite similar to the pattern observed for the five D1 countries used as comparators, and even to the group of A, B and C countries taken as whole: 70 months, compared to 71 and 73 months, respectively. Extensions have been longer, however – the index of elapsed execution time over originally planned execution period for the FSO countries is 1.69, as compared to the 1.54 ratio observed for the D1 countries – thus suggesting, that the Bank may have in fact overestimated the execution capacity of these countries.
- 2.14 Finally, the data show that FSO projects display significantly lower cancellation rates. Only 4% of the resources approved for the FSO countries between 1994 and 2009 have been cancelled, compared to 19% for the five D1 countries and 15% for the group of A, B and C countries.⁷³ These large differences cannot be explained by the quality of project execution. The proportion of Project Performance Monitoring Reports (PPMRs) showing implementation problems is, on average, 11% higher in FSO investment operations than in the investment projects approved for the D1 countries, and about 5% smaller than for the project from the A, B, and C countries.⁷⁴ It is, therefore, possible that the explanation for the low cancellation rates, and the higher extension rates, may lie on the incentive structure embodied in the low cost terms of these operations and, also possibly, on the multiple debt relief initiatives.

C. The poverty and social equity emphasis of FSO lending

- 2.15 The data available do not show that FSO lending is characterized by a greater emphasis on projects targeted at the poor and/or aimed at reducing social inequities. In fact, the figures show an important decline in the proportion of FSO projects aimed at improving social equity. These results go against the original poverty-reduction and equity and social improvement goals that were present in the FSO in its inception.
- 2.16 The approval data related to the relevant period – between May of 1997 and the end of 2009 – do not show that the FSO countries present a substantially larger proportion of

⁷² “Proposal for Concessional Resources for the Eighth Replenishment.” GN-1763-9, February 19, 1993. The original text uses the word “gestation” when referring to project execution. We have replaced the term to avoid misinterpretation.

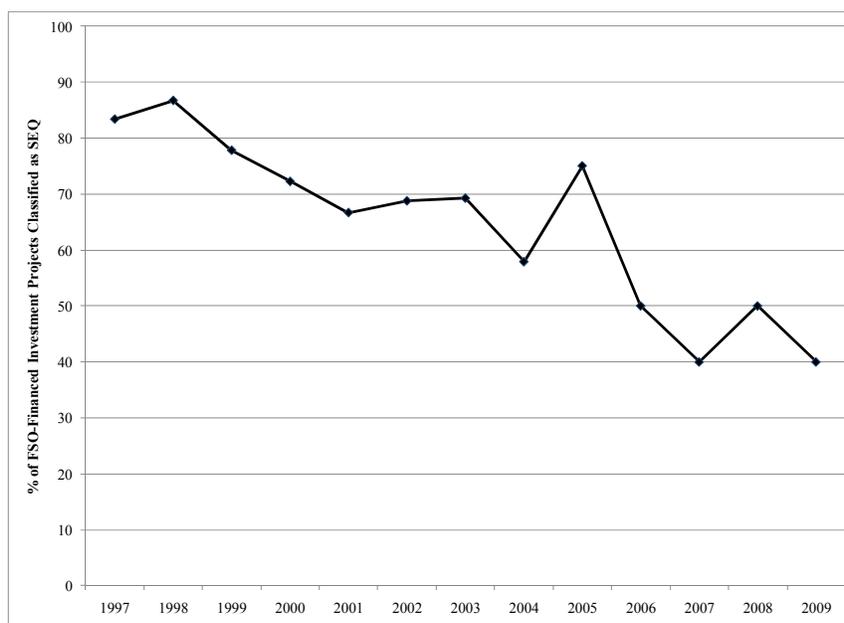
⁷³ In order to obtain a series for the entire 1994-2009 period, we have proxied cancellation by the difference between current approval and original approval amounts. Although, this proxy may not necessarily exactly match the formal definition of cancellation, the data available suggest that the differences are not substantial (around 10%).

⁷⁴ Data is for the 1997-2009 period, the only years for which data are available.

investment projects classified as poverty targeted investments (PTI), than the D1 comparators.⁷⁵ approximately 45% and 41%, respectively.⁷⁶

- 2.17 Most importantly, however, the proportion of FSO-financed investment projects classified as SEQ (social equity) fell steadily and substantially between 1997 and 2009 (see Chart 2.2, below), generating two main consequences.⁷⁷ First, it reduced the proportion of projects classified as SEQ in the five FSO countries to less than one half: from 83% in 1997 to 40% in 2009. Second, the FSO countries move from being the group of countries with the highest proportion of investment projects classified as SEQ in 1997, to being the one with the smallest percentage of SEQ projects in 2009.⁷⁸

Chart 2.2: % of FSO-Financed Investment Projects Classified as SEQ: 1997-2009



Source: OVE estimates from the Bank's data warehouse.

D. Sector distribution

- 2.18 In terms of the sector distribution of FSO approvals, the data do not show any particular pattern that could be directly related to the concessional nature of the loans. The fact that these countries have access to concessional resources does not seem to *systematically* drive the thematic or sectoral distribution of projects approved when these are compared to the D1 comparators or the A, B and C group countries.

⁷⁵ Between June 1995 and April 1997, all projects approved for the five FSO countries were automatically classified as PTI (poverty-targeted investments). For that reason we have restricted our comparisons to the period after April 1997.

⁷⁶ The proportion of investment projects approved for the A, B and C countries after April 1997 and classified as PTI was, however, smaller: 33%.

⁷⁷ The following criteria define an SEQ project: all social sector operations; any PTI operation, a non-social sector and non-PTI project that is expected to have a significant and direct impact on poverty reduction and greater equity.

⁷⁸ While in 1997 the proportion of FSO projects classified as SEQ was similar to the proportion observed in the D1 countries (83% and 82%, respectively), and substantially greater than in the A, B and C countries as a whole (with 46%); in 2009 both the D1 and even the A, B, and C countries had greater proportions of projects classified as SEQ (60% and 45%, respectively).

- 2.19 A possible exception might occur in relation to the financing of large infrastructure investments. The sector data show that FSO countries have had, relatively to the size of their portfolios, more and larger energy operations than the D1 and A, B and C countries. This, with the fact that transportation constitutes the sector with the second highest concentration of approvals – almost 18% of the amount approved by the Bank for the FSO countries between 1994 and 2009 – may suggest that these countries may have, to some extent, used the relatively inexpensive (hard currency) FSO resources to finance larger investments.⁷⁹

III. CLOSING REMARKS

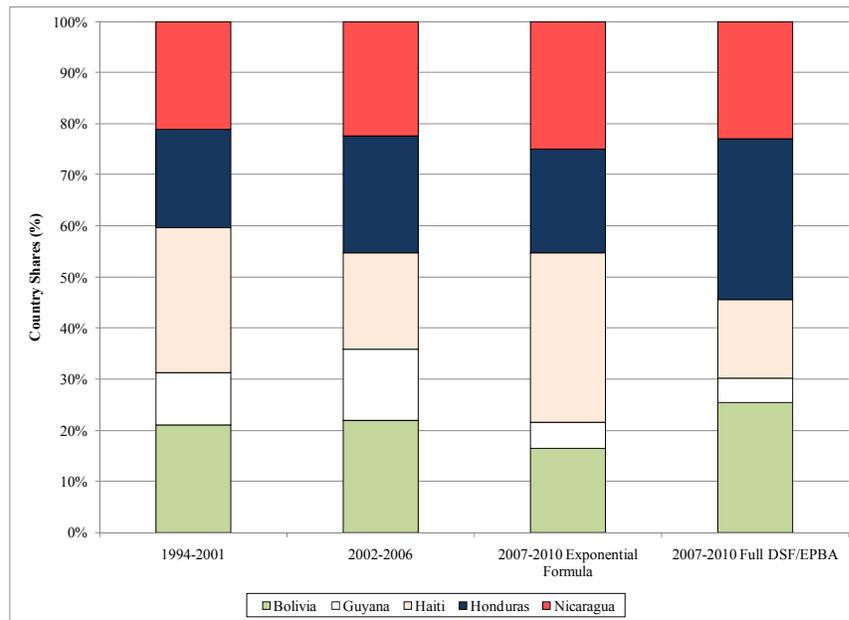
- 3.1 The period of the Eighth Replenishment was marked by major adjustments to the methodology responsible for the allocation of the Bank’s concessional resources. These adjustments that have had significant impacts on the across-country distribution of these funds, summarized in Table 3.1 and Chart 3.1, below.

Table 3.1: Some Impacts of the Methodological Changes

Effect	Change in Methodology		
	Need-based → linear performance-based formula	Linear performance-based formula → exponential performance-based formula	Exponential performance-based formula → blended lending (full DSF/EPBA)
Main beneficiary	Guyana	Haiti	Honduras
Most negatively affected	Haiti	Guyana	Haiti
Dispersion			
Shares	Decreases (minimum)	Increases	Increases (maximum)
Per capita allocation	Increases (maximum)	Decreases	Decreases (minimum)
Unintended bias	Yes	Yes	Yes
Average country ranking (allocation of shares)			
Bolivia	3 → 3	3 → 4	4 → 2
Guyana	5 → 5	5 → 5	5 → 5
Haiti	1 → 4	4 → 1	1 → 4
Honduras	4 → 1	1 → 3	3 → 1
Nicaragua	2 → 2	2 → 2	2 → 3

⁷⁹ Three sectors have concentrated more than 50% of the number and volume of resources approved by the Bank for the five FSO countries between 1994 and 2009: reform and modernization of the state (approximately 21% of approvals (in real terms) and 24% of the number of projects); transportation (almost 18% of the amount approved, and 11% of the number of projects); and social investment (17% in terms of amount and number of operations).

Chart 3.1: Average Country Shares (%) of Concessional Resources: 1994-2010



Source: OVE estimates based on data from CC-5325; GN-1856-11; GN-1856-18; GN-1856-33; GN-1856-43; GN-1856-48; GN-2442-16; GN-2442-20.

- 3.2 The fact that these methodological changes have necessarily positively affected some countries and negatively impacted others raises some important questions: was any country “unduly” affected by the adoption of a new formula? Or, was any country “excessively” favored in any of these adjustments? More generally, what is a proper benchmark to judge changes in the allocation of resources due to methodological adjustments?
- 3.3 Unfortunately these questions cannot be answered at this point, for they require the explicit definition of some concept of fairness or distributive justice against which these changes can be judged, a task that the Bank has not been willing or able to engage. The fact is that we do not know what the Bank aims to achieve with its allocation methodologies. As a result, it could be argued that the Bank has introduced new instruments to allocate its most scarce financial resource among its neediest members without the tools and guiding principles to properly evaluate them and, therefore, to adequately understand their impact.
- 3.4 The issues raised in 2003 by OVE in RE-279 of unintended bias against higher need countries, and the problems of transparency and objectivity, inadequate incentive effects, and limited developmental relevance, remain in the Bank’s current allocation methodology. In this sense, the Bank’s current efforts to improve the objectivity of the CIPE scores are welcomed, but they do not solve the broader transparency issue that is inherent to the scoring process. Finally, it should be noted that the new exponential formula does not seem to adequately fulfill its intent of rewarding performance, as the concept is defined in the allocation methodology, for it tends to be based on inputs or efforts, rather than results, or actual performance.

3.5 Finally, a few operational issues are of concern: (a) the evidence available suggests that access to concessional resource financing during the period of the Eighth Replenishment might have been restricted by supply constraints. Whether these constraints have pushed the FSO countries to seek alternative, more expensive, sources of funding that could negatively affect their debt profiles, is an issue that should be assessed by the Bank; (b) the fact that FSO operations do not present a distinct pro-poor bias and the significant decline in the proportion of FSO projects classified as promoting social equity go against the key principles that established the Bank's concessional window; (c) the end of carry-overs seems to have had the "perverse incentive" of inducing project approval in order to exhaust the concessional resources allocated for the year; and (d) the low cancellation pattern of FSO operations may suggest that the low cost of these projects, and/or the debt relief initiatives may have generated some moral hazard.