

Public Sector Governance and Risks: A Proposed Methodology to do Risk Assessments at the Program Level

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Abbreviations and Acronyms

ADB	–	Asian Development Bank
CPS	–	country partnership strategy
DMC	–	developing member country
GACAP II	–	Second Governance and Anticorruption Action Plan
GICRA	–	governance and institutional corruption risk assessment
MOG	–	machinery of government
OED	–	Operations Evaluation Department
PAM	–	program administration memorandum
PSE	–	public sector enterprise
RRP	–	Report and Recommendation of the President to the Board of Directors
TA	–	technical assistance

Executive Summary

Risk assessment methodologies and processes for development programming at the country and sector levels are well explained both in the literature and in the practices of several institutions. What is needed, and more relevant on a day-to-day basis for the programming of the Asian Development Bank (ADB), is a risk assessment methodology at the individual program level. This paper suggests one particular methodology to do risk assessments at the program level in designing ADB programs.

To get a better appreciation of risks and of risk assessment at the program level, it is instructive to review, first, the broader context of the political economy of the developing member country (DMC) and how governments in the DMCs view risks in general. By and large, governments tend to be risk averse and tend to approach risks in the public sector with a healthy dose of apprehension. The incremental nature of public processes and policies is partly a manifestation of this.

In light of this, the paper asserts, among others, that (i) governments tend to give priority to the “here and now” problems over long-term planning; (ii) the public element to government decision making means that the precautionary principle should be given primacy in risk management; (iii) some institutions and functions in the public sector (such as procurement) are more prone to malgovernance risks and so this risk differential should be factored into the risk assessments at the program level; (iv) the different roles of government in the economy mean that there is no one uniform level of risk appetite of governments; and (v) communicating risks to the public, and across government agencies, helps democratize risks which, in turn, is central to ensuring stakeholder buy-in to risk-mitigating measures.

With particular reference to the methodology of assessing risks at the program level, the paper argues that the fundamental basis of such an assessment is the problem/constraints analysis that should be carried out for every program to be formulated with the DMCs. This not only helps in determining the program logic but also highlights the binding constraints in the program, which are the starting point of the risk assessment. The risk assessment itself covers several domains in that risks are either endogenous to the program, endogenous to the sector in which the program is to be developed, exogenous to both the program and sector (i.e., endogenous to the DMC), or exogenous to the DMC (i.e., risks arise in the external environment over which the DMC will have little control).

Program-level risk assessments also rely on properly determining the severity of the identified risks. This severity is a product of the hypothesized magnitude of the impact of the identified risks and the likelihood of such risks occurring. Such determination of severity of risks at the program level tends to be, by and large, subjective relying as it does on perception-based heuristics of the analysts; hence, the methodology calls for reviewing inherent biases and triangulating the analysis through iterations with government officials and other stakeholders. This is an important part of the risk assessment methodology at the program level.

One specific component of the risk assessment has to do with the mitigating measures, which, prior to final determination, need to be shared with governments. In particular,

governments will be keen to consider the nature of the residual risks in the program; these are the additional “costs” to the governments as a result of implementing the mitigating measures, i.e., these are risks that will continue to be evident even after the mitigating measures have been put in place. Governments will consider long and hard the magnitude of the residual risks prior to engaging in any form of risk management for individual programs.

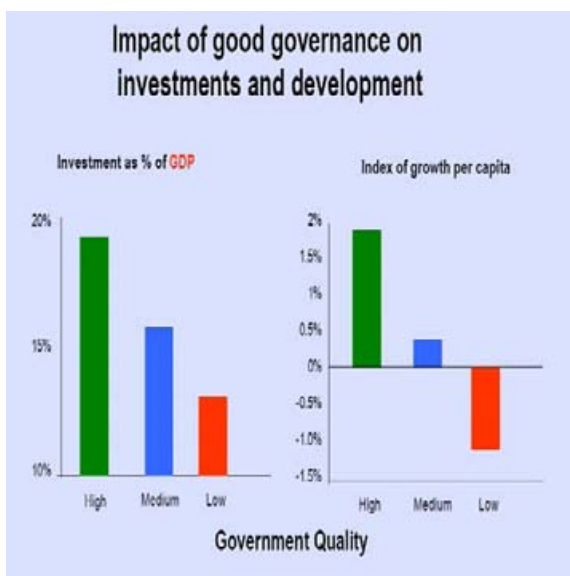
Finally, though DMCs are generally nowhere near to institutionalizing this, it may be the right time for them to move from the traditional focus on risk mitigation (which focuses on using controls to limit exposure to problems and is generally a reactive approach to risk management) to risk portfolio optimization (which helps seize opportunities based on the risk appetite of government and is generally a proactive approach to risk management). Adherence to risk portfolio optimization will also ensure that risks at the program level are seen in a broader light and decisions to accept a given level of risks in a program can be seen as being proactive about maximizing opportunities for greater developmental impact. While DMCs are yet to get to this stage, it is an objective worth advocating to them.

A. INTRODUCTION

Governance and Risks

1. The overriding consensus on development has always been: governance matters for development¹ (see, for example, Figures 1 and 2), and that “good governance is necessary to ensure efficient services to the poor, support the development process, increase the efficiency and effectiveness of public investment, and mobilize and regulate private sector resources.”² There also appears to be consensus among development practitioners that issues centered on public sector governance (i.e., on policy making and management in the public sector, including transparency, accountability, corruption, development effectiveness) are complex to deal with. Because good governance is critical, governance failures inhibit development effectiveness of policies and programs, and risks of such failures need to be fully analyzed and mitigated. Hence, a risk-based approach to governance and development is clearly warranted in development programming.

Figure 1. Governance matters (1)

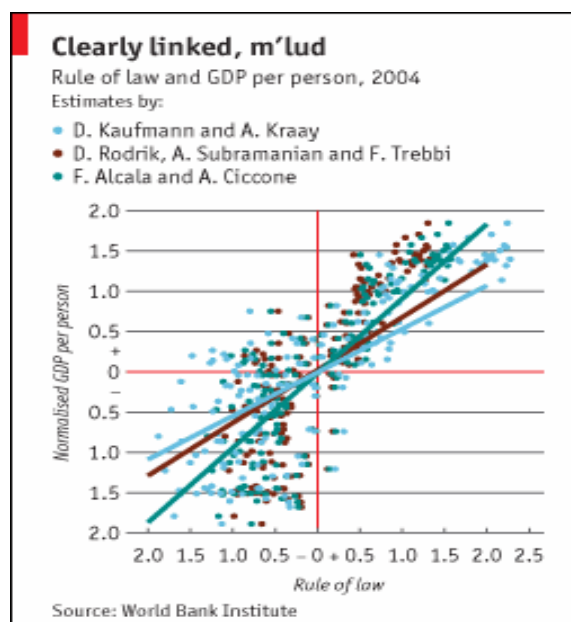


Source: F. Recanatini. 2001. *Diagnostic Tools and Empirical Analysis of Governance as an Input in the Fight against Corruption*. World Bank Institute, August.

2. Governance in any setting is complex; in a public sector context, this is even more so. Stakeholders are diverse, the problems to resolve are complex, and policy makers and public sector managers manage in fishbowl (i.e., very much in the public eye and constantly under scrutiny). Governments have to constantly deal with what are known as “adaptive problems”;

these are problems for which no technically correct answer can be

Figure 2. Governance Matters (2)



Source: *The Economist*. 2008. Economics and the Rule of Law: Order in the Jungle. March 13.

¹ See J. Page, Does Governance Matter? In *Governance Innovations in the Asia-Pacific Region: Trends, Cases, and Issues*, edited by G. Bhatta, and J. Gonzalez. Aldershot: Ashgate, 1998, pp. 23–46. See also, for example, N. Birdsall, D. Rodrik, and A. Subramanian. How to Help Poor Countries, *Foreign Affairs*, 84, 4 (July/August 2005), pp. 136–152, who argue that governance is the “deepest challenge” for countries in the poorest parts of the world.

² ADB. 2001. *Moving the Poverty Reduction Agenda Forward In Asia And The Pacific: The Long-Term Strategic Framework of the Asian Development Bank (2001–2015)*. Manila, March, p. 5.

determined. Also known as wicked problems,³ these can be vexing, and because they are rather unsolvable, continue to prove to be sources of risks for governments. What compounds the problem is that such wicked problems tend to be addressed only by ad hoc risk taking and without really factoring in any strategic considerations.

3. It is thus important to consider the nature of risks in public sector governance, including factors that impact the degree of risk tolerance and risk appetites of governments, and ascertain how the decision parameters on how to engage in policies, programs, and projects shift for governments as their tolerance and appetite for risks shift. What economists term “risk-ambiguity aversion” (see para 21) is a common phenomenon. But it is generally accepted that the public sector is more risk averse thus possessing a lower risk appetite for making swift substantial policy changes, even when they may well be warranted. It is this tendency to be risk averse that explains a higher degree of decision regret⁴ in the public sector since all too often suitable opportunities are not taken advantage of.

4. Such opportunities arise in individual policies/programs/projects (henceforth abbreviated to “programs”)⁵ that governments continually have to decide on. The questions here become (i) given a particular vector of risks in the program, with x level of severity of the risks, and y level of risk appetite of the government, should it proceed with the program? (ii) if so, how should the risks be mitigated? This necessitates a closer look at risk assessments and risk management at the individual or micro level (of the proposed program).

Research Methods

5. This paper picks up on the general theme of risks as they apply to governance in a developing country context. It seeks to present a specific methodology to conduct the relevant risk assessment of a program.⁶ The analytical framework of the paper rests on two key meta concepts:

³ Wicked problems are ill formulated, where the information is confusing, where there are no “stopping rules,” and where there are many clients and decision makers with conflicting values (C. West Churchman, “Wicked Problems,” Guest Editorial, *Management Science*, 14, 4 [1967]: B-141-B-142). For a practical application of this concept, see, for example, R. Bruce, and N. Cote Taming Wicked Problems: Theory and Practice. *The Public Manager* 31 (2002), pp. 39–46.

⁴ Also known as the likelihood of regret, this concept simply refers to the existence of a variance between what is expected as an outcome and the actual outcome itself. The greater the negative variance, the greater will be the regret. Policy makers will thus opt to make those policy decisions that will produce for them the lowest variance between ex ante specifications and hypothesized ex post observations.

⁵ While the three terms obviously differ, the term “program” is used throughout the paper for purposes of simplicity. The analysis, however, applies equally to all three.

⁶ It is important to distinguish here between governance assessments done at the national or macro level, and that done at the program or micro level. In the latter, for example, the emphasis on specific evidence that is gleaned from extensive surveys, and other detailed sources, is not emphasized to the degree that is for governance assessments at the national level. For discussions of the former type of assessments, see, for example, (i) OECD. *Survey of Donor Approaches to Governance Assessment*, DAC Network on Governance, Paris: February 2008; and (ii) Oslo Governance Centre (United Nations Development Programme) and Chr. Michelsen Institute, *Governance Assessments and the Paris Declaration: Opportunities for Inclusive Participation and National Ownership*, Seminar Report of the 2007 Bergen Seminar, Norway: 23–25 September 2007.

- (i) rational choice (since all governments are more intent on maximizing their own utility and on minimizing risk exposure),⁷ and
- (ii) environmentalism (where the premise is that risks also stem from the broader environment within which governments make policies and opt for particular programs associated with such policies, and where governments engage in environmental scanning to determine the parameters of their risk appetite and risk tolerance).

6. The paper analyzes the issue of risks in development programming in a public sector context from a systems perspective and puts forth an argument that risks need to be considered in the public sector in a manner that takes into account the environment that the public sector operates in. The role of the State in development is central to the main thesis of the paper.⁸ Two central ontological (i.e., à priori) assumptions are made in this paper:

- (i) Taking a political economy approach, it is argued that in development programming, it is the government that is the ultimate bearer of risks, and that the risk is of unacceptability of political and economic costs of policy distortions as a result of retaining risks that should have been avoided.
- (ii) Drawing from New Institutional Economics,⁹ it is argued that institutions are central to understanding risks in the public sector, and that risks manifest themselves in particular ways in public sector institutions that are different than those evident in private sector firms.¹⁰

7. There are several caveats (paras 8–12) in the analysis to follow. These have to do with the focus of the paper, as well as the specific methodology used.

8. *Specific to ADB programming methodology.* The paper draws upon the various ADB-centric tools and requirements to show how risk assessments can be done and reflected in the programming documentation. Thus, generalizability of the analysis here is limited to development programs developed by ADB, given the specific nature of its program processing.

9. *Focus on governance.* The paper concentrates less on corruption itself and more on the issue of governance (and the risks of what could be termed “malgovernance” i.e., that good governance is lacking).¹¹ The incidence of corruption in the country is obviously a manifestation of malgovernance but the analysis does not dwell on this at any great length.

⁷ See also para 19.

⁸ See, for example, V. Tanzi, *The Changing Role of the State in the Economy: A Historical Perspective* (September 1997), IMF Working Paper No. 97/114; available at SSRN: <http://ssrn.com/abstract=882647>.

⁹ See, for example, O. Williamson, The New Institutional Economics: Taking Stock, Looking Ahead, *Journal of Economic Literature*, 38, 3 (2000), pp. 595–613.

¹⁰ A good discussion of this, with respect to risks, can be found in J. Yeabsley and A. Sundakov (eds), *Risk and the Institutions of Government*, Wellington: Institute of Policy Studies and NZIER, 1999.

¹¹ This lack of good governance constrains and distorts the development process in a country and, more worrisome, has a disproportionate impact on the marginalized and disadvantaged segments of society since they are almost universally the most vulnerable victims of inefficient and inadequate public service delivery. These groups also are negatively impacted disproportionately by inaccessible, unpredictable, and inefficient legal systems that lack transparency, the hallmarks of malgovernance. See ADB, *Moving the Poverty Reduction Agenda Forward In Asia and The Pacific: The Long-Term Strategic Framework of the Asian Development Bank (2001–2015)*, Manila, March 2001, pp. 20–21.

10. *Individual program level.* The focus of the analysis here is on risks at the individual program level rather than at the sector or even broader (macro) level.¹² This notwithstanding, the context of the risk analysis is the broader scope of the country's public management system.

11. *Method of inquiry.* Finally, this paper is largely based on heuristic inquiry; this mode of inquiry is a form of phenomenology, wherein the personal experiences of the researcher toward the phenomenon are used to draw inferences in, and to make sense of, the experiences related to the phenomenon being studied.¹³ The analysis in the paper is not meant to be a full treatment of the intellectual underpinnings of risks in governance and development programming; it is meant to be more practice oriented.

12. The structure of the paper is as follows: first, a brief review of the key concepts in the area of governance and risks is provided. This is followed by a general discussion on a holistic approach to considering risk management in public policy, as well as how risks enter into the domain of the public sector. A particular focus here is on how governments tend to respond to risks. The subsequent section covers a particular methodology to conduct a risk assessment at the micro or individual program level. Finally, the notion of risk communication is introduced in light of the fact that adherence to good governance itself dictates that governments communicate risks to all relevant stakeholders. The annexes at the end provide illustrative examples of risk assessment at the program level.

Brief Review of Key Concepts¹⁴

13. The following are some principal concepts used in the paper.

Accountability

14. Accountability refers generally to answerability, i.e., an obligation to demonstrate that what had been mandated has actually been done to agreed standards and rules. It also implies reporting fairly and accurately on performance results that would have been specified ex ante. Three broad types of accountability can be said to exist in public management: (i) financial (i.e., the manner in which funds are used for prespecified mandates); (ii) managerial/administrative (i.e., how the mandated work was implemented and administered); and (c) political (i.e., answerability to constituents by holders of public office). As is clear here—certainly for (i) and (ii)—ex ante specifications are critical to ensure that there is something to be answerable about.

Corruption¹⁵

¹² For a detailed discussion on how risk assessments can be done at the broader sector and national level in the context of ADB programming, see ADB, GACAP II Implementation Guidelines, Draft, April 2008.

¹³ For a discussion of heuristic inquiry as a research tool, see M. Patton, *Qualitative Evaluation and Research Methods*, 2nd ed., Newbury Park, CA: Sage, 1990, pp. 71–73. The paper is also based on the research agenda of the author, and two presentations (on governance and on risks) at the South Asia Seminar Series at ADB in 2007 and 2008.

¹⁴ This section draws largely from G. Bhatta, *International Dictionary of Governance and Public Management*, New York: M. E. Sharpe, 2006; and G. Bhatta, Don't just do something, stand there! Revisiting the Issue of Risks in Innovation in the Public Sector, *The Innovation Journal* 8, 2 (2003), pp. 1–12. Permission from the publishers to cite the book and the article selectively is gratefully acknowledged.

15. Corruption is a widely used term although there is no general consensus on what practices should constitute corruption. Still, it has been said that at the core of this concept are three elements: (i) blurring between the official and unofficial spheres of action; (ii) recognition that corrupt acts involve an exchange, in which one party offers inducements (monetary or otherwise) in return for special advantages; and (iii) a sense that such exchanges are improper.¹⁶ A basic definition that takes into account these three elements is: “corruption is the misuse of office for unofficial ends.”¹⁷ The links between corruption and growth have been studied thoroughly and the unmistakable conclusion is that the two are inversely related.¹⁸

Governance

16. While the definition of governance has been varied,¹⁹ a review of the literature shows that there are some common constituent components. In general, these include²⁰ rule of law, democratization, human rights, sound legal and judicial system, public administration reform, public financial management, decentralization, enhancement of civil society, anticorruption, transparency, and accountability. A related term, good governance, is a normative concept and brings into the picture concepts of accountability and transparency of decision making, and rule of law (including respect for contracts). Newer formulations of the term have tended to focus on the political aspects, including that of democratic governance, which also includes respect for human rights, and representativeness.

Institution

17. While the term is broadly used to refer to an organization, it also includes the legal framework, social norms and conventions, etc., within which all activities take place in society. The term also refers to the rules of the game governing contractual relationships between parties that wish to interact with each other. Institution building is

¹⁵ Though the paper does not focus specifically on this concept, it is defined here largely because in developing countries governance failures are, by and large, centered on issues of corruption and mismanagement of resources.

¹⁶ Sandholtz, W., and W. Koetzle, *Accounting for Corruption: Economic Structure, Democratic Norms, and Trade*. Paper 98-05. Center for the Study of Democracy, University of California, Irvine..

¹⁷ Klitgaard, R. 1998. International Cooperation Against Corruption. *Finance & Development*. March, pp. 3–6. Klitgaard conceptualizes corruption as: $C=M+D-A$ (i.e., corruption equals monopoly plus discretion minus accountability) to describe more clearly where in the system vulnerabilities to corruption are most visible.

¹⁸ For example, P. Mauro, Corruption and Growth, *The Quarterly Journal of Economics*, CX, 3 (1995), pp. 681–712.

¹⁹ A simple definition that will suffice for our purposes is given as follows: “the exercise of political power to manage a nation’s affairs” (see P. Landell-Mills and I. Serageldin, Governance and the Development Process, *Finance & Development* 28, 3 (1991), pp. 14–17). For a brief review of the various definitions, and how there is some confusion in this regard, see, for example, T. Landman, J. Bewsher, and E. Carvalho, *Preliminary Survey on Donor Use of Governance Assessments*, University of Essex and the United Nations Development Program (UNDP), 2007. Available: www.undp.org/oslocentre/docs07/bergen_2007/Survey%20of%20Donor%20Use%20of%20Governance%20Assessments.pdf.

²⁰ Unbundling the notion of governance points to these components: (i) structure of government; (ii) political accountability; (iii) active and independent civil society that, among others, makes government answerable; (iv) public sector management, including a meritocratic civil service that is transparent, and rigorous budget and financial management; and (v) a competitive private sector. For a discussion of these components, see *Reforming Governance: World Bank Experience to Date*, Cheryl Gray, World Bank, March 2002 <http://unpan1.un.org/intradoc/groups/public/documents/UN/UNPAN002747.pdf>.

an associated term that has been taken to mean creation of capacities in the organizations and systems/processes in place. Such institution building could entail doing away with the old ways of doing things and focusing on reforming (i.e., improving the efficiency and effectiveness of) existing institutions. This latter also often includes strengthening the capabilities of the staff of these institutions.

Rationality

18. The principle of rational behavior is also central to the study of risks. Rationality assumes that governments always understand their preferences clearly, know which alternatives are available, know how to act on this information, and then apply decision criteria consistently. Clearly, this is not the usual case when dealing with wicked problems, or in countries where fragile coalitions are the norm, or where State capture is evident. Also, it is not always possible to have all the information; and even if so, it is not always possible to use all the information that one has (thus, bounded rationality tends to be the norm).²¹ The end result of this is what has been described as policy incrementalism, and incrementalism invariably yields the problem of creeping risk (i.e., a progression of adverse consequences that is so gradual, yet persistent, that governments get used to it).²²

Risks

19. A risk is simply the uncertainty of outcome. There is general agreement that it is this element of uncertainty in policy making that makes the study of risks so relevant in public sector management.²³ Typical risks which governments face include anything that jeopardizes the proper fulfillment of their mandates, and anything that damages their reputation (and are, thus, political risks)²⁴ (see para 35). More broadly, public risks are categorized either as strategic (i.e., representing the fundamentals; also called “policy

²¹ See H. Simon, *Administrative Behavior: A Study of Decision Making Processes in Administrative Organizations*. New York: Macmillan, 1947, pp. 39–41, for the original discussion on bounded rationality. For a review of bounded rationality as it applies to public policy, see, for example, B. Jones, Bounded Rationality and Public Policy: Herbert A. Simon and the Decisional Foundation of Collective Choice, *Policy Sciences*, 35, 3 (2002), pp. 269–284.

²² This is also known as the “boiling frog syndrome”; see, for example, G. Bhatta, Organizational Competence and the “Boiling Frog” Syndrome, *Organizations & People*, 8, 3 (2001), pp. 11–16.

²³ Uncertainty itself stems from a lack of information across time (i.e., it is generally hard to know—with any degree of certainty—what lies ahead), from information asymmetry across space (i.e., some agencies have more information than others and are thus more certain of their operating environments), and in its static state (i.e., even with some level of information available to different agencies, their interpretation and response will invariably vary). The notion of information asymmetry thus is also central to the study of risks. One particular application of information asymmetry is in what the economist Joseph Stiglitz calls the “political economy of information,” i.e., how information affects political processes and collective decision making since clearly not all parties to the process have the same level of access to information (see J. Stiglitz, Information and the Change in the Paradigm in Economics, *The American Economic Review*, 92, 3 [2002], pp. 460–501). For a brief application-oriented discussion of decision making under uncertainty, see, for example, P. Yuile, Governing Risk: Decision Making Under Uncertainty, *Canberra Bulletin of Public Administration*, No. 112 (2004), pp. 42–46.

²⁴ Political risks are partly reputational risks (or secondary risks); for a concise discussion of this term, see, for example, M. Power, *The Risk Management of Everything: Rethinking the Politics of Uncertainty*, Demos, London: 2004, pp. 32–36.

risks:) or trading (i.e., day-to-day or operational fluctuations).²⁵ Risk is measured in terms of likelihood and potential impact.

20. A useful and related term to note here is risk-ambiguity aversion which denotes that policy makers prefer to take risks based on known—rather than unknown—probabilities. This is a common occurrence in policy making and goes to some extent to explain the risk-averse nature of the public sector.²⁶ Risk aversion is a preference for not wanting to take any risks (or preferring a lower level of risk holding the expected benefit constant), and it implies a bias toward playing safe by governments. It is this characteristic that leads to incremental policy formation which poses difficulties in attaining grand policy reforms that are often called for in ADB's development programs.

Transparency

21. This term refers to low-cost access to relevant and understandable information. It has to be low cost so that accessibility is not exclusive, and it has to be relevant and understandable so that users can make sense out of it and assess for themselves possible downside risks of specific government action. Transparency enhances the accountability of public officials and organizations to citizens. A transparent policy measure is one that is open to the public for scrutiny, through the use of, for example, the Freedom of Information Act, sunshine provision, or something similar.

Holistic Framework for Risk Management in Public Policy

22. Given the policy complexity that exists in the public sector, the treatment of risks needs to be done in a holistic and multidimensional manner. Figure 3 is one such way of looking at how to approach risk management in public policy.

23. Various components of the framework presented in Figure 3 merit a look. These are the following:

(i) Risk identification can be based on research findings or from occurrence of incidents. It could also be based on some legal and administrative mandate that the legislature, for example, has imposed.

(ii) Risk identification is tempered by two simultaneous contextual requirements: the first is the empirical/factual one (i.e., the measurable parameters of the problem), and the second is the public context one (i.e., what the public may or may not have an appetite for).

(iii) The development of the policy options refers to decision rules such as on cost-benefit analysis and instrument choice that the government needs to make to address the public policy problem.

(iv) The decision itself will have political input and will at times require Cabinet approval.

(v) The implementation of the public policy refers to the administration and management of the policy (the broken line from "public context" refers to the

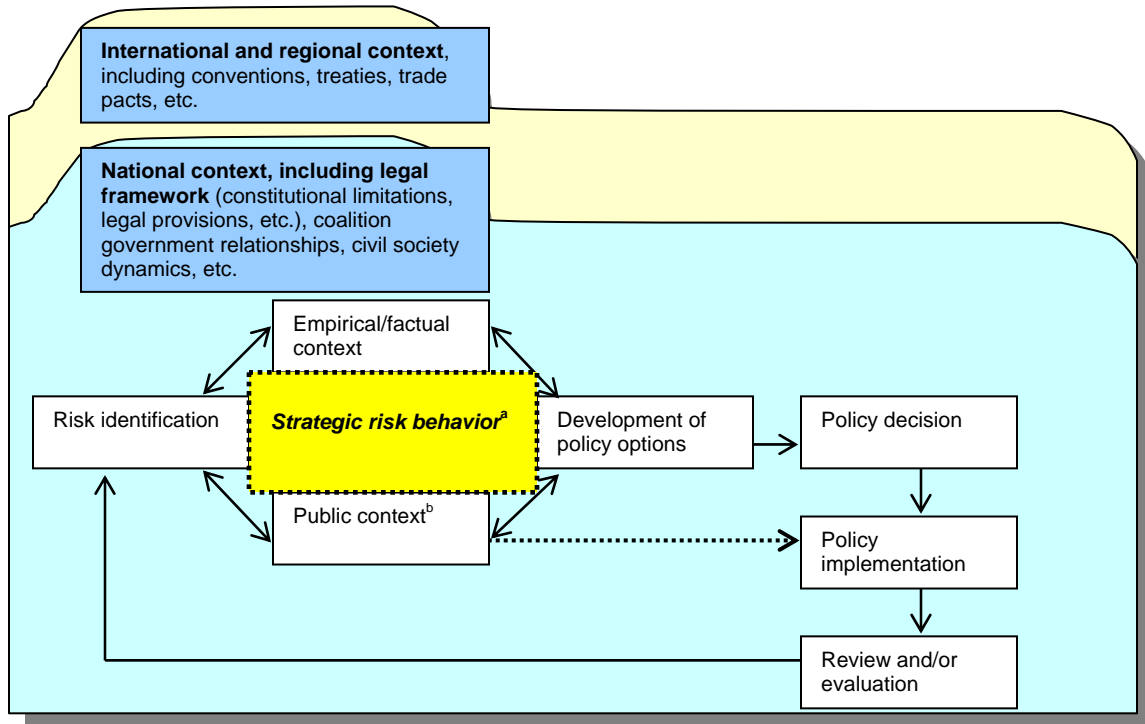
²⁵ G. Scott. 1999. Managing Operational and Policy Risks at the Centre of Government. In *Risk and the Institutions of Government*, edited by J. Yeabsley and A. Sundakov. Wellington: Institute of Policy Studies and NZIER, 1999, pp. 14–34.

²⁶ A cogent discussion of the term is given in D. Ellsberg, Risk, Ambiguity, and the Savage Axioms. *The Quarterly Journal of Economics*, 75, 4 (1961), pp. 643–669.

need for governments to be aware of public perceptions of risks in the policy even during implementation).

(vi) Review/evaluation refers to any revisions that may be needed in any dimension, or implementation process, of the policy.

Figure 3. A holistic framework for risk management in public policy



^a Refers to decision behavior of governments that are based on risk propensity, decision context, and risk horizon.²⁷

^b Refers to the public's view of acceptable risk.

Source: Adapted from Privy Council Office. 2000. *Risk Management for Canada and Canadians: Report of the ADM Working Group on Risk Management*, March, p. 9.

24. The framework thus reflects the interrelationships among issues associated with public policy decisions in an environment of uncertainty and risks.

B. GOVERNMENTS AND RISKS

25. It is useful to discuss the holistic framework further, in particular, how the matter of risks enters into the domain of the public sector, and how governments perceive them, take them into account, and contextualize them. Governments have to make risks their key agenda because these may lead to policy distortions if not managed properly. The beginning point in understanding risks in the public policy domain and how governments deal with them starts from a set of assertions.²⁸

²⁷ For a good discussion of strategic risk behavior (albeit in the context of the private sector), see T. Das, and B. Teng, Strategic Risk Behavior and its Temporalities: Between Risk Propensity and Decision Context, *Journal of Management Studies*, 38, 4 (2001), pp. 515–534.

²⁸ This section draws from the analysis in, among others, Treasury Board of Canada Secretariat, *Integrated Risk Management Framework*, 2000, and Privy Council Office, Canada, *Risk Management for Canada and Canadians: Report of the ADM Working Group on Risk Management*, March 2000.

Assertion Set

26. *Assertion 1:* All governments have a tendency toward uncertainty avoidance whereby, all things being equal, the “here and now” problems are given precedence over planning for the long term.²⁹
27. *Assertion 2:* In the public sector, decision making cannot be done in isolation of the broader political economy within which the State operates.³⁰ Also, the public’s willingness to accept or tolerate risks must be legitimate considerations for public decision making.
28. *Assertion 3:* There is a public element to virtually all government decision making, and it is a central and legitimate input to the process. This public element means that governments have to rely extensively on the precautionary principle in making policy decisions (i.e., governments are meant to serve the public interest. Thus, in considering risks in operations and policies, they have to be cautious about upholding the public interest in the final analysis).
29. *Assertion 4:* Governments are rational in the sense that they seek to minimize their exposure to risks. The greater the degree of risk exposure, the greater is the tendency to risk aversion, unless governments have very high levels of risk appetite and risk threshold.³¹
30. *Assertion 5:* The tolerance for risks and the perception of control over the activity, policy, or program generating a given risk are intricately linked.
31. *Assertion 6:* Some institutions (such as procurement agencies) are more prone to malgovernance and corruption risks than others. This risk differential is central to understanding the degree and extent of failures in programs and how to mitigate the risks.

²⁹ This tendency to focus on uncertainty avoidance is associated with the concept of irreversibility, i.e., a situation where expenditure and impacts are not reversible (meaning, they cannot be undone). Deterioration of environmental quality as a result of a decision to proceed with a particular infrastructure project is a relevant example here. Thus, resources set aside for projects with possible negative irreversible effects down the road tend to have high opportunity costs. For this reason, irreversibility should feature prominently in any risk assessment.

³⁰ Consideration of a political economy approach in program formulation and in risk assessment is critical, particularly in policy-based lending (see, e.g., Operations Evaluation Department, *Policy-Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries*, Special Evaluation Study, Reference No. EVU: OTH 2007-18. Manila: ADB, August 2007). As is clear in this evaluation study, reforms are tied to political considerations because choices often involve conflicting views and interests, and incentives for settling differences are not clear. Where policy reforms involve organizational change, there are further risks and uncertainties, and hence a risk-based approach is critical to good programming.

³¹ This appetite refers to the tolerance for risks (or risk threshold) and the extent of chances that any government is willing to take. Each government’s appetite for risks will be unique and will vary according to any one (or combination) of several variables, including any fuzzy boundaries around important institutions, degree of intractability of the problem being considered, the bureaucratic culture in place, and others. In general, the risk appetite of policy makers is a function of the degree to which (i) they feel they can control the mitigation process (thus control and mitigation are related concepts), (ii) the level of openness that exists in government, (iii) the level of information the policy makers possess to address a particular problem, and (iv) the perceived level of risk tolerance of society at large.

32. *Assertion 8:* Governments have different roles as risk manager, including as purchase agent, owner of national assets, protector of human and other rights, manager of the national economy and environmental assets, and deliverer of social and other services. The risk appetite across these roles invariably varies, and as such it will not be accurate to say that a government has one uniform level of risk appetite, even for programs in the same sector.

Risks Governments Face

33. Governments have always had to face risks, and uncertainty in the public sector and in the public policy domain is nothing new. However, the nature of risks that governments now have to face has subtly changed. This is largely because the probabilities of “manufactured risks” (such as genetic modification work) have increased dramatically and also because the world is now more interconnected than ever before, thus making systems and processes in one jurisdiction extremely susceptible to threats emanating from elsewhere (consider the Asian financial contagion in the 1990s—the so-called “Asian Economic Crisis”). Also, despite the movement to reduce the role of the State in the economy, much more is still expected of the State by and large. For example, even when the delivery of essential services by private providers is faulty, people still look to the State to remedy it. Also, the demand for transparency in public affairs continues to be more and more vocal, and citizens wish to be consulted ever more. All these serve as risk drivers for governments.³²

34. The United Kingdom National Audit Office specifies that government departments face five typical risks.³³ For all these, with the possible exception of the last one, departments will ultimately need to be answerable to relevant legislative committees.

- (i) Anything that jeopardizes attainment of departmental objective or service delivery for citizens (i.e., their statutory mandates);
- (ii) Anything that could reduce departmental reputation (thus incurring a political risk on the government of the day);
- (iii) Failure to guard against mismanagement, impropriety or waste;
- (iv) Failure to comply with regulations (such as on workplace safety, safeguard measures on the environment, etc.); and
- (v) An inability to respond to the changed operating environment and hence the risk of missing an opportunity (better known as “decision regret”).³⁴

35. In some situations, governments could face rather severe concentration risks. A concentration risk is one where many critical functions are centered in one institution, and this single-point-of-concentration intensifies the impact of any disruption in systems and processes. Often, central financial institutions and central agencies in finance (such

³² Risk drivers are broad factors that generate the need for proper risk management. The risk drivers for governments could include (i) need for due diligence, (ii) pace of change in a particular sector, (iii) stakeholders’ expectations for good governance, and (iv) adherence to international treaties that mandate particular policies and programs on the part of governments (such as on emission control, or anticorruption, etc.).

³³ National Audit Office. 2000. *Supporting Innovation: Managing Risk in Government Departments*, Report by the Comptroller and Auditor General, HC 864, Session 1999–2000, 17 August, p. 1.

³⁴ Footnote 4.

as the ministry of finance) in developing countries are susceptible to the concentration risk.

36. There are also risks related to the “degree of default” by the government (these are risks that governments face for not being able to deliver on the promises made, and, as such, being voted out of office; the “default” here is the nonelection to a subsequent period in power). These are related to the downside risks of specific programs not being successful and need to be thoroughly reviewed at the time of program formulation. Moreover, in designing programs, and largely to avoid the degree of default risks, it is helpful to specify abandonment options at the time of program formulation, i.e., options to drop the program in light of the emergent and downside risks that may be evident.

37. A particular problem that governments sometimes tend to face is “risk-shift.” This is a situation where, as a result of group-think (because of the illusion of unanimity and certainty of action within government), decision makers tend to shift the risks higher and where they tend to take bigger risks because of the perceived unanimity and certainty.

38. Governments also have to consider independent risks. These are risks which are inherent in programs where they occur separately (i.e., where the adverse effects of one are not related to those of the others). They also have to keep in mind interdependency risks, particularly in complex programs. Interdependency risks are those that emerge when there is a significant level of interactions among different entities and the failures in one cause disruption in systems and processes in the others. This is evident, for example, in the failures of one sort or another in highly leveraged businesses, which may adversely impact the operations of banks and financial institutions.

39. Risk preferencing is also an issue of concern in governments. This refers to the acceptance of preferences toward risk taking that is shown only by leaders and those in senior management. This could mean that the program is divorced from the ground-based operational reality of the environment within which the program is to operate. This situation could lead either to a conservative bias of risks (where the overriding tendency of bureaucrats is to err on the side of caution and to be tentative in seeking and taking even manageable risks) or an optimism bias (i.e., not very aware of the true degree of severity of risks in the program to be developed).³⁵ Regardless of which it is, it is generally true that the revealed preferences of governments for the level of risk appetite is not the same as their stated preferences for the same.

40. Finally, given the different roles played by government (such as, for example, purchase versus ownership), it is relevant to discuss the issue of risk differentials. This is often evident in differences in risk appetite between the principal (in this case, the government) and an agent (e.g., a contracted party). In the private sector, typically, principals are inherently risk neutral while agents are risk averse, and this differential creates an opportunity cost for principals. In the public sector, this risk differential is evident in, for example, governments dealing with public sector, or state-owned, enterprises where the government’s purchase interests over ownership interests vary. Risk differential is a concern for governments since it brings to the fore the variance in risk appetite and risk tolerance as well; this makes risk assessment that much more difficult.

³⁵ See, for example, HM Treasury, *The Green Book: Appraisal and Evaluation in Central Government*, London: The Stationery Office, 2003, pp. 29–30.

How Governments Deal with Risks

41. All governments face risks, but they sometimes have a tendency to look at risks as a steady-state function (i.e., that the contextual environment of risks will remain the same in a future period $t+1$, ...). This results from the inherent risk-averse nature of governments, and it is largely because governments face wicked problems that they are prone to becoming risk averse. This risk aversion (either to taking any risks, or taking a lower level of risk for the same level of expected benefit) means that the governments' risk appetite tends to be low.³⁶ The paradoxical situation is that the risk exposure of governments tends to be quite high. Such risk exposure is measured by the costs to be incurred if risks do materialize, or by the level of costs incurred to contain any risks but the risks do not materialize.

42. Governments deal with risks in multiple ways.³⁷ Often, they tend toward risk reduction through disaggregating complex issues into smaller and more manageable bits so that they can get a better handle on the contingencies that arise for each. However, this tendency of decision simplification (i.e., making the process of coming up with a decision simpler by disregarding the more risky aspects of a decision) may help them do away with the uncertainties that the risks would entail. But in its most basic form, decision simplification clearly leads to incrementalism, which, in turn, leads to ad hoc risk taking, i.e., making decisions affecting the core public sector without any strategic and long-term considerations.³⁸

43. Largely because governments have a tendency to focus on short-term issues (of which they can be fairly certain of the directions they will take) rather than take the long-term view (which has more uncertainty), they seek what is known as "quasi-option value," which is the value that policy makers get when they put off deciding on policy

³⁶ In general, the government's risk appetite (as considered from the perspective of a government department) will vary according to any one (or combination) of several variables including nature of organizational mandate, degree of problem intractability, degree of access to relevant information, organizational culture, and the relevant departmental minister's risk appetite (which itself is also a function of the collective risk appetite of government, and of the perception of severity of risk but lagged because it generally takes time to diffuse to departmental level). For further discussion, see, for example, G. Bhatta, Don't just do something, stand there!: Revisiting the Issue of Risks in Innovation in the Public Sector. *The Innovation Journal: A Special Issue on Innovation in Governance*, 8, 2 (2003), pp. 1–12. Available: www.innovation.cc/peer_reviewed/BhattaRisks.pdf.

³⁷ A useful way to analyze how governments respond to risks may be to look at their possible response set in line with the traditional cost-benefit analysis thus: $GR = f\{[C/B]*RA\}$ where GR=government response to the risk, C=sum total of costs, B=sum total of benefits, RA=degree of risk appetite of government (with C and B suitably discounted). With specific reference to individual departments that need to take risk action, there may well be a "first mover disadvantage" if the risk is either severe or if there is no precedence for the department to draw upon. In general, governments have less room to maneuver in managing risks than private sector firms for reasons that have been alluded to earlier. For example, firms increasingly make use of the method of real-options analysis to improve decision making and, coupled with the possibility of "exit," this method effectively minimizes their losses while preserving potential gains; this is a luxury governments do not normally have. For a discussion of the application of the real-options analysis under conditions of uncertainty, see, for example, J. Janney and G. Dess, Can Real-Options Analysis Improve Decision-Making? Promises and Pitfalls, *Academy of Management Executive*, 18, 4 (2004), pp. 60–75.

³⁸ Despite this, governments often do scrutinize strategic risks (these are risks that have serious or catastrophic consequences even though the probability of occurrence may be quite low). This particular risk has been framed as a zero-infinity problem; this refers to the probability of a problem occurring which is very small yet whose potential impact is enormous. This means governments cannot be complacent about risks that have a very low likelihood of occurrence if the consequences are likely to be severe.

options that they will eventually have to reconsider in the hope that new evidence will emerge, which will impact the assessments of net benefits so that a decision is much simpler to make. When dealing with wicked issues, policy makers often generate quasi-option values since hard decisions tend to be postponed.

44. The government's options of response to risks can be varied, and all risks can be dealt with in any one (or combination) of ways.

45. *Allocate*. This is a process of assigning risks to the various parties involved with an activity. Such an allocation is usually reflected in the amount of premium to be paid upfront or a proportion of benefits to forego in the event of the risk playing out and there being adverse effects.

46. *Transfer*. The organization can pay a premium to have a third party, such as an insurance company, bear the risks and deal with the consequences; or the work can be contracted out.

47. *Diversify*. This occurs when governments begin to invest in, or focus on, different portfolios to spread out—and thus reduce—their risks. Public organizations are less able to diversify risks since they cannot shift their mandates, or core business, as easily as private sector firms can. However, it is possible for them to enlarge their contractual relationships, thus effectively diversifying their risks as well.

48. *Tolerate (or accept)*. This occurs when governments do nothing and bear the adverse impact of the risk when, and if, it plays out (at times when the ability of the government to do anything is minimal—or when costs are prohibitive—it may simply opt to tolerate the risks). Risk acceptance is an informed decision to accept a particular risk and all its subsequent consequences in relation to a specific policy option. It implies that policy makers have analyzed the downstream effects of undertaking the policy that carries the risk.

49. *Terminate (or avoid)*. End (or avoid) the particular activity that is generating the risks in the first instance (not necessarily an option, however, for some public sector agencies). Risk avoidance means not becoming involved in a risk-generating situation, or taking actions to avoid being subject to risks that may, however, still occur in the operating environment.

50. *Retain and treat*. Should all other options for minimizing and avoiding risks fail, governments will tend to retain the risk. This occurs when governments feel that the associated costs of retaining the risks may be manageable in the final analysis. Once the risks are retained, attempts are made to treat them, i.e., contain the risks to an acceptable level, using internal control measures.³⁹

51. On the subject of risk avoidance, there are only limited ways for governments to manage many systemic risks. They do not have the luxury of exposure netting, i.e., trying to equalize the exposure to risks in one part of the public sector with those in

³⁹ For a simple and practical review of internal control measures with respect to risks, see, for example, HM Treasury, *Management of Risk: A Strategic Overview*, London, January 2001.

another part.⁴⁰ This can act as a severe constraint in policy action. In general, then, because they cannot readily diversify risks (largely given the statutory mandates of constituent organizations), governments tend to manage risks by avoiding them. Still, the risk-related decision rule in the public sector is the same as it is in the private—minimize the cost of uncertainty.⁴¹ This minimization function largely sits at the heart of government inaction.

52. One emergent way in which governments could deal with risks is through what is known as “risk optimization.” This refers to purposive action by governments to understand their risk limits and, through an iterative process within government and with other major stakeholders, to settle on a risk level with which they are comfortable. This level of comfort may be evident when, for example, the revealed risk preferences of those in the Cabinet or in the relevant legislative committee is made known.

53. One way of risk optimization is through “democratizing risks.”⁴² This refers to the actions of governments to discuss the risks with as many stakeholders as is possible to ensure that the stakeholders are also aware of the risks faced by the government with respect to a particular policy decision or a program and that the eventual policy decision, or shape of the program, will reflect that level of risk awareness among the stakeholders. This is a very useful way of dealing with the downside residues of risk mitigation actions. This is an important point that is picked up later in the paper while discussing the concept of “risk communication.”

C. RISK ASSESSMENT AT THE PROGRAM LEVEL⁴³

54. The discussion above on governments and risks sets the context for a look at how governance risk assessments can be approached at the micro or program level. While much of the focus in the literature has tended to be on the more macro-oriented governance assessments, there is just as much need for a critical look at this issue at the program level. The focus on a more macro-level assessment is generally justified by asserting that the broader risk appetite of governments tends to determine their degree

⁴⁰ For a look at how this works in the private sector, see, for example, K. Miller and G. Waller, Scenarios, Real Options, and Integrated Risk Management. *Long Range Planning*, 36, 1 (2003), pp. 93–107.

⁴¹ This assertion is only with respect to risk-related decision rules. In general, decisions in both the sectors are driven by a maximization rule—try to maximize the risk-adjusted expected “net return” from one’s actions.

⁴² See, for example, M. Power. 2004. *The Risk Management of Everything: Rethinking the Politics of Uncertainty*. London: Demos.

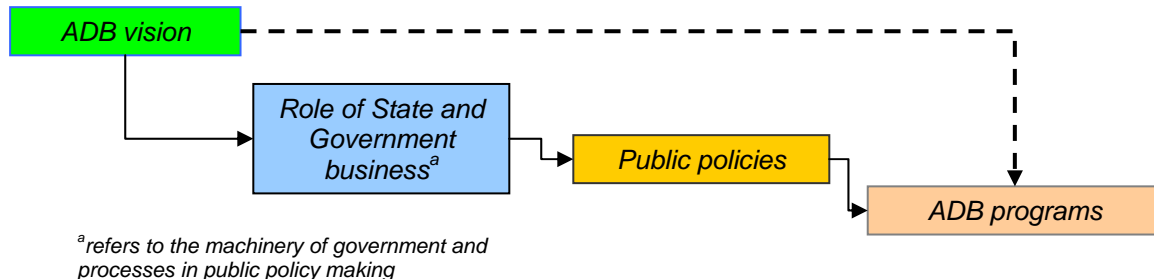
⁴³ To reiterate, this paper focuses on the assessments at the micro (or program level). For governance assessments at the macro (or national) level, three basic approaches appear to be in wide use, and each is suited for specific country contexts: (i) multiple external assessments, (ii) self-assessment, and (iii) peer-based reviews. In the first, which has tended to be the norm across developing countries until only very recently, the donor-specific methodology varies considerably and coordination costs for governments are high. In the second, the ownership of the assessment is firmly with the government and use is made of what are termed core and satellite indicators (the former refer to indicators that are used globally, and the latter are indicators that are related to the core ones but are redesigned to suit the country context). The third approach draws from the second, and a self-assessment is then extensively reviewed by peer groups within a country which results in a comprehensive country self-assessment report and a national program of action. Civil society also contributes to the review process, and this is assumed to increase the degree of ownership of the assessment. For a review of these methodologies, see Oslo Governance Centre (United Nations Development Program [UNDP]) and Chr. Michelsen Institute, *Governance Assessments and the Paris Declaration: Opportunities for Inclusive Participation and National Ownership*, Seminar Report of the 2007 Bergen Seminar, Norway: 23–25 September 2007.

of acceptability of risks in individual programs; however, this does not negate the appeal of looking at risks at the micro level as well.

Assessment Rationale

55. The rationale of considering governance and risk issues in ADB programming is clear. This is reflected in the link chain as shown in Figure 4.

Figure 4. Governance rationale in ADB programming



56. The rationale starts from the ADB vision (“an Asia and Pacific region free from poverty”) and the predominance of the role of the State in attaining such vision. (The private sector, indeed, plays a critical role in this but the guiding and facilitative role played by the State is at the core of ADB’s assistance in developing member countries [DMCs].) The role of the State is underpinned by specific and well laid-out government processes (part of what is known as the broader machinery of government), which manifest themselves in the public policy-making process. Since it is this set of public policies that ADB’s programs target, all programming activities need to internalize the centrality of the role of the State. Hence, strong consideration should be given to governance issues in ADB programming.

57. Governance issues are also relevant in ADB programming because development requires, among others, accountable institutions and effective management of such institutions. Also relevant is to note that evaluations conducted by ADB’s Operations Evaluation Department have also highlighted the need to consider governance and political economy in program design.⁴⁴

Assessment Methodology

58. The risk assessment methodology proposed here at the individual program level starts off with the problem/constraints analysis which feeds into the sector/subsector analysis in the program document.⁴⁵ The problem/constraints analysis then lays the groundwork for the risk assessment itself.

⁴⁴ See, for example, G. Abonyi, *Towards a Political Economy Approach to Policy-Based Lending*, Economics and Research Department Working Paper Series No. 14, Manila, 2002; and OED, *ADB Support to Public Resource Management in India*, Special Evaluation Study, Reference Number SST: REG 2007-22, September 2007.

⁴⁵ While starting off with a problem/constraints analysis is not exactly akin to doing a first principles review (which would require going over the fundamental premises and assumptions that underlie a particular policy), it does help in setting the context of the problem that the particular program is expected to address. Not embarking on this would be a risky undertaking in developing programs.

Problem/Constraints Analysis

59. ADB practices in programming concentrate on the following components of the problem analysis:

- (i) generalized specification of a problem assessment,
- (ii) the program logic,
- (iii) stakeholder analysis,
- (iv) binding constraints, and
- (v) results chain.

60. *Generalized specification of a problem assessment.* This generalized specification aids in setting the context for the problem analysis. It shows the exogenous variables that cannot be controlled for in the program, and the specific policy variables that are targeted to yield the desired outcome. This specification can be shown in a functional form as follows (Annex B contains an illustrated example):

$$Y = f(x_1 \dots x_n, p_1 \dots p_n) + e^{46}$$

where Y = desired outcome

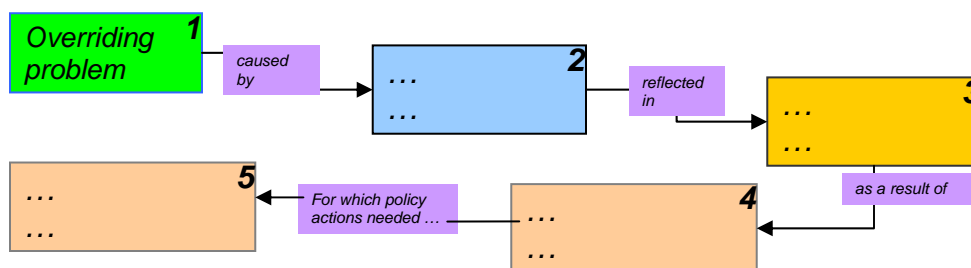
$x_1 \dots x_n$ = series of uncontrollable exogenous variables

$p_1 \dots p_n$ = series of policy instruments

e = error term

61. *Program logic.* Once the generalized specification of the exogenous variables and the series of policy instruments is laid out, the program logic offers an analytical tool to specify the overriding problem that the program seeks to address, and what causes the problem (with specification only of those that are to be addressed by the proposed program) (Figure 5). Those causes themselves will be reflected in some existing conditions, which are also a result of some other variables. Finally, the policy actions that are the focus of the program are specified; this logic provides a clear link between the overriding problem to be addressed in the program with the specific policy actions that will make this possible.

Figure 5. Flow of program logic



Source: Author.

⁴⁶ It has to be noted here that: (i) the hypothesized relationships between $p_1 \dots p_n$ and Y are positive, while between $x_1 \dots x_n$ and Y could be positive or negative; (ii) time lags need to be considered [i.e., Y is rarely a function of just p_1 , but actually $p_{1(t-n)}$ where n is some period]; and (iii) the **x**s and **p**s themselves are functions of other independent variables.

62. The determination of the program logic will be prefaced by specification of some underlying assumptions. For example, in a support program for public resource management, the assumptions may be that any social unrest that may exist in the DMC could be at the core of the development paradigm that has governed public policy expenditure in the country, or that greater fiscal space will result in reorientation of expenditure into social and economic infrastructure and that creating fiscal space is a necessary but not a sufficient condition to resolving the government's financial and economic woes.

63. *Stakeholder analysis.* This analysis determines who the stakeholders are, how they have an interest or stake in the program being developed, how they perceive the broader development problem as it relates to the narrower program-specific problem, what resources they have at their disposal to influence program outcomes, and what mandates they have, if any, that are related to the program.⁴⁷

64. Other variables that need to be considered with respect to stakeholder analysis are the expectations of the stakeholders, their capacities to be a part of program implementation, any interests that they might have that would conflict with the primary thrust of the program, and any alignment or divergence in the interests of the various stakeholders. The latter is particularly important as risk perceptions are likely to vary across groups, and those perceptions impact the degree to which the stakeholders will tend to support or oppose the program.

65. *Binding constraints.*⁴⁸ Also critical to look at in the problem/constraints analysis is the notion of binding constraints, or bottlenecks, inherent in the program. These are constraints within which the program will have to operate, and constitute what policy makers accept as being given (i.e., constraints that have to be accepted). Binding constraints are analyzed with the use of a problem tree (or a diagnostic decision tree) method.⁴⁹ Binding constraints change over time.

66. *Results chain.* The next step is to construct a results chain diagram that shows the links between impact, end-of-program outcomes, intervention modality (e.g., program, project, technical assistance [TA]), and the components of the proposed

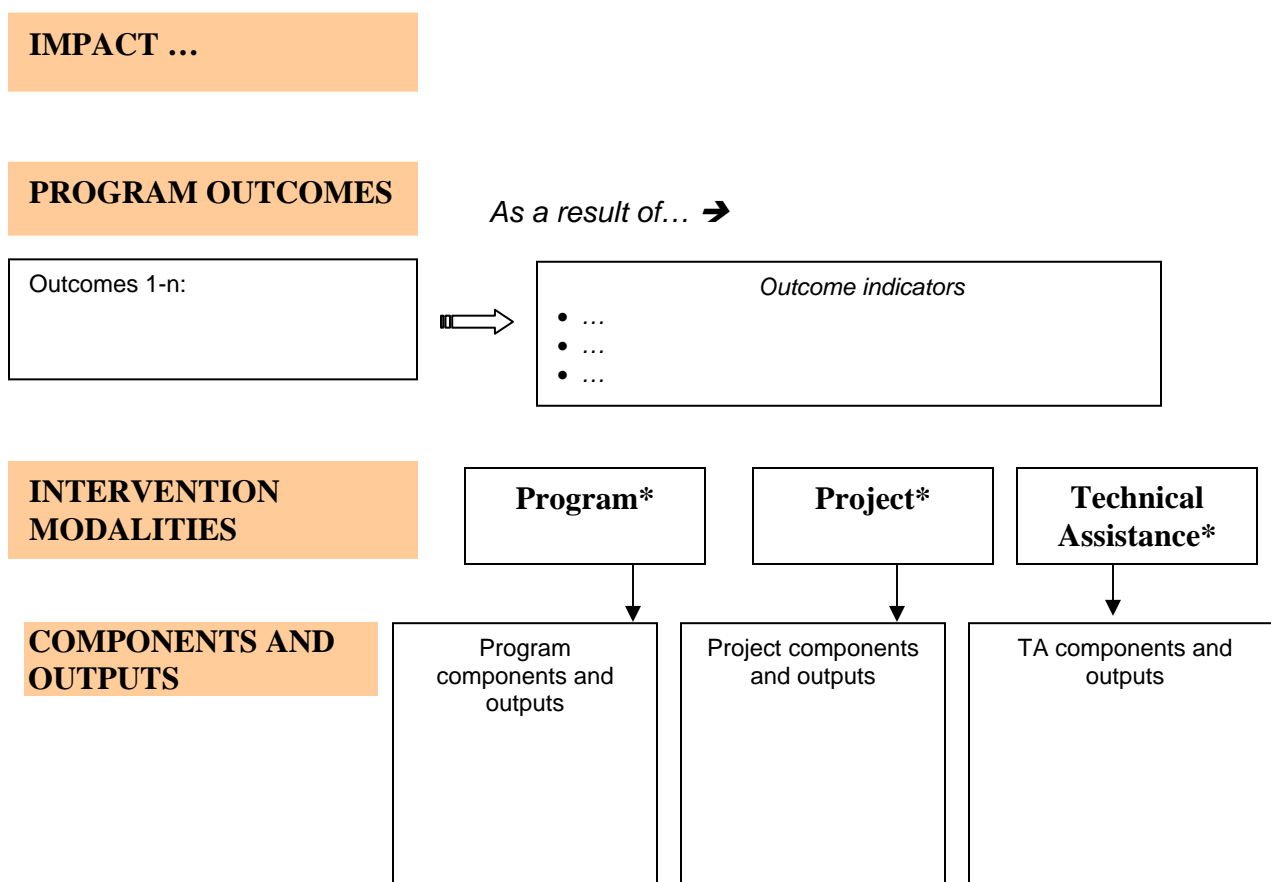
⁴⁷ Stakeholder analysis is one of the first diagnostic tools in the design of the program. It helps determine who benefits/loses and how, and which groups are likely to support as well as oppose the program. Stakeholder groups may be narrowly or broadly defined depending on the thrust of the program, and it is important that the analysis is considered again during program implementation in case the composition and/or interests of the stakeholders have shifted since program design. The OED special evaluation on policy-based lending has also highlighted the criticality of the stakeholder analysis (see *Policy-Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries*, Special Evaluation Study, Reference No. EVU: OTH 2007-18. Manila: ADB, August 2007).

⁴⁸ See, for example, ADB, *Strengthening Country Diagnosis and Analysis of Binding Development Constraints in Selected Developing Member Countries* (TA Report, Project no. 41040, April 2007) for a discussion on how binding constraints can be analyzed for analytical insights to formulate country assistance strategies. This practice has also been undertaken by the World Bank and the Inter-American Development Bank.

⁴⁹ For an illustration of this, see, for example, ADB, *Identifying Binding Development Constraints—A Diagnostic Approach*, Appendix 1 in *Economic Analysis Retrospective, 2005, Strengthening Quality-at-Entry of ADB Operations, 2005*, pp. 30–32. Available: www.adb.org/Documents/Reports/2005-EQ-Analysis/appendixes.pdf. For a country-level application of the concept with respect to growth, see, for example, K. Enders, *Egypt—Searching for Binding Constraints on Growth*, IMF Working Paper WP/07/57, March 2007. Available: <http://ksghome.harvard.edu/~drodrrik/Growth%20diagnostics%20papers/EgyptEnders.pdf>

program and its outputs (Figure 6). The results chain is relevant to show how specific program interventions link with the overall outcome sought.

Figure 6. Results chain



**Not all these intervention modalities will necessarily be employed together at the same time, although at times they are.*

67. This completes the set of analytics that needs to be considered in conducting the problem/constraint analysis. While the process can be time consuming, it is central not only to the risk assessment itself to follow but also to the proper specification of the program. Much of the analysis done here will ultimately be reflected in the Design and Monitoring Framework of the RRP⁵⁰ that is the hallmark of all ADB programming.

Risk Assessment

68. After the problem/constraints analysis, attention then moves to ascertaining risks for those relevant areas of the problem that are to be addressed in the program. The risk assessment itself begins with an analysis of the broad governance issues in, as well as

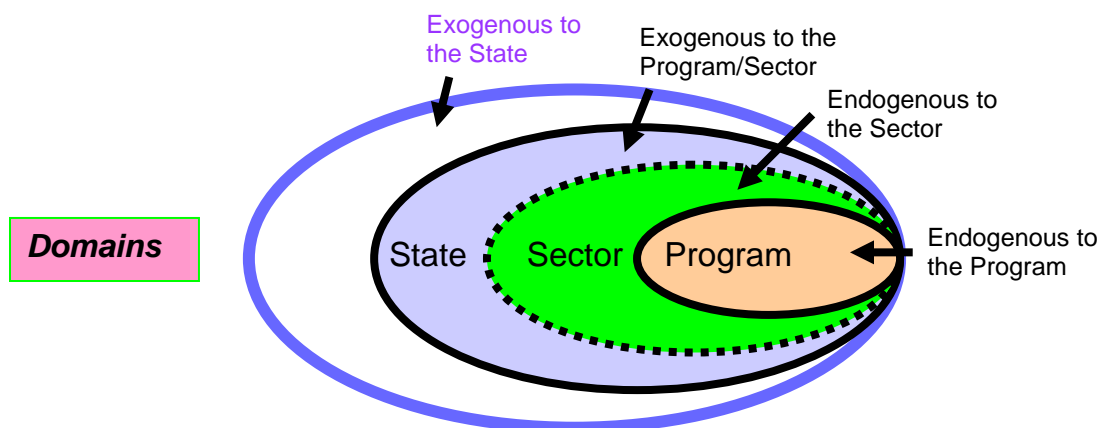
⁵⁰ Report and Recommendation of the President to the Board of Directors, or RRP, is the primary document that needs to be prepared in ADB programming.

the political economy of, the DMC. Once the major issues (such as, for example, on legal and political dimensions of reforms in the particular sector of operations, procurement, corruption, public finance management, public service, etc.) are analyzed, the risk assessment proceeds to specify the risks.

69. *Risk specification.* Risk specification starts from risk scanning, which is the process of reviewing the operating environment and determining what risks loom in the horizon and their potential magnitude. Governments use environmental-scanning techniques to get a better sense of what their environment holds for them. This is an important exercise since getting the risk specification (and thus, risk identification) wrong means the government will be addressing a wrong problem.

70. Risk specification can take the analysis into four specific domains of risks: (i) those that are endogenous to the project,⁵¹ (ii) those that are evident in the sector, (iii) those that are evident across the country, and (iv) those outside the purview of the program, as well as the State (Figure 7).

Figure 7. Domains of risk specification



Source: Author.

71. *Adjusting for bias.* After relevant risks have been specified and risk tolerance levels have been more or less determined but before measuring the likelihood and impact of the risks (i.e., determining the risk severity), it is instructive to adjust for any biases that may have cropped up in the analysis. This adjustment process enables the government to better grasp the true severity of the risks. One practical and useful method of adjusting for bias in risk assessment is to review critically the underlying reasons for any optimistic or pessimistic bias, then revisit the risks to see if this review changes the analysis (these biases refer to the unwarranted over- (or under-) statement of the potential costs and benefits or impacts of a particular program). Some ways to tease out such biases include conducting an overview of past experiences, doing a critical analysis of the underlying assumptions (called a “first principles review”),⁵² and

⁵¹ Some risks at this level are operational risks (i.e., those that are associated with program implementation) that can be either structural in nature (e.g., of organizational form), technical (e.g., lack of relevant equipment), or procedural (e.g., weak rules).

⁵² Where a first principles review is implausible (by virtue of, for example, absence of meaningful information, constrained budget envelope, or time), then analyzing all significant assumptions can also serve a useful purpose. These assumptions could relate to policy concerns, evaluation criteria, scope and

canvassing expert opinion. Another method of adjusting for bias is to triangulate the information that results from the perceptions of those doing the risk analysis. Such triangulation can mean reaching out to citizens, enterprises, and others to verify the perceptions, assumptions, and the information used in the analysis.⁵³

72. *Determining risk severity.* Once the various risks have been generally identified, an assessment of their severity needs to be conducted. The risk severity is given by

$$RS = I * L$$

where *RS* = risk severity

I = impact

L = likelihood

73. In determining risk severity, the sources of information are normally the evaluator's own observations, reports and publications already in the public domain, semi-structured and open-ended interviews with stakeholders (including policy makers), and others. Generally, however, the analysis is done using evaluator-centered heuristic measures. This refers to rules, routines, and criteria determined by the evaluator based on empirical observations and own perceptions. These measures have three key implications:

(i) The emphasis is on perceptions of observable phenomena and their implications rather than on empirical information itself; this is an important variance.

(ii) The assessment of severity is evaluator based. Because the analysis is based on perception, biases can crop up given that each evaluator is likely to have a different frame of reference.

(iii) What this means is that as a result, there is need for iteration of the risk assessment with government, which is not normally inclined to share the same perceptions of the empirically observable phenomena. At this stage, the review of the assessment by government is likely to throw up a barrage of objections to not only the specification of risks but also their severity, and the range of mitigating measures required.

74. Other sources of evidence will normally be secondary in nature, i.e., published reports, assessments, analyses, etc.⁵⁴ Evaluators are also encouraged to talk to

boundaries of the analysis, soft or intangible issues that are ignored or inadequately dealt with, value judgments and tradeoffs assumed, objective functions used, etc. (see, for example, M. Power, *The Risk Management of Everything: Rethinking the Politics of Uncertainty*, London: Demos, 2004, p. 38).

⁵³ Triangulation would require, for example, comparing the views of public officials with those of managers and individual citizens who deal with government to ascertain the true type and degree of, say, corruption; or, comparing the views of the users of the public service as against those of the service providers. Triangulation helps bolster the results by incorporating relevant experiences, needed quantification, and measurement of margin of error. At times, the triangulation process includes focus group discussions; targeted interviews with policy makers, anticorruption officials, etc. Triangulation is needed because of the introduction of perceptions in the risk assessment.

⁵⁴ The sources of evidence will obviously vary depending on which particular realm of activity is being considered. For public financial management, countries may have a country fiduciary and accountability assessment (CFAA) or a public expenditure and financial accountability assessment (PEFA). Care needs to be taken though to ensure that any updates on these are collated, largely from Ministry of Finance and other sources. As for procurement, a country procurement assessment report (CPAR), or the baseline indicator system (BIS) report (developed under OECD-DAC) may exist. Once again, risk analysts will need to ensure that any updates are obtained on these studies. Finally, for corruption risks, there is a rich source of

experienced key informants in government and elsewhere (for example, independent consultants that may have done some assessment for a development partner) so as to be able triangulate some perceptions, and even some empirical information. Key informants can also provide any updates that may be available.

75. *Risk Severity Matrix.* This matrix is seen as a useful device to show the level of seriousness of a particular risk, and is normally presented as in Figure 8.

Figure 8. Risk severity matrix

		Impact		
		High	Moderate	Low
Likelihood of Event Occurring	High	Type I	Type II	Type III
	Moderate		Type II/III	
	Low			Type IV

Source: Author.

76. Two primary observations on Figure 8 can be made—(i) the levels of magnitude for likelihood and impact could be made more spread out, if necessary, i.e., there could be five levels of likelihood and of impact (some prefer this since it provides greater specificity)⁵⁵; and (ii) Figure 8 clearly illustrates the four possible types of risks that can be ascertained for any program. Their specification is provided in Table 1.

secondary information, ranging from ADB's own country performance assessments to World Bank's Governance Matters VI data set as well as comparative ratings from Transparency International.

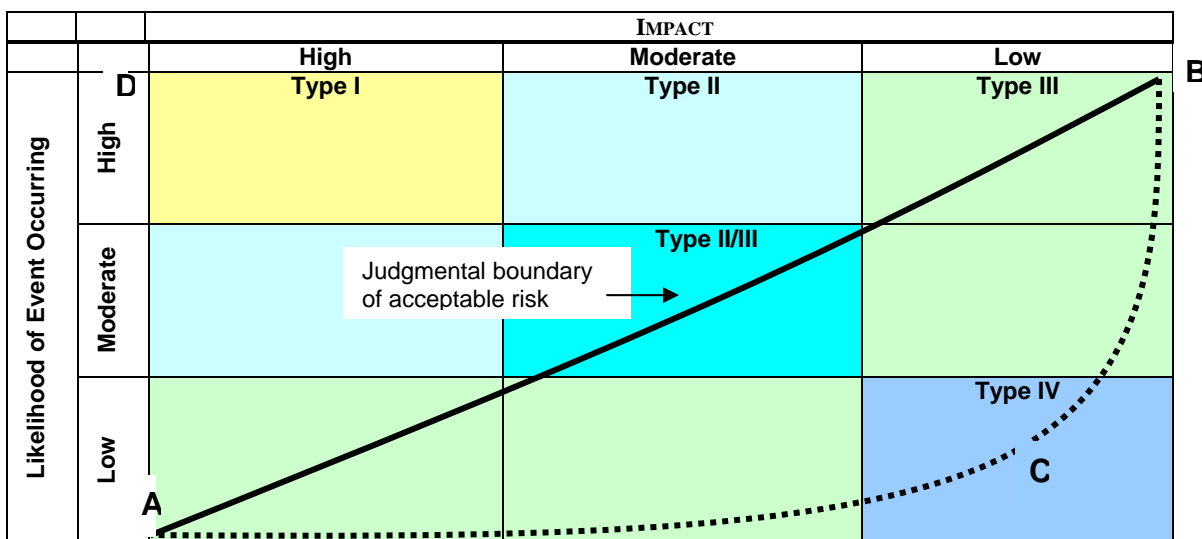
⁵⁵ But it is important to note the following with respect to this point: (i) more levels provide an opportunity to be better fine-tuned to a particular likelihood and impact, and fewer levels mean that governments will need to work hard to get consensus from others about what specific level should be ultimately selected; (ii) the 5*5 matrix yields a possible 25 actions for governments to contemplate when considering an appropriate risk management response, and this can be considered to be too cumbersome on governments; and (iii) where the risk acceptance curves are placed in the figure is contingent on the government's risk tolerance levels.

Table 1. Types of risks

Type 1	<i>Risks that require urgent attention and need to be mitigated/addressed prior to any assistance being rendered; also require regular monitoring.</i>
Type 2	<i>Risks that, although less urgent, still require attention and monitoring (assistance could still go ahead in the presence of these risks but they need to be mitigated/addressed eventually).</i>
Type 3	<i>Risks that should be regularly reviewed to ensure that they do not develop and become more serious.</i>
Type 4	<i>Risks that are generally left to be managed by routine project controls, including built-in processes of the agencies eventually to be in control of funds.</i>

77. *Risk acceptance levels.* The risk acceptance levels can also be mapped into Figure 8. At a generic level, acceptance curves can be specified as in Figure 9.

Figure 9. Risk severity matrix with acceptance curves



Source: Adapted from RBAF Guide, Treasury Board of Canada Secretariat, 2004.

78. In Figure 9, all the risks that fall to the left of the judgmental boundary (i.e., area DAB) need to have very strong risk mitigation measures in place while those to the right of the curved dotted line (i.e., BCA) are clearly acceptable risks. The area contained in ABC in the middle (i.e., bounded by the two curves) shows risks that are also acceptable but require more detailed review. The area ABC, but certainly DAB, should have a decision heuristic for the government to reduce risks as low as reasonably practicable.⁵⁶

⁵⁶ For a good discussion of this, see Cabinet Office, *Risk: Improving Government's Capability to Handle Risk and Uncertainty*, London: Strategy Unit Report, November 2002, p. 50.

79. *Risk Mitigation Measures Matrix*. Mitigation refers to adequately addressing a particular risk at three separate entry levels:

- (i) before the risk incidence or event (which focuses on minimization, prevention, reduction, or avoidance depending upon which is the most plausible action),
- (ii) during the event, largely for purposes of containment, and
- (iii) after the event, for compensation, restoration, or recovery.

80. Once the types of risks are ascertained, a risk mitigation measures matrix is prepared which provides information on the ongoing and proposed measures of mitigation for the specific risk, and focuses on the residual risk that remains (see Table 2 for an example). Governments tend to be more interested in the proposed mitigation measures, but particularly on the residual risk component as this is the “cost” they may ultimately end up paying for addressing the particular risk.

Table 2. Risk mitigation measures matrix (example)

Risk Specification	Ongoing Mitigation Measures	Proposed Mitigation Measures	Residual Risks, if any
Dispersion of government functions in fiscal management	Central level inter-ministerial coordination committee has been established and given considerable powers to ensure policy coherence	<ul style="list-style-type: none"> • Provide greater resources to the inter-ministerial coordination committee • Ensure a coherent policy on key subsectors (such as debt management, tax) • Conduct a MOG (machinery of government) review 	<ul style="list-style-type: none"> • The coordination committee could take on too many powers and not allow flexibility in operations • High transaction costs could well derail the consolidation

Source: Author.

81. Table 2 contains the following elements:

- (i) Risk specification: this draws from the analysis done during the risk identification stage.
- (ii) Ongoing mitigating measures: these are measures that the government will already have been implementing.
- (iii) Proposed mitigating measures: these are the separate measures that the program recommends the government to consider in the program to ensure that the risks are properly addressed.
- (iv) Residual risks: these are risks that will either continue to be in place even after the mitigating measures have been put in place or will be new ones resulting from implementation of the proposed mitigating measures.

82. To complete the risk assessment at the program level, a set of recommendations, which not only addresses the risks but also enhances the design and implementation of the proposed program, is presented. These recommendations generally include

- (i) technical assistance (TA) to be provided to better address any Type I risks that focus on lack of capability;

- (ii) incorporate several provisions on good governance and anticorruption as loan conditions and assurances as relevant (some of these will be upon inception, and some for future tranche release);
- (iii) review the risk analysis with the government (see para 86);
- (iv) get stakeholder buy-in to—and concurrence of—governance and corruption risk mitigation strategies; and
- (v) acquire information during monitoring review missions on, for example, revised structures and processes to assess progress in managing governance and corruption risks, longitudinal review of any incidences of mismanagement and inefficiencies in the public sector, etc.

83. *Risk monitoring.* All risks and consequent risk management plans (that will detail which party plays what role in risk mitigation) will need to be monitored for the mitigating measures to be effective. For ADB programming purposes, this monitoring takes place at two specific levels: (i) at the CPS level, this will be done during the country programming review mission (CPRM) and the mid-term review mission for the program; and (ii) at the program level, the risk monitoring process will be specified in the program administration memorandum (see Appendix C), and will be reflected in the regular review missions.

84. Should there be some residual risks, and even in the process of managing existing risks, active monitoring will be critical in risk management. This implies that government agencies will need to regularly and actively monitor management practices and controls in departments to assess their effectiveness.⁵⁷ The aim is to facilitate early action where significant risks or deficiencies emerge so that management practices can then adapt toward effectively addressing perceived vulnerabilities.

Things to keep in mind in doing the risk assessment

85. Doing the risk assessment need not be made very complicated nor time and resource extensive; however, it does require that the relevant issues be accurately brought forth so that government decision makers are clear about what risks are contained in the program, how serious they are to compromising program effectiveness, and how they can be mitigated. In equal part, this will be the main focus of the ADB Board of Directors as well since resource commitment to very risky programs (or with programs where possibly serious risk could emerge but have been not been adequately analyzed) is a contentious issue.

86. There are some pointers on how risk assessments at the program level can be conducted. These draw not only from the literature but also from the practical experiences of development partners, as well as those of the author, across the range of DMCs. The main points to keep in mind in doing the assessment are:

- (i) *Everything is political.* The government's decision on whether or not to proceed with a program (regardless of the sector of operations) and what level of risks to take is inherently a political one;⁵⁸ in that regard, those

⁵⁷ See Treasury Board of Canada Secretariat, *Policy on Active Monitoring*, Ottawa: Treasury Board of Canada, 2001, pp. 1–2.

⁵⁸ See, e.g., discussions on the experiences of the Department for International Development in conducting governance assessments where politics is center stage in the assessments (Oslo Governance Centre (United Nations Development Programme [UNDP]) and Chr. Michelsen Institute, *Governance Assessments*

conducting the assessments need to possess a degree of updated knowledge of recent developments in the country's political economy.

(ii) *The givens*. The government will also have business processes that are to be taken as givens (i.e., treated almost as first principles). These first principles will constitute the core of what a government will not be willing to negotiate on (or change very readily), and getting an understanding of this is critical to a rigorous risk assessment. For example, the process of submitting Cabinet papers for decisions by the government will already have been incorporated in the government's rule of business, and should be accepted as such and incorporated in the analysis accordingly.

(i) *"The mad aunt in the attic."* Malgovernance and risks inherent in it are sensitive subjects, and analysts should be aware of these sensitivities. While DMCs are not generally willing to discuss specific malgovernance related issues (such as on corruption), analysts would do good to gently raise the matter in non-threatening language. Re-termining 'governance and corruption risk assessment' as 'governance analysis', e.g., or making specific reference to already published news stories and analysis in the local media, may make it more palatable.

(ii) *"My, what big teeth you have grandma."* However, once the issue has been broached, there are gains to be had by telling it like it is, warts and all. Often, this enables a more rigorous analysis of the risks and, more important, of the mitigating measures. Using diplomatic language, which is more engaging, will ensure that analysts 'live to fight another day'.

(iii) *Iterative process*. A good risk assessment is one that has gone through a fair number of iterations, also with government officials. This is because the assumptions inherent in the assessments need to be subject to scrutiny with government and others, as do the analysis on the severity of the risks and the mitigating measures. The premise here is that if the iterative process has taken place, then the mitigating proposals are likely to be practical as well as owned by Government.

(iv) *Ex-ante scrutiny by all stakeholders*. The importance of this particular activity in the risk assessment exercise cannot be over-emphasized. Using local input has been highlighted by practically all agencies that have been involved in such assessments.⁵⁹ This scrutiny is at several levels, including:

- (a) in designing the methodology for the assessment,
- (b) in determining the core and satellite indicators to be used in the assessment,
- (c) in ascertaining the method of data collection and its use,

and the Paris Declaration: Opportunities for Inclusive Participation and National Ownership, Seminar Report of the 2007 Bergen Seminar, Norway: 23–25 September 2007).

⁵⁹ See, e.g., OECD, *Survey of Donor Approaches to Governance Assessment*, Paris: OECD, February 2008; and CIDSE, *Governance and Development Cooperation: Civil Society Perspectives on the European Union Approach*, Background Paper, Brussels: CIDSE, August 2006. The latter documents that southern civil society representatives that responded to the organization's survey on governance assessments vehemently rejected the concept of external assessment by the World Bank on governance (pp. 12–13).

- (d) in specifying the first principles and the underlying assumptions that are critical to the risk analysis, and
- (e) in determining the severity of the risks as well as the practicality of the mitigating measures.

(v) *Lack of harmonized approach with donors*: The Paris Declaration on donor harmonization in development work calls on donors to “work together to reduce the number of separate, duplicative, missions to the field and diagnostic reviews.” But, in general, this has not happened in the governance field.⁶⁰ There are dozens of existing diagnostic tools for governance, each advocated by particular donor agencies. This requires that analysts engage with other development partners in the country to gauge the level of work that has been done on other governance assessments, and to ensure that harmonization takes place effectively.

87. Of the pointers mentioned above, probably the most significant one has to do with the need to share the assessment with government decision makers early on in the process. This can improve not only the accuracy of the assessment but also the ownership of the same. This lesson is often lost in the risk assessment and program development work.

D. RISK COMMUNICATION

88. An advantage of sharing the risk assessment with government decision makers early on is that it enables them to communicate the risks better to relevant stakeholders (both to share the parameters of the risks and to glean effective mitigating measures). This risk communication will not only be with the public but also across government agencies itself (after all, it is not reasonable to assume that risks in one part of government could well jeopardize actions elsewhere in government). As was alluded to earlier (see para 53), this process of risk communication helps in democratizing risks, which could become an effective way to optimize risks. It is thus relevant to briefly dwell on the concept of risk communication.

89. There are some very good reasons to communicate risks: not only is this often mandated legislatively but it also overcomes any downstream opposition to the decisions being taken. Communicating risks also helps in minimizing the differences in the ultimate policy or program to be developed.⁶¹ Not communicating risks properly results in a risk information vacuum, which is a primary factor in the social amplification of risks (i.e., without proper information, society begins to perceive a greater level of risks than what is actually evident).⁶²

90. Three important principles that have been discussed in terms of such risk communication have centered on the following normative measures:⁶³

⁶⁰ See, e.g., CIDSE, op cit.

⁶¹ For a discussion on communicating risks, see, e.g., OECD, *Communicate Risk*, Public Management Service, Public Management Committee, PUMA/MPM(2001) 5, 10 October 2001.

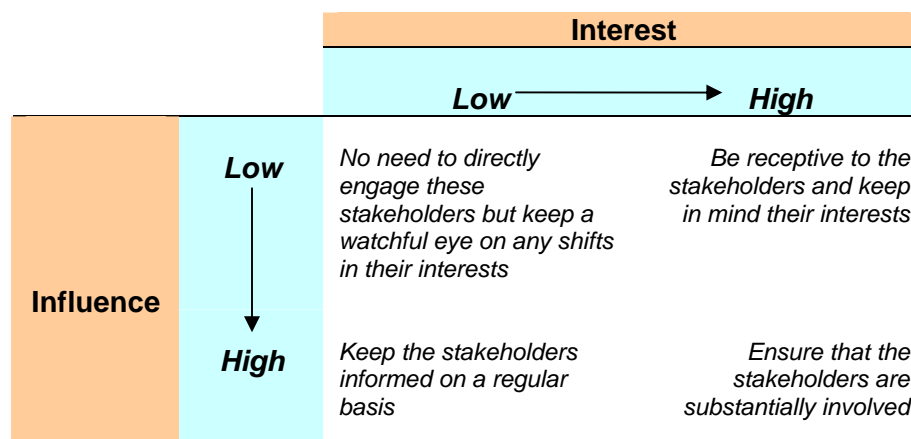
⁶² Op cit, pp. 5–6.

⁶³ For more on these and other principles, see UK Cabinet Office, *Risk: Improving Government's Capability to Handle Risk and Uncertainty*, London: Cabinet Office, 2002.

- (i) *openness and transparency*: there is need to show the public and others how the risks were assessed, what evidence and assumptions were used, and where any gaps and caveats may have been specified;
- (ii) *engagement*: it is critical to involve the relevant stakeholders that will be affected by the actions to be taken in risk mitigation (i.e., consult widely); and
- (iii) *evidence*: governments should obviously base all decisions on evidence whose sources have been verified; risk communication serves the purpose also of verification of evidence; in large part, however, perceptions of policy makers and government officials tend to replace evidence in risk assessments in soft sector programs (such as governance reforms); hence risk communication in such cases becomes critical.

91. It is important to keep in mind that while some stakeholders will have influence over the manner in which the risks are managed, others will only have an interest but less influence. This interplay between influence and interest is best captured in the following matrix, which provides cues to governments on how to engage in risk communication (Figure 10).

Figure 10. Matrix of influence and interest in risk communication



Source: Adapted from UK Resilience, *Communicating Risk*, 2003.

92. Depending upon which risk is under consideration, the government will need to prioritize the stakeholders since it is not likely to possess adequate resources to engage all of them to the same degree, and nor will it have to. Figure 10 shows that all those stakeholders that have influence and interest will need to be involved in some way in the risk analysis and management since they will be influential in attainment of the outcomes of the program but will also be interested in ensuring that the risks in this process are well managed. It is also clear in this matrix that stakeholders that fall in the different quadrants will need to be approached differently.

E. CONCLUSION

93. This analysis has focused on one practical method of assessing risks at the program level during the course of ADB programming in DMCs. Several important conclusions can be drawn from this analysis. These relate not only to the method of the risk assessment, but also the broader context in which the assessment is done. Most

important, the analysis highlights the central role that assessment of risks should play in development programming.

94. *Whole operating context.* Understanding the totality of the operating context of the government and the public sector is critical if risk assessments are to be meaningful to the government. This means analysts are expected to be aware of the general context of the proposed program and should be able to draw on that context to present useful assessments. This further implies that the broader political economy of the country should be studied in conducting risk assessments even at the program level. This is because ADB programs in DMCs are always in the public domain. This centrality of the public domain further means that the risks that governments face in ADB programming always have a public element; hence, governments face the difficult task of determining estimates of risk that are both technically valid and politically acceptable.

95. *Risk differentials and preferencing.* Some important conclusions emerge from the fact that, given that governments have different roles to play in the economy, risk differentials are always an important consideration to keep in mind while assessing risks for individual programs. The risk differentials further imply that risk preferencing is a likely consequence if one particular role tends to dominate the government process (such as, for example, ownership over purchase).

96. *Incrementalism and risk aversion.* The general nature of government processes in DMCs is such that incrementalism in policy making and risk aversion are the norm rather than the exception. Incrementalism parallels ad hoc risk taking, which further reinforces incrementalism. Risk management in this environment becomes devoid of strategic and long-term considerations.

97. *Importance of communicating risks.* Risk communication has not become as acceptable in DMCs as in the advanced countries. And yet, communicating the risks to the public, and more specifically to the relevant stakeholders, not only allows a broader appreciation of the risks by the public it also often helps garner more support and more realistic and practical mitigating measures. At a minimum, it buffers the government from blame due to failures as a result of some risks playing out that earlier may not have been communicated.

98. *Cooperation of stakeholders.* For a rigorous risk analysis to take place, cooperation from all relevant stakeholders, particularly in government, is clearly needed so that access to critical information is possible. While this appears to be generally assumed, in practice, this is not always forthcoming. In some cases, it is also not possible to do a risk analysis for a program in a DMC since the government itself is not receptive to this type of work. That can be a binding constraint to good program design.⁶⁴

99. *Role of governments.* The analysis highlights the role that governments can play in better managing risks of malgovernance. The following are some things that governments can do to properly manage risks in governance:

⁶⁴ For example, a government may require that external assessors use different yardsticks of measurement of corporate governance since subjecting local firms to standards applied elsewhere would necessarily distort the picture. In this regard, see, for example, Niranjana Bharati, Rate us the way we are, govt tells World Bank, OECD, *The Economic Times* (Chennai), Monday, 11 February 2008, p. 13.

- (i) Establish clear accountability of, and responsibility for, risk decisions.
- (ii) Provide right incentives for the bureaucracy to deal adequately with risks.
- (iii) Make the risk decision-making process as explicit as possible.
- (iv) Improve interdepartmental and interdisciplinary coordination.
- (v) Highlight the role of precaution in risk management.
- (vi) Develop control systems to set the parameters of risk taking.

100. This last point (on control systems) merits further discussion: governments are encouraged to develop control systems (housed in one central agency) to set the parameters of risk taking, which can include the extent to which government officials are empowered to take risks (for example, those that can be termed “sensible risks”) or determining—and communicating—acceptable risks. It is important to note that when establishing control systems, minimization of transaction costs should be a decision parameter, and the ability of government departments to achieve other objectives should not be constrained.

101. Finally, one consideration of risks in governance as it relates to public sector agencies is the need to move from the traditional focus on risk mitigation (i.e., “using controls to limit exposure to problems”) to risk portfolio optimization (i.e., “determining ... risk appetite and capacity among a group of risks ..., seizing opportunities within those defined parameters, and capitalizing on the rewards that result”).⁶⁵ Extending that further, it has been said that governments should practice integrated risk management, i.e., a continuous and systematic process to understand, manage, and communicate risks from a holistic angle that will enable the government to be proactive about optimizing its returns from activities. Adherence to risk portfolio optimization will ensure that risks at the program level are seen in a broader light and decisions to accept a given level of risks in a program can be seen as being proactive about maximizing opportunities. While DMCs are yet to get to this stage, it is an objective worth advocating to them.

⁶⁵ See KPMG, *Understanding Enterprise Risk Management: An Emerging Model for Building Shareholder Value*, New York: KPMG, 2001, p. 5.

Annex A. Problem/Constraints Analysis (Public Resource Management Program at a Subjurisdiction Level)⁶⁶

A. Introduction

1. The problem/constraints analysis proceeds from the following generalized specification which shows a functional link between a particular desired outcome and the variables that impact it:

$$Y = f(x_1 \dots x_n, p_1 \dots p_n), e$$

where Y = desired outcome
x₁...x_n = series of uncontrollable exogenous variables⁶⁷
p₁...p_n = series of policy instruments
e = error term

2. For purposes of the program on public resource management, the functional relationship shown above could be generally specified as follows:⁶⁸

$$\begin{aligned} \text{Creation of Fiscal Space} = & f\{x_1(\text{political will of government}),^{69} \\ & x_n(\text{central government policies}),^{70} \\ & x_n(\dots); p_1(\text{revenue enhancement}), p_2(\text{expenditure} \\ & \text{rationalization}), p_3(\text{debt management}), p_4(\text{institutions} \\ & \text{of governance}), p_n(\dots)\} + e \end{aligned}$$

Note: The hypothesized relationships between all policy instruments and the outcome are positive in the following instances: higher revenues, lower expenditures, lower debts, and strong institutions of governance, or combinations thereof.

B. Problem Analysis

Broader Political Economy Considerations

3. The problem/constraints analysis for this program has to start from a critical look at the broader political economy context of the jurisdiction in question. This should include, among others, the role of the central government; the policy framework within which the jurisdiction conducts its public sector work; its political history in brief; the

⁶⁶ This example draws from an analysis done recently for a support program on governance and public management reforms at a subjurisdictional level in a developing member country (DMC) of the ADB. The analysis here is for illustrative purposes alone.

⁶⁷ These are akin to the binding constraints; see the main text (para 65).

⁶⁸ This is a very simplified formulation of the problem analysis, and is meant more as a starting point for a discussion on what the problem is, and what are the most feasible entry points to better address it. As is evident above, the formulation is incomplete as there are *n* other variables and policy instruments relevant for the problem analysis. Simply, however, **FS=f(DM, RE, ER), e** (i.e., fiscal space is a function of proper debt management, revenue enhancement, and expenditure rationalization; **e** refers to an error term that signifies other unspecified variables).

⁶⁹ Political will is assumed to be an exogenous variable because it is difficult to predict whether or not any subsequent government will necessarily retain a particular level of political will that it may profess prior to taking over the reins of government.

⁷⁰ These refer to, among others, any regional policy of the central or federal government.

broad development paradigm employed by the jurisdiction (e.g., one that is public expenditure-led in jurisdictions where the bureaucracy is instrumental in the economy); the role of markets in key sectors that dominate the jurisdiction; any political and social unrest that may be evident and which has an impact on the fiscal position of the Government; and broad endowments, both physical and human.

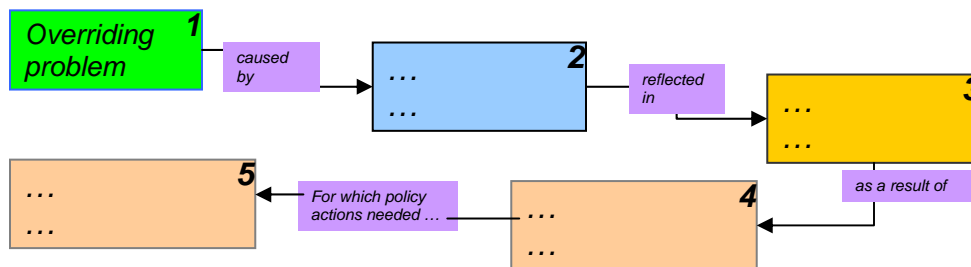
Program Logic

4. Once the broad political economy considerations are discussed, the program logic is specified. The logic chain for the fiscal reform program could be said to anchored in some assumptions, including but not limited to

- (i) that any social unrest in the jurisdiction could be at the core of the development paradigm that has governed public policy expenditure in the jurisdiction;
- (ii) that the program will help create the fiscal space needed to allow the government to invest further in public infrastructure, which will, in turn, promote private investment thus leading to income generation and employment⁷¹;
- (iii) that greater fiscal space will result in reorientation of expenditure into social and economic infrastructure;
- (iv) that creating fiscal space is a necessary but not a sufficient condition to resolving the government's financial and economic woes⁷²;
- (v) that transparency in fiscal affairs is important to ensure that the government is held accountable for its actions⁷³; thus, good governance and proper fiscal management are complementary.

5. Proceeding from the general specification above, the particular issue of creating greater fiscal space can be analyzed in the following manner (Figure A1):

Figure A1. Chain of problem specification



⁷¹ If there were any situation of social unrest in the subjurisdiction (caused in large part by youth unemployment, for example), then creating greater fiscal space has a consequential impact on the resolution of the problem of social unrest.

⁷² Thus, the proposed program focuses on a few other policy actions as well, including, for example, enhancing transparency through auctions of public assets and licensing, increasing capability of some economic institutions, reducing mismanagement through automation in bureaucracy, etc.

⁷³ For example, transparency in fiscal affairs could be evident in making public the contingent liabilities, if any, that the government may have incurred as a result of years of support to failing state-owned enterprises.

Applying this program logic gives us the following.

Figure A2. Schematic diagram of the program logic

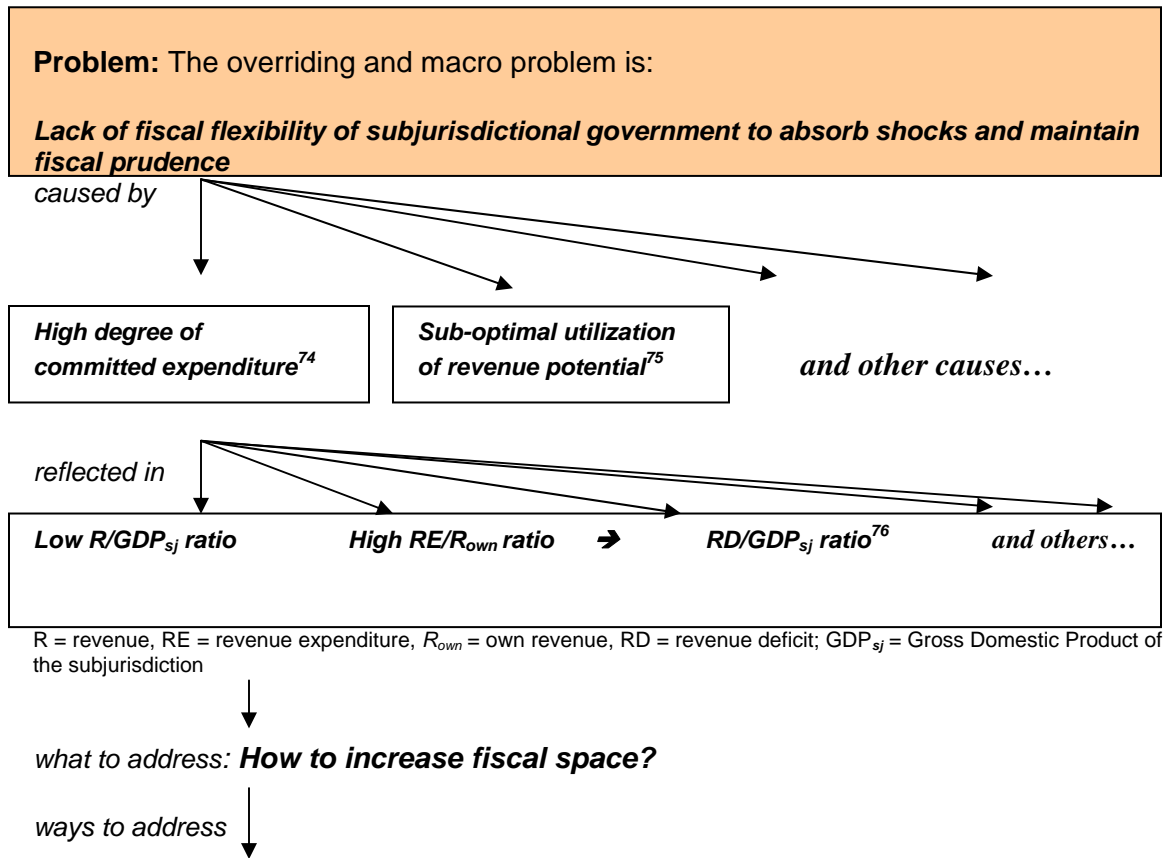


Table A1. Associated policy actions to increase fiscal space

Fiscal Space Component	Sub-component	Sample Policy actions
I. Revenue Administration	Value-Added Tax	<ul style="list-style-type: none"> Prepare and adopt the VAT Audit manual, if none available Simplify filing requirements under the VAT Act to, for example, reduce the frequency of submission of returns Upgrade the Tax Information Management System to make it fully functional such as (i) system upgrading, (ii) enabling e-filing of VAT returns, (iii) enabling e-filing of motor vehicle data, (iv) establish and make operational a Large Taxpayer Unit, etc.
	Excise taxes, Stamp Duty and Registration Fees/Land	<ul style="list-style-type: none"> Auction licenses (e.g., allotment of country liquor shops) Computerize registration of properties, and land records Prepare guidelines for, and computerize, the Objective Valuation Method for all major classes of properties and linked

⁷⁴ Also known as nondiscretionary expenditure, this includes salaries, pensions, debt servicing costs, etc. Notationally, $NDE=f(\text{Size}_{govt}, DS, WR)$ where NDE = non-discretionary expenditure, Size_{govt} = size of subjurisdictional government, DS = debt stock, WR = wage rate. Also note that the hypothesized relationships among the endogenous and exogenous variables are all positive.

⁷⁵ Revenue itself is generated from tax and non-tax sources; as it relates to taxes, revenue $(R)=f(TR, TB, E_{TA})+Ext$ where R = revenue, TR = tax rate, TB = tax base, E_{TA} = efficiency of tax administration, and Ext = externalities.

⁷⁶ A low R/GDP_{sj} ratio combined with a high RE/R_{own} ratio results in high revenue deficit to GDP_{sj} ratio.

Fiscal Space Component	Sub-component	Sample Policy actions
	Revenue, and composite check posts	<ul style="list-style-type: none"> to property registration Operate composite check posts to maximize efficiency of tax collection and increase tax revenues
II. Expenditure Management	Outcome-based budgeting, O&M expenditure, Fixed Assets Register	<ul style="list-style-type: none"> Introduce outcome budgeting across departments Resource departments accordingly Ensure sustainable O&M expenditure in all spending departments Prepare fixed asset registers across departments
	Pension management	<ul style="list-style-type: none"> Finalize modalities of employees' contributions to the Pension Fund Submit statements on the collection of employee's contribution to the Pension Fund (for purposes of transparency)
III. Proper debt management	Debt Management Unit (DMU) and Policy	<ul style="list-style-type: none"> Staff, and adequately resource, a dedicated DMU Make provisions for suitable training of the DMU staff on debt management tools Prepare comprehensive and realistic debt management policy and procedural manual
	Contingent liability management and loan reconciliation	<ul style="list-style-type: none"> Issue guarantees for borrowings by government agencies Establish and manage a guarantee redemption fund Reconcile loans from administrative ministries of central government that are outstanding
IV. PSE Restructuring and Closure	Asset management	<ul style="list-style-type: none"> Set up and make functional an asset management cell to estimate assets of closed PSEs Review all PSE restructuring and closure possibilities Liquidate assets of closed PSEs Conduct statutory audits of PSEs that are closed
	VRS and social safety nets	<ul style="list-style-type: none"> Prepare necessary guidelines on VRS and provide VRS compensation as per those guidelines Make provisions for training in alternate skills to those employees availing VRS

DMU = Debt Management Unit, PSE = public sector enterprise, VAT = value added tax, VRS = voluntary retirement scheme

Source: Author.

6. Other relevant policy actions are with respect to the broader issues of governance in public management at the subjurisdictional level; while the program has a consequential impact on them, they are critical to program success.⁷⁷

Table A2. Other relevant sample policy actions

Area of focus	Weaknesses	Policy actions
Governance, management, and accountability mechanisms, including in the public financial management system	Complex bureaucratic procedures and outdated business processes	<ul style="list-style-type: none"> Review and institute needed business process reengineering, including strengthening E-governance Review machinery of government (e.g., rightsizing, including simplifying interagency coordination, aligning economic policies with social development)
	Mismanagement of resources	<ul style="list-style-type: none"> Address the problem in selected (and visible) institutions of government Strengthen role of relevant bodies on anticorruption/vigilance

⁷⁷ There are *n* number of policy actions that the subjurisdiction can take to improve governance and public management; not all of them are discussed here. This particular program deals with those primary ones that deal with the ability of the government to absorb economic shocks and maintain fiscal prudence.

	Weak internal accountability mechanisms	<ul style="list-style-type: none"> • Consider results-oriented management in nonfinancial and economic agencies as well • Strengthen existing arrangements for internal control, internal audit, and accounting standards in public bodies • Enhance accountability and transparency in fiscal matters (e.g., making public the level of contingent liabilities, etc.) • Improve capacity in line ministries for public budgeting practices (e.g., any medium-term budgeting framework) • Continue to emphasize increased transparency in the working of the bureaucracy (including through greater facilitated application of any RTI laws)
Relationships with devolved bodies	Weak local administration and autonomous councils	<ul style="list-style-type: none"> • Hold necessary elections for local governments • Grant greater fiscal autonomy to local governments • Implement all existing provisions of local administration legislative and other arrangements • Further devolve administrative and fiscal powers • Build capacity of local administrations, particularly with respect to provision of social and economic services • Strengthen local elected councils
Empowerment of citizens (particularly the marginalized ones) to improve governance	Weak voice mechanisms for citizens	<ul style="list-style-type: none"> • Identify and strengthen relevant institutions that foster good governance • Strengthen capacity of judiciary (and alternative mechanisms) to enforce voice provisions, including grievance redress mechanisms • Enable increased demand from citizens for effective service delivery • Further strengthen relevant bodies on anticorruption/vigilance • Review laws that have wider application to the more marginalized segments of the population to assess the degree to which they make life easier for the poor

RTI = Right to Information Act.

C. Stakeholders

7. The relevant stakeholders in the program include the governments of the day at the center and at the subjurisdiction level, the subjurisdiction bureaucracy, institutions other than the core bureaucracy, business associations, any training institutions that would be involved in retraining employees availing voluntary retirement scheme (VRS), and citizens at large in the subjurisdiction.

8. The **government of the day in the subjurisdiction** is responsible of ensuring that all policy actions are taken to facilitate greater fiscal space, and that all relevant governance mechanisms are taken into account with respect to meeting the outcomes of the program. The subjurisdiction's commitment to reforms also will need to be assessed, particularly if there are any similar prior reform programs and/or policy commitments made public (e.g., through a budget speech).

9. The **subjurisdiction bureaucracy**, including, for example, the Department of Finance, and other relevant agencies, such as the Tax Office, which will play a critical role in the implementation of the program. This set of stakeholders also includes individual employees of the subjurisdiction government that will have a stake in the manner in which the government conducts its business (such as, for example, on IT training, revised business processes, etc.). A further subset of this set of stakeholders includes employees of the closed public sector enterprises (PSEs) (these are individuals who will be in receipt of the VRS and who will avail of opportunities for training).

10. The **government of the day at the center** is also a key stakeholder given the existing devolved relationships that exist in any federal system of government. This obviously impacts the political economy of the subjurisdiction in many substantial ways (e.g., in taking on the costs of subsovereign loans, in making central level fiscal transfers, and in instituting relevant policies related to the management of specific subjurisdictional affairs [such as policies on dealing with social unrest, if any; adherence to international treaties; cross-border trade, etc.]).

11. **Institutions other than core government ones** at the subjurisdiction level also have a stake (albeit a rather indirect one) in the program. These include, for example, the Accountant General, and others who will play a role in ensuring that program actions are in consonance with existing rules and regulations.

12. **Business associations at the local level**, including industry associations, and chambers of commerce that have considerable stake in the program since they will be subject to the tax and other provisions of the program. Experiences from programming in jurisdictions and subjurisdictions elsewhere have shown that while in the short run these associations (representing private business) perceive greater compliance and transaction costs of the program, they also see long-term benefits in terms of greater efficiencies resulting from program interventions.

13. State-level **training institutes** that will participate with the subjurisdiction to provide training in alternative skills to employees availing VRS. Their role will be important to ensure that any remaining ex-employees of the closed PSEs that are not gainfully employed will be able to enter the labor force with new skills.

14. Finally, the **citizens** at large are obvious stakeholders of the program. While their involvement in the program is indirect, and program benefits are not immediate, they are expected to benefit from the long-term results of the reorientation of subjurisdictional finances toward greater investments in social and economic services.

D. Binding Constraints

15. An analysis of the existing political economy of the subjurisdiction will reveal relevant binding constraints in the Program; these can be generally stated as follows:

(i) Any social unrest or insurgency (either low or high level) will obviously constrain government action on the fiscal side of the economy. This will be evident not only on how the government positions its finances but also how it develops relevant policies for ensuring that development impulses are transmitted to any conflict-hit hinterlands.

(ii) The existence of a public expenditure-led development paradigm will also reveal a binding constraint of a persistent expenditure burden imposed on the subjurisdiction. Minimizing this burden requires a fundamental shift in the logic of how economic growth is to be fostered in the subjurisdiction.

(iii) The geographical terrain, where this is rough, may also serve as a binding constraint. The difficult geographical layout not only hinders effective penetration to the rural hinterlands; it also prohibitively increases the costs to the

subjurisdiction to provide the infrastructure and to the private sector and others to provide needed transport services. If there has been unwillingness/inability of the private sector to come in with substantial resources to invest in infrastructure, this binding constraint will remain.

(iv) The relationship with central government is also a binding constraint on the subjurisdiction. This constraint could be evident in many ways:

(a) If the subjurisdiction is characterized by weak economic conditions, it will be heavily dependent on central resource transfers (which could account for a considerable share of its revenue receipts); this means that the subjurisdiction is inherently constrained by the center's predispositions and actions.

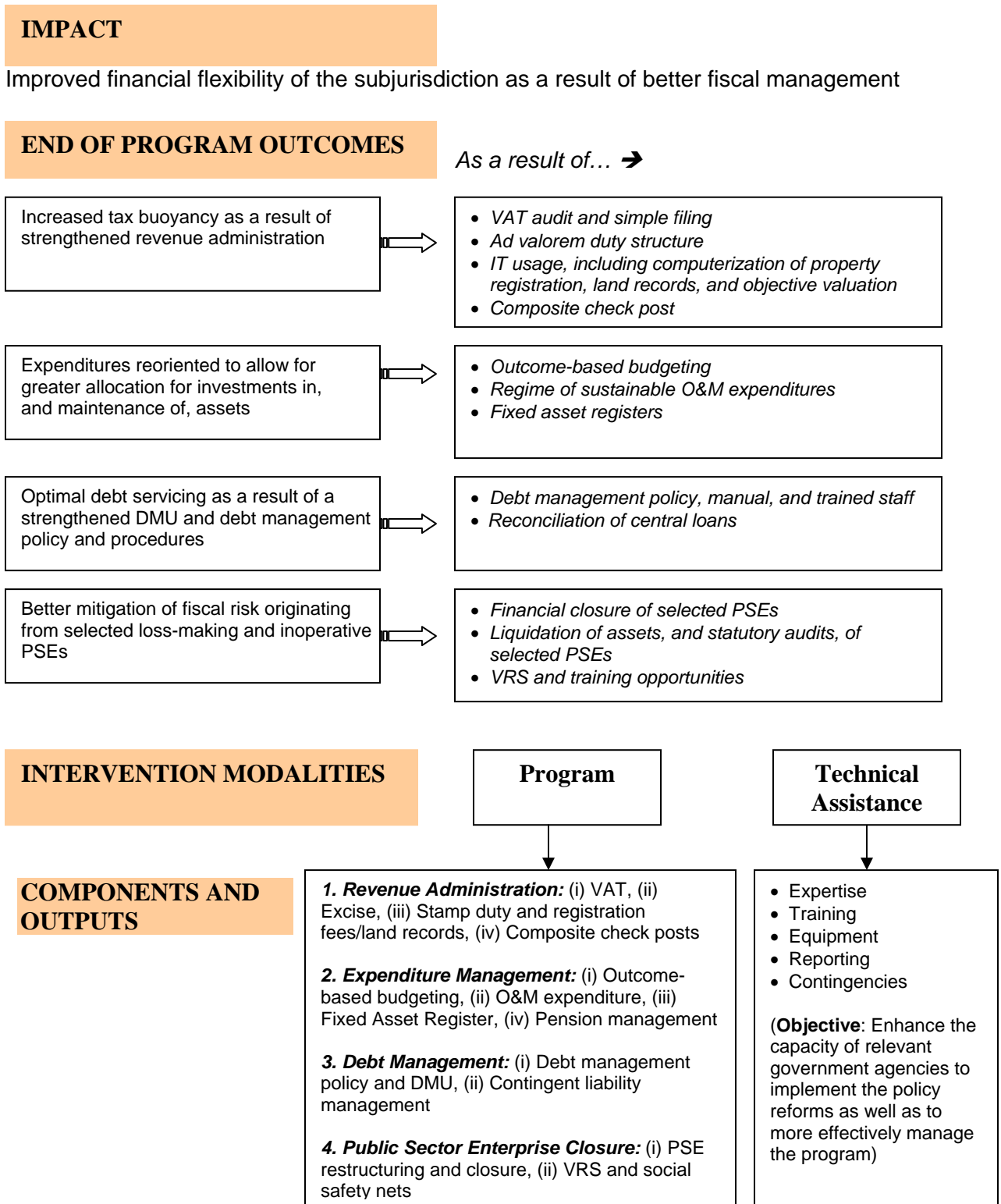
(b) In the event of any festering social unrest or low-level insurgency, the central government, by virtue of its mandate over security and peace, is in a position to dictate to the subjurisdiction what policy actions need to be in place; a fair number of these policy actions will be in the fiscal domain (e.g., in terms of mandatory spending for specific programs in conflict areas).

(c) The work of the various central commissions, if any, will also impact the local economy in substantial ways. In addition, wage recommendations of any central pay commission, e.g., while not necessarily applicable to employees in the subjurisdiction, may also tend to exert pressures on the subjurisdiction government to respond in kind.

16. Any program designed to increase the fiscal space for the subjurisdiction government will thus have to account for these primary binding constraints to be successful.

17. The logic of the program is schematically provided in Figure A3.

Figure A3. Public resource management program results chain



DMU = Debt Management Unit, O&M = operation and maintenance, PSE = public sector enterprise, VRS = voluntary retirement scheme, VAT = value-added tax,

Annex B. Summary Governance and Anticorruption Risk Assessment (Public Resource Management Program at a Subjurisdiction Level)⁷⁸

I. Introduction

1. This assessment takes a risk-based approach to issues in public resource management in the subjurisdiction for which the program is being developed.

II. Relevant Governance Issues

Political economy

2. The broader political economy of the subjurisdiction is characterized by, among others, (i) a degree of social unrest at the core of the political economy which, in turn, constrains the government not only on how it positions its finances but also on how it develops relevant policies for developing the conflict-hit hinterlands; (ii) reliance on the capacity of the subjurisdiction and its bureaucratic arrangements to foster development (development work is public expenditure-led and there is now a persistent expenditure burden imposed on the government); and (iii) considerable reliance on the central government for resources (more than 60% of revenue receipts of the subjurisdiction).

Public service and public sector enterprises

3. The level of government employment in the subjurisdiction is now considered to be fiscally untenable (almost 50% of revenue expenditure goes to the salary and wages bill). Recent remedial measures have included restricting replacement of retiring government employees and growth of salaries, abolishing all posts which have been vacant for more than a year, consideration of voluntary retirement scheme (VRS) in government agencies, and redeployment of staff. The subjurisdiction currently has 48 public sector enterprises (PSEs) but, in 2001, only 6 PSEs were considered “performing well,” this dropped to 5 in 2003 (of these, only 2 were paying dividends and the other 3 had no accumulated loss).

Public finance management

4. The subjurisdiction’s debt burden has risen to 37.4% in 2005–2006. Its contingent liabilities are also high as it has given guarantees to loans taken by public enterprises. As for revenues of the subjurisdiction, the bulk of it (almost two thirds) comes from central government transfers. Weaknesses in revenue administration span the gamut of lack of audit and operations manual to a weak tax information management system. These not only impact the effective collection of enhanced revenues but also reflect vulnerabilities to leakages and mismanagement. Finally, there are gaps in expenditure rationalization that are reflected in the absence of links between capital and recurrent budgets as well as inadequacies in operation and maintenance (O&M)

⁷⁸ This annex continues the example provided in Annex A, and provides a summary governance and anticorruption risk assessment prepared recently for the support program on governance and public management reforms at a subjurisdictional level in a DMC. It has been slightly revised here for purposes of making it for illustrative purposes alone. ADB’s public communication policy stipulates that such assessments should be available in the ADB website once the program has been negotiated with government and the Board has approved it. One such example of a risk assessment which is publicly available can be accessed at www.adb.org/Documents/RRPs/BAN/37017-BAN-RRP.pdf.

expenditures, and weak internal audit function in agencies. Already, the level of revenue expenditures is expected to have reached an unprecedented level of 27%.

5. To better get a handle on its public finance management, the subjurisdiction has recently enacted the Fiscal Responsibility and Budget Management (FRBM) Act (the latest amendment for the same took place less than a year ago) which stipulates several fiscal targets, but more importantly, requires the subjurisdiction to show in the annual budget a detailed statement giving the number of employees in government, public sector, and aided institutions, and related salary.

Procurement, corruption, and transparency

6. The subjurisdiction has prepared a public procurement manual which focuses on, inter alia, the guiding principles of economy, transparency, accountability, equity, effectiveness, efficiency, and ethical standards. Poor governance, lack of accountability leading to leakage of development funds, and the problem of corruption in the subjurisdiction has been reported to be still substantial (the relevant country corruption study puts the subjurisdiction within the bottom 25% ranking in a recent survey).

7. The subjurisdiction now publishes a semiannual report on achievements of financial reforms and budget targets. Also, the recently enacted FRBM Act requires the government to show in the annual budget a detailed statement giving information regarding employees in the government and public sector. As per the FRBM Act, the relevant Finance agency should also undertake a review every year, the trends in receipts and expenditures including the fiscal indicator targets for the current year, explaining the reasons for any deviations and related remedial measures.

III. Identification of Risks, their Severity, and Risk Mitigation Measures

8. Risk assessment for the program is by nature subjective, hence, an iterative process or peer review both within the subjurisdiction and at ADB is recommended.

Underlying assumptions

9. The main underlying assumptions that are made here are (i) that the subjurisdiction will stay the course in reforms, (ii) that effective institution building processes in key agencies in public finance management will continue, and (iii) that the government shares the view that this assessment presents an accurate and rigorous review of the risks in the sector.

Risk specification

10. Some risks that could arise not only in relation to the program but also across the public sector broadly can be specified as under three broad categories:

- **Exogenous to the subjurisdiction.** Includes (i) social unrest, (ii) central level policy changes or delays in specific initiatives, (iii) decline in central

transfers, (iv) exposure to international market risks,⁷⁹ and (v) extraneous events.⁸⁰

- **Within the subjurisdiction machinery.** Includes (i) low capacity in institutions, (ii) continued risk of corruption/mismanagement in the public sector, (iii) weak internal accountability mechanisms in agencies, (iv) low government commitment to continuing with reforms (or even risk of policy reversal), (v) complex bureaucratic processes and outdated business processes, and (vi) containment of the expenditure.
- **Specific program related.** Includes (i) risk of dispersion of subjurisdiction functions in fiscal management; (ii) gaps in relevant rules and regulations, and (iii) PSE-related, e.g., potential proliferation in adjustment costs of PSE closures, costs associated with possible litigation by ex-PSE employees, etc.

Risk severity

11. Figure B1 indicates the four types of risks based on severity; with Type I being the most severe that would require prompt attention.

Figure B1. Risk severity matrix

		Impact		
		High	Moderate	Low
Likelihood of Event Occurring	High	Type I <ul style="list-style-type: none"> • Low capacity throughout all relevant agencies 	Type II <ul style="list-style-type: none"> • Aggravation of the social unrest problem • Other extraneous events (such as fluctuations in the price of key exports) • Risk of dispersion of government functions in fiscal management • Gaps in relevant rules and regulations 	Type III <ul style="list-style-type: none"> • Decline in central transfers
	Moderate	Type II <ul style="list-style-type: none"> • Central level policy changes or delays in specific initiatives • Continued risk of corruption and mismanagement in the public sector • Weak internal accountability mechanisms in government agencies 	Type II/III <ul style="list-style-type: none"> • Exposure to international market risks • Risks related to PSEs (including weak corporate governance arrangements, and possible court cases) • Complex bureaucratic procedures and outdated business processes 	Type III <ul style="list-style-type: none"> • Containment of the replacement of retiring government employees as well as salary expenditure
	Low	Type III <ul style="list-style-type: none"> • Low government commitment to continuing with reforms (or risk of policy reversal) 	Type III	Type IV

PSEs = public sector enterprises.
Source: Author.

⁷⁹ The subjurisdiction is now able to obtain loans directly from multilateral and bilateral sources.

⁸⁰ Such as variations in international prices for the subjurisdiction's key export(s) that can impart a degree of volatility to its tax base.

Ongoing and proposed mitigation measures, and residual risks

12. In proposing mitigating measures for the various risks specified here, it is relevant to note that such measures to address the risks that are exogenous to the subjurisdiction are not practical, and so are not included in the analysis to follow. Ongoing and mitigating measures for Type I and Type II risks are provided in Table B1.

Table B1. Risk mitigation measures matrix

Risk specification	Ongoing mitigation measures	Proposed mitigating measures	Residual risks, if any
Low capacity throughout all relevant agencies	<ul style="list-style-type: none"> Regular capacity development opportunities under existing programs 	<ul style="list-style-type: none"> Efficiently use training resources in existing programs Provide technical assistance for capacity building 	<ul style="list-style-type: none"> Adjustment costs could be high—at least in the initial phase
Dispersion of government functions in fiscal management	<ul style="list-style-type: none"> Coordination being targeted by the Finance Department 	<ul style="list-style-type: none"> Ensure, first, a coherent policy on key subsectors (such as on debt management, tax, etc.) Conduct a MOG review 	<ul style="list-style-type: none"> High transaction costs could well derail the consolidation
Gaps in relevant rules and regulations	<ul style="list-style-type: none"> Several proposals are with government on which specific acts need detailed regulations 	<ul style="list-style-type: none"> Provide technical assistance, if necessary, to expedite the formulation of rules and regulations 	<ul style="list-style-type: none"> Covering all relevant areas would be time consuming and resource constraints may hamper the work
Mismanagement in the public sector diminishes the gains of the Program	<ul style="list-style-type: none"> Provision for an enhanced role of any existing body that plays the role of a vigilance commission Aggressive investigation by the commission 	<ul style="list-style-type: none"> Strengthen the relevant body with an effective dissemination of information on frauds and mismanagement 	<ul style="list-style-type: none"> Resource constraints in the work of the body may hamper the effectiveness of its work
Weak internal accountability mechanisms	<ul style="list-style-type: none"> FRBM Act requires greater level of transparency and accountability in the fiscal domain Application of the Right to Information Act 	<ul style="list-style-type: none"> Consider RBM Strengthen existing arrangements for internal control, and accounting standards in public bodies Improve capacity in ministries for adhering to existing accountability mechanisms Facilitate application of Right to Information (RTI) law 	<ul style="list-style-type: none"> Resource constraints could contain the extent of accountability enhancement, also bureaucratic pressures may stall this reform measure
Risks related to PSEs (including weak corporate governance arrangements, and possible court cases)	<ul style="list-style-type: none"> Corporate governance measures proposed Engagement with potential VRS recipients has put at bay court litigation Established audit committees 	<ul style="list-style-type: none"> Ensure that government improves corporate governance measures in PSEs Continue to engage with ex-employees of closed PSEs through well-designed VRS programs, including providing an opportunity to be retrained at government's expense 	<ul style="list-style-type: none"> There will most likely be few takers for the retraining facility, corporate governance measures may also come across stiff bureaucratic resistance
Containment of the replacement of retiring government employees as well as salary expenditure	<ul style="list-style-type: none"> Administrative reforms to build on its functional reviews for selected subjurisdiction departments and its review of the functioning 	<ul style="list-style-type: none"> Initiation of outcome-based budgeting and evolving an enhanced outcome-based budgeting procedure 	<ul style="list-style-type: none"> The positive impact is expected to occur in the medium and long term; the government may not have a long-term view of the problem
Complex bureaucratic procedures and outdated business processes	<ul style="list-style-type: none"> Organizational restructuring in some parts of the government machinery 	<ul style="list-style-type: none"> Make better use of IT (e.g., CTMIS, TIMS) to streamline processes and raise efficiency Review MOG (e.g., rightsizing, simplifying coordination, etc.) 	<ul style="list-style-type: none"> Bureaucratic resistance to reengineering may slow down reform efforts

CTMIS=Computerized Treasury Management Information System, FRBM=Fiscal Responsibility and Budgetary Management, IT=information technology, MOG=machinery of government, PSE=public sector enterprise, RBM=results-based management, TIMS=tax information management system, VRS=voluntary retirement scheme.

13. Many of the proposed mitigating measures are already included in the program and in the policy matrix inherent in it. The political commitment of the government in the subjurisdiction to implement measures in the policy matrix is an underlying assumption of this risk assessment.

IV. Recommendations

14. The preceding risk assessment points to several recommendations on ways to not only address the risks but also enhance the design and implementation of the Public Resource Management Program. These recommendations include

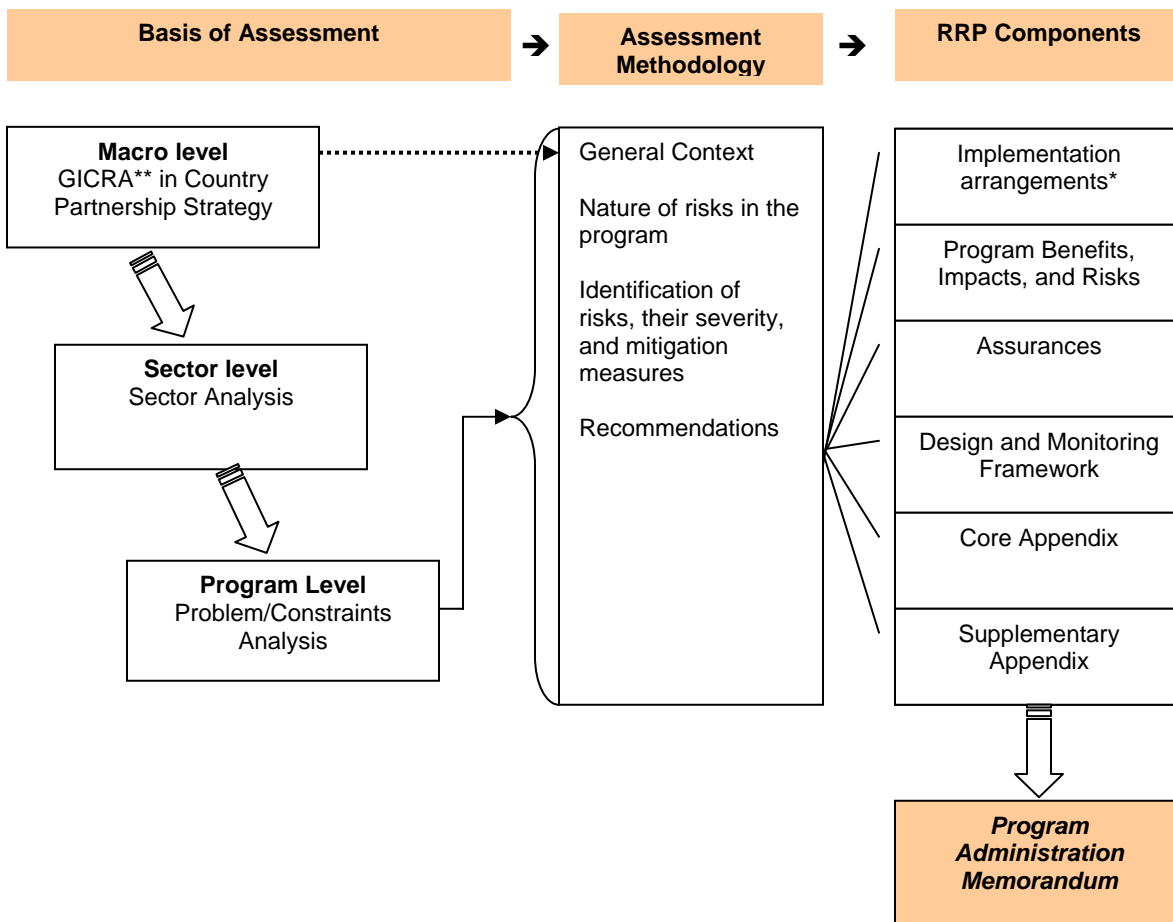
- providing technical assistance (TA) designed to directly address the Type I risk;
- incorporating several provisions on good governance and anticorruption as loan conditions and assurances as relevant;
- reviewing the risk analysis with the subjurisdiction government;
- getting stakeholder to buy in to—and concur with—governance and corruption risk mitigation strategies; and
- acquiring information during monitoring review missions on revised structures and processes in public finance management to assess progress in managing corruption risks and any incidences of mismanagement and inefficiencies in the public sector.

Annex C. Governance and Corruption Risk Assessment and the RRP

Introduction

1. Once the risk assessment has been prepared (and shared with Government), it needs to be incorporated in the Program Document (called the Report and Recommendation of the President to the Board of Directors, in short, RRP). The results of the governance and corruption risk analysis need to be reflected in several sections of the RRP (see Figure C1).

Figure C1. Reflecting the risk assessment in the RRP



*Particularly the section on governance and anticorruption

**GICRA: Governance and Institutional Corruption Risk Assessment

2. Figure C1 merits some explanation, with particular reference to how the basis of the risk assessment (and the assessment itself) is incorporated in the RRP. The basis of the assessment is discussed further below; the assessment methodology has already been covered in the main text of this paper. The RRP components listed above are not in order of importance in the RRP; rather they reflect the relevant sections as they appear in the RRP document.

Basis of Assessment

3. The focus of this paper is only on the program level risk assessment; at this level, the risk assessment draws its essence from two prior assessments at the macro (or country partnership strategy [CPS]) and sector levels.

Macro Level: GICRA in Country Partnership Strategy

4. ADB seeks to deliver its strategic agenda with respect to developing member countries (DMCs) through a selective, planned, and country-focused program. This is contained in the CPS document for each DMC, which includes discussion on, among others: (i) the general development context, issues, and constraints; (ii) linkages between the CPS and ADB's strategic priorities and objectives (as well as relevant strategies, such as on poverty reduction); (iii) Millennium Development Goals; (iv) the DMC's development priorities and strategies; (v) economic, thematic, and sector assessments of the DMC; (vi) ADB's development experience in the country as well as its strategy for the country; and (vii) risks and performance monitoring and evaluation.

5. The final section on risks discusses generic and program performance risks. This section is anchored in the governance and institutional corruption risk assessment (GICRA),⁸¹ which is included as a supplementary appendix in the CPS. The GICRA considers the risks to good governance (including anticorruption) that are focused at the institutional level, and that rely on vulnerability to corruption assessments. These GICRAs enable program level assessments to draw on assessments at the macro level so that risk assessments at the micro level are better informed.

Sector Level: Sector Analysis/Strategy⁸²

6. The sector analysis that the program level risk assessment draws from is contained in the specific assessments done in the GICRA (in those DMCs where this has been completed), and in stand-alone sector analyses done in those DMCs where the GICRA is yet to be complete. Given that there can be several programs/projects in one sector, such a sector analysis is important to ensure that the micro-level risk assessments are reflective of the broader sector-wide risks that may be in evidence. Where such sector analyses (or indeed even where GICRAs) do not exist, the program-level risk assessment will need to consider both the macro and the sector level contexts.

7. The sector level analysis (at times done during CPS preparation and at times in the intervening period) serves to identify the generic risks for each operationally relevant sector for the DMC. Given that information on the national public finance management system, procurement system and processes, and corruption are the main determinants of how the sector functions, there is a close link between the macro-level assessment and the sector level one.

RRP Components

⁸¹ To date (March 2008), ADB has conducted GICRAs in 12 DMCs, including 15 sector studies. Sectors covered have included water and sanitation, railways, public finance management, education, energy, power, road transport, urban development, etc.

⁸² A practical look at the sector-level risk assessment can be found in ADB, *GACAP II Implementation Guidelines*, Draft, April 2008.

8. While the conclusions of the risk assessment can always be reflected throughout the RRP, it is in six particular sections that the assessment results are specifically incorporated.

Implementation Arrangements

9. The implementation arrangements section of the RRP will have to contain specific proposals that may have been made with respect to how risks that could adversely affect program implementation are to be managed and mitigated. The section in the RRP on the governance and anticorruption section will need to be made specific with respect to the risks of the particular program in question. This particular section also highlights provisions of ADB's 1998 anticorruption policy as well, which make it clear what ADB's response will be in the event of risks associated with corruption and mismanagement in the program.

Program Benefits, Impacts, and Risks

10. The next relevant section is that on program benefits, impacts, and risks. The subsection on "risks and safeguards" should contain a rather detailed discussion on the major risks that the program faces and the mitigating measures that are recommended in the program. The section also contains issues related to ensuring that proper safeguards (on, for example, indigenous people, environment, resettlement, if any) are in place.

Assurances

11. The assurances section in the RRP draws from the above and will reflect the analysis of the risks; in particular, any mitigating measures of risks that appear to be of Type I or II (i.e., the more severe ones) may well be specified as assurances (these are assurances that the Government provides ADB prior to program implementation).

*Design and Monitoring Framework*⁸³

12. The design and monitoring framework contains a section on assumptions and risks for the program at three levels: impact, outcome(s), and outputs. The risks specified in the risk analysis should mirror what is included in the design and monitoring framework. However, only those assumptions and risks that are not within the control of the program are listed in the Design and Monitoring Framework (those that are should be taken into account in the program design itself).

Core Appendix

13. While the detailed risk assessment will be included as a supplementary appendix, it is recommended that a summary version of the same be included in the

⁸³ This section is also known as the Program Framework, and aims to ensure a consequential relationship between inputs, activities, outputs, outcomes, and impact(s). It contains information on the program design summary, performance targets/indicators, data sources (or reporting mechanisms), and assumptions and risks. Assumptions are "positive statements of conditions, events, or actions that are necessary to achieve the results..." while risks are "negative statements of conditions, events, or actions that would adversely affect or make it impossible to achieve the intended results" (ADB, *Guidelines for Preparing a Design and Monitoring Framework*, Manila, March 2006).

RRP as a core appendix (this is not mandatory, but does provide an opportunity to the members of the Board to determine how risks have been incorporated in the program). The Board has in the past positively viewed the incorporation of the risk analysis as a core appendix. The bulk of the focus in this appendix will be on the severity of the assumed risks and ways to mitigate them, rather than on the contextual elements of the risk analysis.

Supplementary Appendix

14. The full risk analysis will be included as one of the supplementary appendixes, which will not be submitted to the Board but will be made available should any Board member request it.

Program Administration Memorandum (PAM)⁸⁴

15. Finally, the program administration memorandum (PAM) will also need to contain a summary discussion of the risks of malgovernance and corruption in the program. This is useful because the implementing agencies of the program do not necessarily see the RRP as a good guiding document during program implementation; their reliance is more on the PAM.

⁸⁴ The program administration memorandum contains program data and information that allow the borrower, executing agency, implementing agencies, and ADB to monitor project implementation and evaluate project impact. It is an important document as it operationalizes the components in the RRP by enabling implementing agencies to get a better handle on how they are to carry out the program activities (many officials in the implementing agencies will not see the RRP document [or indeed even understand it] and will not be able to use it for practical implementation purposes; it is the PAM that gives them clearer implementation guidelines).