



## Policy Paper

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October 2018

# Increase in the Base Allocation of the Performance-Based Allocation System for 2019–2020

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Asian Development Bank

## ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
BEPS	–	base erosion and profit shifting
COL	–	concessional ordinary capital resources lending
CPA	–	country performance assessment
DMC	–	developing member country
FCAS	–	fragile and conflict-affected situations
GDP	–	gross domestic product
IDA	–	International Development Association
ODA	–	official development assistance
PARD	–	Pacific Department
PBA	–	performance-based allocation
PCO	–	Pacific country office
PIC	–	Pacific island country
SIDS	–	small island developing states
TA	–	technical assistance

## NOTE

In this report, “\$” refers to United States dollars, unless otherwise stated.

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## I. INTRODUCTION

1. Small island developing states (SIDS) require additional financial support to overcome a range of development challenges. These challenges are the result of their small size, remote location, and exposure to shocks from climate change and natural disasters. Common features among SIDS include low institutional capacity to carry out the basic functions of governing, a small tax base, reliance on volatile external revenue sources (including development assistance), limited private sector opportunities, and high investment costs. These factors create secondary development challenges, including limited formal sector employment, urbanization pressures, rising incidence of noncommunicable diseases, and limited economic engagement of women. The financing needs for basic infrastructure alone in the 13 SIDS that are members of the Asian Development Bank (ADB) and eligible for concessional assistance, are estimated to exceed \$2.6 billion per year—equivalent to 27% of annual government expenditures in these countries.<sup>1</sup> This amount reflects the high cost environment of SIDS and the difficulty in gaining economies of scale in small countries.

## II. PROPOSED INCREASE IN THE BASE ALLOCATION

2. This paper seeks the approval of the Board of Directors for (i) an increase in the amount of the base allocation of the performance-based allocation (PBA) system from the \$6 million per year stipulated in the Concessional Assistance Policy to \$13 million per year for the remaining 2 years of the 11th replenishment of the Asian Development Fund (ADF), covering 2019 and 2020;<sup>2</sup> and (ii) a waiver of the Concessional Assistance Policy to enable such an increase. This increase would be funded from ADF 12 grant resources left unallocated during 2017–2018. Because the unallocated ADF grant resources are available, the original resource allocation for individual countries as outlined in the Work Program and Budget Framework, 2018–2020 and internal planning documents will not be changed.<sup>3</sup>

3. The increase in the base allocation will benefit all 25 developing member countries (DMCs) of ADB that are eligible for concessional assistance during the second ADF 12 biennium. However, the development impact on eligible SIDS would be particularly significant because of their small initial allocation. Therefore, the paper focuses on the proposal's impact on eligible SIDS, whose access to concessional resources would increase by more than 50% over the 2-year period. SIDS will receive about 75% of the proposed additional ADF grant base allocation. Access to the additional base allocation for any new ADB member during ADF 12 will be contingent on an array of factors, including the endorsement by ADF 12 donors and/or approval by the Board of Directors.<sup>4</sup> Appendix 1 lists ADB's SIDS that are eligible for concessional resources. Appendix 2 shows the financing impact of the proposal by country, as well as by SIDS and non-SIDS groupings.

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1 ADB. 2017. *Meeting Asia's Infrastructure Needs*. Manila.

2 ADB. 2016. *Concessional Assistance Policy*. Manila.

3 ADB. 2017. *Work Program and Budget Framework, 2018–2020*. Manila; and ADB (Strategy, Policy and Review Department). 2018. *Indicative Resources Available for Commitment in 2018 and Projected Commitments during 2019–2020*. Memorandum. 14 March (internal).

4 Once a country is declared a full member, upon the government's request, ADB prepares a country classification paper with a development status recommendation. The country classification is approved by the Board of Directors. If classified as group A or group B, any country allocations outside the biennial allocation process are considered by the Board of Directors, upon consultation with ADF donors.

4. The proposal also operationalizes a key aspect of ADB's Strategy 2030, which was approved by the Board on 26 July 2018.<sup>5</sup> Strategy 2030 recognizes the distinct development challenges of SIDS and countries classified as fragile and conflict-affected situations (FCAS), and outlines ADB's differentiated approach to these DMCs. According to the United Nations, ADB's DMCs include 15 SIDS, 13 of which have access to ADB's concessional assistance. Based on the harmonized approach shared by ADB, the African Development Bank, and the World Bank, nine of ADB's DMCs currently eligible for concessional assistance are classified as FCAS. Seven of the FCAS countries are SIDS: the Federated States of Micronesia, Kiribati, the Marshall Islands, Nauru, Papua New Guinea, Solomon Islands, and Tuvalu.<sup>6</sup>

5. The increased base allocation will help ADB to ensure sufficient long-term financing and capacity development assistance in order to continue building resilience and addressing the causes of fragility in SIDS and FCAS countries, as envisaged under Strategy 2030.<sup>7</sup> The differentiated approach under Strategy 2030 builds on ADB's longstanding support for development in FCAS countries, which emphasizes the importance of understanding the local context, making a long-term commitment, ensuring country ownership, and being flexible in responding to challenges.<sup>8</sup> This long-term approach has helped to strengthen institutions and address capacity gaps, including capacity to implement ADB projects. In Pacific FCAS countries, the share of completed sovereign projects financed by ADF and concessional ordinary capital resources lending (COL) rated *successful* increased from 40% during 2010–2012 to 64% during 2015–2017. By comparison, the success rate of ADF- and COL-financed projects in non-FCAS countries was 74% during 2015–2017.<sup>9</sup>

6. The larger base allocation will support institutional and ADF priorities. ADB's support to SIDS has consistently emphasized gender mainstreaming. During 2015–2017, 41% by number (48% by volume) of committed sovereign operations financed by concessional resources in SIDS supported gender mainstreaming. The project pipelines suggest this focus on gender mainstreaming will be sustained.<sup>10</sup> Mainstreaming gender into transport projects in the Pacific has been particularly successful, while the growing demand for social sector projects (education and health) will ensure continued attention to gender mainstreaming. In 2017, ADB provided about \$18 million in financing to respond to climate change needs in eligible SIDS (19% of total concessional assistance for SIDS compared with 17% for non-SIDS). The project pipeline shows a rising need for concessional financing to respond to climate change.

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<sup>5</sup> ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

<sup>6</sup> ADB's harmonized FCAS list is slightly different from that published by the World Bank Group because of (i) the inclusion of Nauru, which is not IDA eligible; (ii) the timing of the publication of the World Bank list, which takes place before the publication of the results of the country performance assessment (CPA); and (iii) the changed timing and frequency of the CPA exercise.

<sup>7</sup> Twelve of the 13 ADB SIDS that are eligible for concessional assistance are among the 30 most vulnerable countries in the world, according to the United Nations' Economic Vulnerability Index. The index captures factors including population size, trade-weighted remoteness, concentration and volatility of economic output (particularly agriculture and exports), and exposure to climate change and disasters as a broad measure of structural vulnerability to economic and environmental shocks. The exception is Papua New Guinea, which is an FCAS country.

<sup>8</sup> ADB. 2013. *Operational Plan for Enhancing ADB's Effectiveness in Fragile and Conflict-Affected Situations*. Manila; and ADB. 2013. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

<sup>9</sup> Because of the small number of observations, the success rates are for completed sovereign operations for all Pacific FCAS countries including Papua New Guinea. The estimates are based on the success rates computed from validated results by ADB's Independent Evaluation Department.

<sup>10</sup> In comparison, non-SIDS gender mainstreaming was 57% by number and 56% by volume in ADF- and COL-financed sovereign projects.

7. The proposed increase in the base allocation will use \$161 million of the \$180 million in ADF grants that were unallocated during 2017–2018. The unallocated resources were principally a result of (i) the PBA framework, which links the allocation of COL with ADF grants, while the resources are segregated in two funds; and (ii) the predetermined levels of COL and grant operations in ADF 12.<sup>11</sup> As a result, the indicative COL allocation generated by the application of the PBA formula was initially higher than available COL resources. Any adjustment of COL volumes affects regular ordinary capital resources lending operations and ADB’s capital resources.<sup>12</sup> Consequently, COL allocations had to be reduced until the allocated amounts corresponded to available COL resources. The adjustments to COL had to follow the ADF grant framework and debt distress classification of countries, which means the allocation of ADF grants also had to be reduced. This iterative process ultimately resulted in the unallocated ADF grant resources.

8. Following extensive consultations, ADF donors endorsed the proposed increase in the base allocations, subject to the Board’s approval of a waiver of the Concessional Assistance Policy. Donors also requested that ADB review the application of the PBA formula to avoid the reoccurrence of such large unallocated ADF grant volumes in the future. ADB committed to reviewing the application of the PBA formula and to presenting a range of options at the ADF 12 midterm review in February 2019.

### III. FINANCING NEEDS OF SMALL ISLAND DEVELOPING STATES

9. The financing needs of SIDS for basic infrastructure, services, and addressing climate change are high and rising. The financing needs for basic infrastructure are large, reflecting the high-cost environment faced by SIDS. Table A3.1 provides comparative data on development challenges faced by SIDS. Table A3.2 and Table A3.3 provide a country- and sector-level assessments of financing needs based on ADB’s indicative pipeline, as well as the gap after accounting for financing available from ADB.

10. The specific financing needs of the SIDS include the following:

- (i) All SIDS need more access to electricity; better connectivity (through marine, air, and road transport); and improved water and sanitation facilities. In Maldives, many of the people from outer atolls are relocating to the capital island, making urban development the country’s top priority. In Timor-Leste, large investments are also needed to close the gaps in the provision of health care, education, and basic infrastructure that are a legacy of past conflict.
- (ii) SIDS are disproportionately affected by climate change. Depending on global efforts to limit warming, the World Bank estimates that Pacific SIDS will need \$350 million–\$1 billion annually during 2020–2029 (and \$400 million–\$1.1 billion annually by 2040) to adapt to climate change, undertake necessary coastal protection, and climate-proof infrastructure.<sup>13</sup> The needs in atoll countries, such as Kiribati, the Marshall Islands, and Tuvalu, are especially acute and could reach 5%–10% of gross domestic product (GDP) annually.

<sup>11</sup> Before ADF 12, COL and ADF grant resources were in the same fund and the levels of the two operations were not predetermined, which facilitated the resource allocation process.

<sup>12</sup> ADB. 2016. *Asian Development Fund 12 Donors’ Report: Scaling up for Inclusive and Sustainable Development in Asia and the Pacific*. Manila.

<sup>13</sup> World Bank. 2017. *Pacific Possible: Climate and Disaster Resilience*. Washington DC. Estimates do not include Fiji, Papua New Guinea, or Timor-Leste.

- (iii) SIDS are highly vulnerable to natural disasters and require resources for preparedness measures, as well as for disaster response, recovery, and reconstruction. The economic impact of Cyclone Pam in Vanuatu in 2015 and Cyclone Gita in Tonga in 2018 was equivalent to 60% of GDP. In SIDS, a single natural disaster can significantly set back development progress for a decade or more.

11. The need for capital investment financing in SIDS is growing rapidly. Capital expenditure for new and existing infrastructure has been generally growing across ADB's Pacific DMCs that are eligible for concessional resources. On average, capital expenditure in the Pacific was the equivalent of about 16.0% of GDP in 2017, up from the 13.1% of GDP during 2007–2016. The same holds true for Maldives, the only non-Pacific SIDS: its capital expenditure increased by 240% from \$187.6 million in 2012 to \$462.2 million in 2017. This trend is expected to continue with \$573.3 million earmarked for capital expenditures in the 2018 budget.<sup>14</sup>

12. The demand for ADF financing is growing. The scope and volume of the demand for ADB support has also grown significantly since 2013. In 2018–2019, more than \$500 million in ADB concessional financing is expected to be approved for the 13 SIDS, compared with about \$208 million approved in 2013–2014. SIDS are presenting more standby projects in their pipelines, an indication that the demand is exceeding financing availability. Growth in demand has been particularly apparent for projects in renewable energy, information and communication technology, and health. While ADB has been able to access some additional financing from the regional pool and savings to fill the financing gap, these resources are not sufficient to address demand on a sustainable basis.

#### IV. ABSORPTIVE CAPACITY

##### A. Absorptive Capacity at the Macro Level

13. **Increasing financial flows.** Financial flows to SIDS are increasing but are still insufficient to cover the financing gap. Since 2010, SIDS on the whole have benefited from increases in financial inflows through growth in tourism and fishing revenue, as well as increased official development assistance (ODA). ODA inflows to SIDS more than doubled from \$954 million in 2000 to \$2.1 billion in 2012 before falling back to \$1.5 billion by 2016.<sup>15</sup> For instance, the average ODA disbursements to Tonga grew from \$30 million during 2003–2009 to \$82 million during 2010–2016. Similarly, ODA disbursements to Kiribati jumped from \$24 million to \$61 million in that period.

14. **Effective absorption of ADB financing.** The introduction of annual base allocations of \$3 million in January 2015— and the doubling of base allocations to \$6 million in January 2017— has underpinned ADB's growing engagement in SIDS eligible for concessional assistance. ADB is expecting to commit more than \$470 million in ADF grants and COL to these countries in 2017 and 2018, nearly double the commitments of \$249 million in 2015–2016 and \$247 million in 2013–2014.

<sup>14</sup> Maldives Monetary Authority. *April 2018 Monthly Statistics*. Malé.

<sup>15</sup> Organisation for Economic Co-operation and Development (OECD). Development Assistance Committee database. The decline in ODA levels in recent years is largely explained by currency depreciation against the US dollar. (accessed 2 September 2018).



15. The success rate of ADB's investments in SIDS has been trending up. Validation report data for project completion reports show that the share of projects rated *successful* increased from 60% during 2012–2014 to 61% during 2015–2017.<sup>16</sup> Similarly, the capacity of SIDS to convert resources to project delivery is evident in improving contract awards and disbursements—in both aggregate terms and as a proportion of the portfolio. Contract award ratios in SIDS, for example, averaged 31.9% during 2016–2017, above the ADB average. The disbursement ratio for sovereign projects in eligible SIDS was 27.1% during 2016 and 2017, compared with 21.2% for ADB. These improvements reflect increased efforts to ensure that projects are “spade-ready” when financing is approved, as well as the posting of additional staff positions in the field.<sup>17</sup>

16. Ensuring continued improvements in the performance of the Pacific portfolio requires early adoption of appropriate risk-mitigation measures in project design and implementation, based on an understanding of the reasons and factors behind less-than-successful ratings. Project completion reports and portfolio reviews of Pacific operations suggest that the principal reasons for less-than-successful project ratings include (i) longer-than-expected project implementation periods, typically because of procurement delays; (ii) cost overruns because of mismatches between preliminary and final cost estimates, design changes, and exchange rate fluctuations; (iii) the involvement of new and/or inexperienced implementing agencies; (iv) the lack of a sustained on-the-ground presence and support during project implementation; (v) delayed submission of audited accounts and financial statements because of limited in-country audit capacity; (vi) delays in financial closure of projects because of incomplete record keeping by the implementing agencies; (vii) the failure of governments to finance sufficient operation and maintenance activities (including by setting appropriate tariffs) for infrastructure projects; and (viii) the need to support long-duration projects in phases because of insufficient and unpredictable financing envelopes, in combination with high staff turnover in implementing agencies.

17. Internal mechanisms that have been introduced in the Pacific to enhance project performance include (i) project readiness checklists to reduce the time required to award initial procurement contracts and to field consultants; (ii) project design advances and the new project readiness facility to complete detailed project design before project approval, to provide more accurate estimates of project costs, and to enable faster implementation following project approval; (iii) specific targeted training for executing and implementing agencies in the Pacific, as well as provision of additional consultants during implementation to support processes such as procurement; (iv) rolling out Pacific country offices (PCOs); (v) technical assistance (TA) to strengthen supreme audit institutions, and use of project resources to contract private auditors; (vi) support to central agencies in improving financial management, including through implementation of financial management information systems, and budgeting; and (vii) greater use of cofinancing to bring the quantity of finance needed to flagship projects.

18. **Debt sustainability position of small island developing states.** The proposed increase in base allocation would not affect the debt sustainability position of SIDS. ADB is guided by the debt sustainability framework for low-income countries in determining the form of financing for DMCs.<sup>18</sup> Of the 13 concessional assistance-only SIDS, eight are classified as being at high

<sup>16</sup> Compared with non-SIDS ADF and COL project data of 59% in 2012–2014 and 76% in 2015–2017.

<sup>17</sup> ADB. 2018. *Establishment of Pacific Country Offices*. Manila.

<sup>18</sup> The International Monetary Fund and the World Bank introduced the debt sustainability framework for low-income countries in 2005 to help guide them in their borrowing decisions. It has four possible classifications: low, moderate, or high risk of debt distress, and debt distressed. An assessment of being at “high risk of debt distress” reflects one

risk of debt distress and are therefore eligible only for ADF grants; two are at moderate risk of debt distress and receive half their PBA in loans and half as grants.<sup>19</sup> A modest increase of \$3.5 million in annual concessional lending (with the other \$3.5 million in grants) will not increase the risk of debt distress. The remaining three SIDS are group B countries (Palau, Papua New Guinea, and Timor-Leste) with a low risk of debt distress and no access to ADF grants; they receive their entire PBA as concessional loans.<sup>20</sup> ADB works closely with the International Monetary Fund and the World Bank to ensure that additional financial inflows into all DMCs adhere to the International Monetary Fund's debt sustainability guidelines and frameworks to reduce the risk of debt distress.

**19. Concessional financing can improve debt sustainability.** The availability of concessional financing can improve debt sustainability in SIDS. Many are indebted because of the impacts of disasters and the high costs of recovery, further exacerbated by constrained fiscal space, limited revenue generation potential, and expensive public services. Expanded concessional allocations will allow SIDS to move further away from potentially higher cost sources of financing. For those SIDS already receiving 100% grant assistance, greater allocations will immediately and unambiguously fill financing needs. Many of the Pacific SIDS avail themselves of policy-based operations to improve debt sustainability by supporting improved fiscal management, revenue generation, expenditure rationalization, resource mobilization, state-owned enterprise reform, and private sector investment.

## **B. Absorptive Capacity at Executing Agency and ADB Level**

**20. Increasing investment in institutional capacity building.** Governments and development partners are taking steps to ensure that DMCs can translate increased public investments into stronger development outcomes. ADB is taking proactive measures to address capacity limitations in Pacific SIDS. The Pacific Project Improvement Action Plan<sup>21</sup> includes four core areas of support: (i) encouraging governments to establish or strengthen centralized procurement and fiduciary functions, (ii) supplementing counterparts' capacity to strengthen portfolio management, (iii) ensuring that land acquisition and safeguard issues are addressed up front, and (iv) improving project readiness with detailed designs before approval of financing. As part of the action plan, TA (\$3.9 million)<sup>22</sup> engages a regional project and procurement support team to provide training to executing agencies. Specialized expertise is also mobilized under the TA to provide on-the-job training and problem-solving, helping resolve complex project implementation and procurement issues that had emerged.

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or more thresholds being breached under the baseline long-term growth scenario, but the country does not currently face any repayment difficulties. The drivers behind these breaches vary across SIDS. In the Federated States of Micronesia and the Marshall Islands the scheduled end of compact grant assistance in 2023 is a key factor in the country ratings. Features added in recent years to ensure consistent treatment of remittances and the risk of natural disasters across countries has seen both Samoa and Tonga shift back and forth between high and moderate risk. Kiribati, Nauru, and Tuvalu, by virtue of their size and revenue limitations, present as at high risk despite holding valuable trust funds.

<sup>19</sup> The countries at high risk of debt distress are the Federated States of Micronesia, Kiribati, Maldives, the Marshall Islands, Nauru, Samoa, Tonga, and Tuvalu. The two at moderate risk of debt distress are Solomon Islands and Vanuatu.

<sup>20</sup> Country classifications determine eligibility to ADB's resources. Group B countries are not eligible for ADF grants. ADB. 2008. *Review of the 1998 Graduation Policy of the Asian Development Bank*. Manila.

<sup>21</sup> The Project Improvement Action Plan was prepared in 2016 to address specific constraints in SIDS to timely and effective preparation and implementation of investment projects.

<sup>22</sup> ADB. 2016. *Building Project Implementation Capacities in the Pacific*. Manila (TA 9086-REG).

21. A new TA is being prepared (\$3 million) to support the use of a differentiated approach in the Pacific, in line with Strategy 2030, by helping SIDS adopt a longer-term planning horizon, promoting synergies across sectors, and supporting governments in developing more programmatic approaches to sector investments. Extensive support for public financial management in SIDS is also being provided through both TA and policy-based operations, with the broad objective of improving both revenue streams (e.g., through better taxation administration and transparency) and expenditure controls, (e.g., through stronger oversight functions such as audit). ADB is also supporting peer-to-peer learning through its Pacific Fellows Program (\$900,000), which will strengthen the capacities of senior government representatives across the Pacific.

22. **Improving institutional performance.** An analysis of ADB's country performance assessment (CPA) ratings shows that SIDS, on average, perform best in public sector management and institutions, as well as policies for social inclusion and equity.<sup>23</sup> These areas capture dimensions that are crucial for effectively utilizing investment funds, including the quality of budgetary and financial management, the quality of public administration, the equity of public resource use, and the development of human resources. CPA portfolio performance ratings for SIDS have been improving steadily and have kept pace with a similar positive trend for other ADB concessional assistance countries since 2008—potentially signaling sufficient absorptive capacity in SIDS to efficiently utilize higher levels of concessional assistance.<sup>24</sup> Moreover, ADB has helped to improve the tax capacity of DMCs and has helped several countries join the Global Forum on Transparency and Exchange of Information for Tax Purposes<sup>25</sup> and the Inclusive Framework on Base Erosion and Profit Shifting (BEPS).<sup>26</sup> ADB also assists SIDS in enforcing anti-money-laundering measures and is ready to offer similar support to meet other global standards in the broad area of public financial management.

23. **Development partner coordination.** In SIDS, development partner coordination is necessary to ensure that development resources are used effectively to achieve the intended outputs and outcomes. The number of counterpart staff in SIDS is typically limited, and their capacities are often constrained. Coordination among development partners can ensure complementarities are leveraged and duplication is avoided. For example, the national infrastructure investment plans prepared by the Pacific Regional Infrastructure Facility<sup>27</sup> have strengthened the priority-setting processes of SIDS and enabled development partners to support the most critical projects. In a growing number of cases, this collaboration takes the form of joint cofinancing of projects by development partners, which allows coordinated support to build absorptive capacity and sufficient financing to meet priority needs. For example, the Kiribati

<sup>23</sup> Averages of 3.4 of 6.0 for each area as of 2016 (on a 1–6 scale). ADB. 2016. *Annual Report on the 2016 Country Performance Assessment Exercise*. Manila.

<sup>24</sup> The average score for small states improved from 3.4 in 2008 to 3.7 in 2016, while the average for other ADB concessional assistance countries increased from 3.6 to 4.0 over the same period.

<sup>25</sup> The Global Forum is a platform that supports the OECD in addressing risks to tax compliance posed by noncooperative jurisdictions. The Global Forum has 153 members and is the premier international body for ensuring the implementation of internationally agreed standards of transparency and exchange of information on taxation. OECD. Global Forum on Transparency and Exchange of Information for Tax Purposes. <http://www.oecd.org/tax/transparency/>.

<sup>26</sup> BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax locations where there is little or no economic activity. The Inclusive Framework on BEPS brings together more than 115 countries and jurisdictions to collaborate on the implementation of the OECD/G20 BEPS Project, which includes 15 actions to equip governments with the domestic and international instruments needed to tackle BEPS. OECD. About the Inclusive Framework on BEPS. <http://www.oecd.org/ctp/beps-about.htm>.

<sup>27</sup> The facility was established in 2008 to provide TA and research and knowledge products on key infrastructure issues to Pacific island countries; and as a coordination facility for the principal development partners in the region.

Fiduciary Services Unit provides project management oversight, coordination, and fiduciary and procurement services for major infrastructure projects. This helped boost effective coordination of development partner assistance to different sectors.

**24. ADB staff support needed to strengthen absorptive capacities.** Strengthening the absorptive capacity of SIDS also requires that ADB staffing levels and in-country presence are sufficient to ensure project quality, close coordination with government counterparts, effective knowledge transfer, improved portfolio performance, and better monitoring of development outputs and results. Recognizing rapid portfolio growth, particularly in the 11 smallest Pacific island countries (PICs), the *Pacific Approach, 2016–2020*<sup>28</sup> highlights the need to formalize ADB's presence in each DMC in order to support the continued expansion of assistance and stronger country partnerships. As 12 of the 13 concessional assistance SIDS are in the Pacific, ADB has taken the following steps to increase the staffing levels of its Pacific Department (PARD), both in headquarters and in the field:

- (i) A detailed analysis of staffing needs in PARD resulted in 22 new positions to be provided from 2017 through 2019. These positions will be based in headquarters as well as in ADB's resident missions and regional offices in the Pacific.<sup>29</sup>
- (ii) Preparations are under way to formalize ADB's presence in the 11 smallest PIC countries by establishing PCOs. A phased approach to rolling out the PCOs is expected to start in 2019. Once complete, each of the 12 SIDS in the Pacific will be covered by in-country ADB staff through either PCOs or resident missions (Papua New Guinea and Timor-Leste).
- (iii) Australia's Department of Foreign Affairs and Trade has agreed to a Pacific Partnership Facility with ADB, under which the government will finance about five new contractual staff positions in PARD for 5 years (2019–2023).

**25.** To ensure that ADB has adequate staff resources to deliver existing and planned operations in the Pacific, ADB will continue to undertake an annual departmental-level workload workforce analysis.

### **C. ADB Pipelines**

**26. Effective use of increased concessional resources.** ADB's level of annual commitments, portfolio performance, and its pipeline of potential investments demonstrate the capacity to effectively deliver increasing resource flows to SIDS. In the small Pacific states eligible for grants, total commitments are equivalent to \$20 million per country per year, including cofinancing.<sup>30</sup> For most SIDS, available funds are fully programmed in the initial biennium of the ADF period, reflecting high demand for concessional financing and exacerbating resource constraints in the medium term.

**27. ADB's projected financing gap for small island developing states.** Even with the doubling of the base allocation for concessional resources from \$3 million to \$6 million in January

<sup>28</sup> ADB. 2016. *Pacific Approach, 2016–2020*. Manila.

<sup>29</sup> ADB's full resident missions and regional offices in the Pacific are Papua New Guinea Resident Mission; Timor-Leste Resident Mission; Pacific Subregional Office in Suva, Fiji; and Pacific Liaison and Coordination Office in Sydney, Australia.

<sup>30</sup> Commitments are considerably higher than country allocations because of the scope to mobilize ADF regional cooperation and integration resources, as well as cofinancing.

2017, the 2018–2020 pipeline for the 13 SIDS requires more than \$2.2 billion in financing compared to the indicative concessional resource allocation of about \$692 million. The financing gap of about \$1.5 billion in ADF and COL demonstrates a strong demand for concessional resources (Table A3.2). Delivering this pipeline will therefore require significant mobilization in cofinancing from partners, whereas additional national ADF and/or COL allocations would ensure that ADB can play a stronger leadership role in projects.

28. Allocating more funds to ADB’s eligible SIDS would support priority investments that are aligned with ADB’s Pacific Approach, 2016–2020, which serves as ADB’s operational framework for the Pacific region and the country partnership strategy for the 11 smaller PICs. The Pacific Approach outlines a three-pronged strategy of reducing costs, managing risks, and enabling value creation.

29. The proposed increases in resources would also support investment needs as outlined in ADB’s country partnership strategies for the larger SIDS: Maldives, Papua New Guinea, and Timor-Leste.<sup>31</sup> In Maldives, the government asked to shift the focus of its assistance to developing the national capital area. This is because the increasing population in the area is adding significant pressure on already stressed urban infrastructure, posing a threat to both the living conditions of the local people and its major industries (fishing and tourism). The country operations business plan, 2019–2021<sup>32</sup> includes a waste-to-energy project in its TA and investment program, which supports improvements to solid waste management in the capital area by installing an incineration facility. ADB will also process a project to improve basic infrastructure in the capital area and a trade facilitation project. The total cost of these projects will exceed \$200 million, far beyond ADB’s ADF allocation for the country of \$43.26 million for 2019–2021.

30. In Papua New Guinea, ADB is working with the government to convert the country’s resource wealth into inclusive and environmentally sustainable economic growth. Inclusive growth will be supported by investing in transport and energy, reducing business and trade costs, expanding job and livelihood opportunities, strengthening rural primary health care delivery, and improving access to water supply and sanitation services. To promote environmental sustainability, ADB is prioritizing renewable energy investments and climate-resilient infrastructure designs.

31. In Timor-Leste, ADB is supporting the emergence of a sustainable non-oil economy through the development of infrastructure, human capital, and a more enabling environment for business. Large investments are needed to achieve basic levels of connectivity and service, but Timor-Leste faces financing constraints because of its narrow economic base. ADB and its cofinancing partners are helping to rehabilitate and upgrade national and district roads that provide links to services and markets. Grant financing has been used to develop water supply systems in two district capitals and to expand access to technical and vocational training across the country. ADB is working closely with the Government of Timor-Leste to develop plans for achieving universal access to basic services such as clean water. It is also supporting the government on complex reforms to develop financial and productive sectors, strengthen fiscal policy, and prepare for regional integration. Additional concessional resources would allow ADB

<sup>31</sup> ADB. 2016. *Interim Country Partnership Strategy: Maldives, 2016*. Manila; ADB. 2016. *Country Partnership Strategy: Timor-Leste, 2016–2020*. Manila; and ADB. 2015. *Country Partnership Strategy: Papua New Guinea, 2016–2020*. Until the new strategy for Maldives is prepared, the country operations business plan, 2017–2019 includes an indicative pipeline of priority projects supporting the development of the Greater Malé Region based on a preliminary analysis of the government’s proposed projects, and detailed consultations with relevant officials.

<sup>32</sup> ADB. 2018. *Maldives Country Operations Business Plan 2019-2021*. Manila.

to expand its support for transformative investments that will help Timor-Leste achieve its development goals.

32. **Quality at entry, sustainable investments, and cofinancing.** Looking beyond the role of additional financing for infrastructure, social services, and climate change in SIDS, the concessional resources support program sustainability while further catalyzing cofinancing to (i) improve implementation readiness before the approval of project financing; (ii) strengthen the capacities of counterpart agencies for project design, implementation, and monitoring; (iii) improve project sustainability through earmarked operation and maintenance funding; and (iv) help attract additional concessional resources in the form of cofinancing, including private sector investments.

## V. WAIVER OF EXISTING ADB POLICY

33. The Concessional Assistance Policy determines the country allocations of ADF grant and COL resources. The policy established the PBA. For group A DMCs, the ADF grant framework (which forms part of the Concessional Assistance Policy) establishes additional criteria for the allocation of ADF grants to these DMCs based on their debt distress classification.

34. The PBA system for ADF 12 incorporates earmarked funds for (i) a base allocation, (ii) exceptional support for post-conflict and reengaging countries, (iii) the regional pool, and (iv) disaster risk reduction. The volume of the base allocation is stipulated in the Concessional Assistance Policy at \$6 million a year for all DMCs eligible for concessional resources. To increase the base allocation for the 2 remaining years of ADF 12 (2019–2020), the Board of Directors must approve a waiver of the requirement in the Concessional Assistance Policy that the base allocation amount be set at \$6 million per year.

## VI. RECOMMENDATION

35. It is recommended that the Board approve

- (i) an increase in the base allocation of the performance-based allocation system of the Concessional Assistance Policy from \$6 million per year to \$13 million per year for the remaining 2 years of the 11th replenishment of the Asian Development Fund (ADF 12) covering 2019 and 2020, and
- (ii) a waiver of the requirement in the Concessional Assistance Policy that the base allocation amount be set at \$6 million per year to enable such an increase.

## ADB'S SMALL ISLAND DEVELOPING STATES

The United Nations has identified 15 small island developing states among the developing member countries of the Asian Development Bank (ADB). Thirteen had access to ADB's concessional assistance as of 1 July 2018.<sup>1</sup>

### Eligibility of ADB Small Island Developing States for Concessional Assistance

Eligible for Concessional Assistance	Not Eligible for Concessional Assistance
Kiribati	
Maldives	
Marshall Islands	
Federated States of Micronesia	
Nauru	Cook Islands
Palau	Fiji
Papua New Guinea	
Samoa	
Solomon Islands	
Timor-Leste	
Tonga	
Tuvalu	
Vanuatu	

ADB = Asian Development Bank.

Source: United Nations. 2018. *United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States*. <http://unohrrls.org/about-sids/country-profiles/>.

<sup>1</sup> Access to concessional assistance (Asian Development Fund and/or concessional ordinary capital resources) for any new ADB member is contingent on consultation with the Asian Development Fund donors.

**IMPACT OF ADDITIONAL BASE ALLOCATION**  
**IMPACT OF ADDITIONAL BASE ALLOCATION ON OVERALL BIENNIAL ALLOCATION, 2019–2020**

(\$ million)

DMC	Biennial Allocation 2019–2020 as of March 2018		Additional Biennial Base Allocation 2019–2020			Biennial Allocation 2019–2020 After Increase in Base Allocation	Increase (%)
	Allocation	Of which, Original Base Allocation	ADF Grant	COL	Total		
<b>SIDS</b>							
Kiribati	15.63	12.00	14.00		14.00	29.63	90
Maldives	28.84	12.00	14.00		14.00	42.84	49
Marshall Islands	13.17	12.00	14.00		14.00	27.17	106
Micronesia, Fed. States of	13.51	12.00	14.00		14.00	27.51	104
Nauru	10.65	12.00	14.00		14.00	24.65	131
Palau	14.65	12.00		14.00	14.00	28.65	96
Papua New Guinea	85.45	12.00		14.00	14.00	99.45	16
Samoa	27.64	12.00	14.00		14.00	41.64	51
Solomon Islands	38.11	12.00	7.00	7.00	14.00	52.11	37
Timor-Leste	60.47	12.00		14.00	14.00	74.47	23
Tonga	21.06	12.00	14.00		14.00	35.06	66
Tuvalu	11.38	12.00	14.00		14.00	25.38	123
Vanuatu	21.98	12.00	7.00	7.00	14.00	35.98	64
<b>Subtotal (A)</b>	<b>362.53</b>	<b>156.00</b>	<b>126.00</b>	<b>56.00</b>	<b>182.00</b>	<b>544.53</b>	<b>50</b>
<b>Non-SIDS</b>							
Afghanistan	472.19	12.00	14.00		14.00	486.19	3
Bangladesh	1,166.94	12.00		14.00	14.00	1,180.94	1
Bhutan	139.45	12.00		14.00	14.00	153.45	10
Cambodia	535.12	12.00		14.00	14.00	549.12	3
Kyrgyz Republic	248.96	12.00	7.00	7.00	14.00	262.96	6
Lao PDR	231.15	12.00		14.00	14.00	245.15	6
Mongolia	114.18	12.00		14.00	14.00	128.18	12
Myanmar	725.37	12.00		14.00	14.00	739.37	2
Nepal	823.66	12.00		14.00	14.00	837.66	2
Pakistan	948.06	12.00		14.00	14.00	962.06	1
Tajikistan	201.04	12.00	14.00		14.00	215.04	7
Uzbekistan	639.58	12.00		14.00	14.00	653.58	2
<b>Subtotal (B)</b>	<b>6,245.70</b>	<b>144.00</b>	<b>35.00</b>	<b>133.00</b>	<b>168.00</b>	<b>6,413.70</b>	<b>3</b>
<b>TOTAL</b>	<b>6,608.23</b>	<b>300.00</b>	<b>161.00</b>	<b>189.00</b>	<b>350.00</b>	<b>6,958.23</b>	<b>5</b>

ADF = Asian Development Fund, COL = concessional ordinary capital resources lending, DMC = developing member country; Lao PDR = Lao People's Democratic Republic, SIDS = small island developing states.

Notes: Allocations for Nauru and Tuvalu as of March 2018 were lower than the original base allocation because of the volume discount applied to countries that receive 100% of their allocation in ADF grants. Numbers may not sum precisely because of rounding.

Source: Asian Development Bank



## ADB'S SMALL ISLAND DEVELOPING STATES—CHALLENGES AND NEEDS

**Table A3.1: Challenges in ADB's Concessional Assistance Small Island Developing States**

<b>Small Island Developing States</b>	<b>Urban population growth</b> (%, 2012–2016 average)	<b>Access to electricity</b> (% of population, 2016)	<b>People using at least basic drinking water services</b> (% of population, 2015)	<b>People using at least basic sanitation services</b> (% of population, 2015 <sup>a</sup> )	<b>Infant mortality rate</b> (per 100,000 live births, 2016)	<b>Overage students, primary</b> (% of enrollment, 2016 <sup>b</sup> )
Kiribati	2.0	84.9	64.4	39.8	42.4	5.2
Maldives	5.1	100.0	97.9	95.9	7.3	2.7
Marshall Islands	0.6	93.1	78.2	86.9	29.1	9.9
Micronesia, Federated States of	0.4	75.4	88.4	56.3	27.5	8.8
Nauru	5.2	99.2	100.0	65.6	28.5	1.4
Palau	1.7	99.3	99.6	100.0	13.7	13.3
Papua New Guinea	2.2	22.9	36.6	18.6	42.4	24.9
Samoa	(0.2)	100.0	95.5	96.6	14.8	8.3
Solomon Islands	4.2	47.9	64.0	31.3	21.8	36.7
Timor-Leste	4.3	63.4	70.2	44.0	42.4	18.2
Tonga	0.8	97.0	99.9	93.5	14.1	6.5
Tuvalu	2.5	99.4	99.3	91.4	21.4	0.1
Vanuatu	3.4	57.8	90.5	53.5	23.1	25.8

( ) = negative, ADB = Asian Development Bank.

Note: Latest available data shown.

<sup>a</sup> Denotes data as of 2014 for the Federated States of Micronesia.

<sup>b</sup> Denotes data as of 2012 for Papua New Guinea; 2014 for the Federated States of Micronesia, Palau, and Tonga; and 2015 for Tuvalu and Vanuatu.

Source: World Bank World Development Indicators database.

**Table A3.2: Financing Needs in ADB's Small Island Developing States Eligible for Concessional Assistance, 2018–2020**  
(\$ million)

<b>SIDS</b>	<b>Financing Needs for ADB Pipeline</b>	<b>Financing Available from ADB</b>	<b>Financing Needed from Others</b>
Kiribati	159.35	37.69	(121.66)
Marshall Islands	43.95	17.79	(26.16)
Micronesia, Federated States of	117.20	22.40	(94.80)
Nauru	99.29	42.25	(57.04)
Palau	55.57	33.70	(21.87)
Papua New Guinea	514.70	135.36	(379.34)
Samoa	224.48	79.87	(144.61)
Solomon Islands	432.50	73.02	(359.48)
Timor-Leste	135.00	109.72	(25.28)
Tonga	223.13	52.33	(170.80)
Tuvalu	44.72	20.88	(23.84)
Vanuatu	64.89	37.89	(27.00)
<b>Total Pacific</b>	<b>2,114.78</b>	<b>662.90</b>	<b>(1,451.88)</b>
Maldives	132.70	28.4	(103.86)
<b>Total SIDS</b>	<b>2,247.48</b>	<b>691.71</b>	<b>(1,555.74)</b>

( ) = financing gap, ADB = Asian Development Bank, SIDS = small island developing states.

Notes:

1. Financing needs for pipeline and financing available from ADB for group B countries (Palau, Papua New Guinea, and Timor-Leste) reflect concessional ordinary capital resources lending and Asian Development Fund grants only.
2. Projects are listed in the year they are on standby. Excludes 2021 standby projects and projects funded under other special funds.
3. Program for Maldives according to the country operations and business plan, 2019–2021; Pacific Department's 2018–2020 indicative pipeline as of June 2018 (based from country programming missions and regional management team review).
4. The 2018 program, based on 15 June management information system. 2018 allocations, is net of 2017 actual signing and includes additional allocations from regional funds, saving and cancellations, and disaster risk finance.
5. The projected financing needs are indicative and subject to change.

Source: ADB estimates.

**Table A3.3: Sector Financing Needs of ADB's Small Island Developing States Eligible for Concessional Assistance, 2018–2020**  
(\$ million)

<b>Sector</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>Total Sector Financing Needs for Pipeline</b>
Agriculture, Natural Resources, and Rural Development		3.00		3.00
Education		6.00	15.00	21.00
Energy	282.78	135.88	136.50	555.16
Finance		60.00		60.00
Health	87.50	38.00	10.00	135.50
Information and Communication Technology	72.80	25.00	6.00	103.80
Public Sector Management	17.90	92.00	62.50	172.40
Transport	156.49	103.00	409.80	669.29
Water and Other Urban Infrastructure and Services	3.80	468.96	54.57	527.33
<b>Total</b>	<b>621.27</b>	<b>931.84</b>	<b>694.37</b>	<b>2,247.48</b>

ADB = Asian Development Bank.

Notes:

1. Projects are listed in the year they are on standby. Excludes 2021 standby projects and projects funded under other special funds.
2. Program for Maldives according to the country operations and business plan, 2019–2021; Pacific Department's 2018–2020 indicative pipeline as of June 2018 (based from country programming missions and regional management team review). The 2018 program, based on 15 June management information system. 2018 allocations, is net of 2017 actual signing and includes additional allocations from regional funds, saving and cancellations, and disaster risk finance.
3. The projected financing needs are indicative and subject to change.

Source: ADB estimates.