

## COST-BENEFIT ANALYSIS AT A CROSSROADS: THE NEW WORLD BANK AND ASIAN DEVELOPMENT BANK GUIDELINES ON ECONOMIC ANALYSIS OF INVESTMENTS

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**Abstract:** The World Bank and the Asian Development Bank are revising their respective *Guidelines for Economic Analysis of Investments* in response to a changed economic environment. Organization and management changes are also occurring as the banks attempt to both reduce the budget and improve project quality. These changes have implications for the consultants who increasingly conduct the banks' project appraisals. The new guidelines generally encourage the use of a willingness-to-pay numeraire expressed at the domestic price level and a shadow exchange rate. This article addresses the distribution of project impacts in distribution tables rather than using income weights.

**Résumé:** En réponse au nouveau contexte économique ainsi qu'à une volonté accrue de réduire les coûts et d'améliorer la qualité des projets, la Banque Mondiale et la Banque Asiatique de Développement révisent leurs «règles d'analyse économique des investissements». Ces modifications ont d'importantes conséquences pour les experts évaluant les projets. En général, ces nouvelles lignes directrices préconisent l'utilisation d'une volonté de payer numéraire aux niveaux de prix intérieurs et de taux de change de référence. La distribution de l'impact des projets est désormais mesurée par des tables de distribution plutôt que par des revenus pondérés.

Both the World Bank and the Asian Development Bank<sup>1</sup> were redrafting their respective *Guidelines for Economic Analysis of Investments* during their fiscal years 1995 and 1996. For the World Bank, the new guidelines in 1996 replaced a number of manual statements and notes written primarily between 1974 and 1984 (and largely reflected in Ray 1984). In the case of the Asian Development Bank (ADB), the new guidelines will replace the 1987 edition of a comprehensive set of guidelines by the same official title. In the case

of both organizations, major changes in approach to the economic cost-benefit analysis of investments are planned. In the emerging organizational environment, short-term and long-term consultants are increasingly responsible for the economic cost-benefit analysis of investments conducted by both of these banks. This article outlines proposed changes as they stand in current respective drafts, evaluates the environment in which they are to be introduced, and discusses the implications for consultants to these organizations.

## OVERVIEW OF THE NEW GUIDELINES

The new guidelines of the World Bank and ADB will usher in approaches based on methods that have long been identified with Arnold Harberger (see Harberger 1976, 1989) and lately with Glenn Jenkins (1994), as taught in the widely acclaimed project analysis program at the Harvard Institute for International Development. The new approaches will supplant those identified with the Little and Mirrlees (1969, 1974) revolution in project economic analysis, the revised form of which was captured in Squire and van der Tak (1975), and became the basis of the above-mentioned World Bank manual statements and “notes” and strongly influenced the ADB guidelines as revised through 1987. The primary objectives of the current revisions are (1) to simplify the calculation and interpretation of the economic analysis, (2) to make it easier to tie the economic analysis to the analysis of poverty and sustainability issues, (3) to introduce a more systematic treatment of “risk” into the analysis of investments, and (4) to make it easier to pay greater attention to the “social” sectors and the natural environment relative to the “hard” sectors of agriculture, industry, and physical infrastructure.

The project of rewriting the guidelines was given immediate impetus by a series of internal reports in both organizations — the Wapenhans Report (World Bank, 1992), which addressed project quality issues in the World Bank; *Review of the Quality of Economic Analysis in SARs for Projects Approved in 1993* (the “ECON II Report,” World Bank, 1995); and the *Report of the Task Force on Project Quality* in the ADB (1994) — that signaled increasing recognition in both institutions of fundamental problems with project quality. Contained in the ECON II report was a study conducted jointly by the Operations Evaluation Department and the Operations Policy Department that found a statistical correlation between project quality as judged in *ex post* evaluations and the quality of the economic analysis that was conducted “at entry” of projects into the portfolio.

An earlier study by a Working Group of the Task Force on Project Quality at ADB (ADB, 1993) had reached similar conclusions about the relationship between the quality of economic analysis of projects “at entry” and the quality of the projects that resulted. Earlier still, Squire (1989) and Little and Mirrlees (1990) had remarked about the differences between the theory and the reality of the application of economic analysis to projects in the World Bank, and Pohl and Mihaljek (1992) and annual project operations evaluations summaries in the banks had provided statistical evidence of widening divergences between *ex ante* and *ex post* measures of economic rates of return. After decades of basking in its reputation as the world’s leading institutional user of project economic analysis, the World Bank, in particular, found these results a bitter pill to swallow.

With the onset of the fiscal and debt crises that affected a number of developing countries in the 1980s, the major international development organizations shifted their attention to these crises and — later — to dealing with the “structural” problems that had led to the crises. Staff of these traditionally project-based organizations redirected their attention to addressing macroeconomic and sectoral policies related to structural and sectoral adjustment. Though the banks continued to be project-based — with at least 75% of their lending still going to “projects” rather than to adjustment programs — for more than 10 years project analysis tended to take a back seat to macroeconomic and policy foci. Very little updating of guidelines occurred, project analysis skills deteriorated, and — perhaps most importantly — management discipline slipped as managers struggled to maintain lending targets, in many cases simply to provide short-run support to sustain the financial systems of borrowing countries. The Wapenhans Report and ADB Task Force Report reflected the belief of staff and management that attention had to be redirected to the quality of the projects that the banks funded. A number of initiatives — some managerial, some staffing, and some procedural — are being undertaken to improve project economic analysis and thereby, it is hoped, project quality. The guidelines represent a single prong of each bank’s attack on the project quality problem.

Though the new guidelines will leave flexibility for “old” as well as “new” approaches to economic analysis, the guidance given implies the following changes in primary methods:

- *Numeraire*: Switch from a “foreign exchange” to a “willingness-to-pay” (WTP) numeraire or unit of account in most applications

- *Price Level*: Denomination of economic values at the domestic price level rather than at the border price level in most cases
- *SERs and SCFs*: Use of a shadow exchange rate (SER) in place of standard conversion factor (SCF), in keeping with the domestic price-level presentation
- *Distribution Analysis*: Presentation of an analysis of the distribution of project impacts in those cases that allow such calculations to be made
- *Missing and Incomplete Markets*: Greater guidance on estimation of values in projects and sectors characterized by “missing and incomplete markets” (social sectors, environment, institutional, and organizational change — which make up at least half of the investments undertaken in the 1990s by these banks), and in the conduct of least-cost and cost-effectiveness calculations in these applications

### The Numeraire

The Little-Mirrlees (1969, 1974) approach to economic analysis that ruled the banks from the mid-1970s involved a process of tracing project impacts to tradable goods and then valuing those impacts in units of foreign exchange. In principle, one might say that there were no “nontradable” goods in the foreign exchange numeraire approach, only “tradeable” and “indirectly tradeable” goods. Indirect tradability arose from the principle that all nontradables either used tradable inputs (in round-after-round of tracing) or substituted in consumption for tradables. Thus, *tracing* of direct-indirect impacts was an important part of these methods, and variations on input-output analysis became prominent elements of them (see Page, 1982, and Londero, 1987). Though the new ADB guidelines propose a WTP numeraire, the current draft still reflects a large element of the tracing methods arising from the Little and Mirrlees tradition. The World Bank’s current draft of its revised guidelines, on the other hand, reflects much more strongly the Harberger postulates that “demand” forms the basis for “value” and “supply” the basis for “cost”; thus, tracing of direct and indirect impacts does not play as prominent a role in the World Bank guidelines as it continues to play in the ADB revised guidelines.

Attempts to use the tracing approach in the 1970s and 1980s brought increasing awareness that the choice of numeraire may be more of a practical than a theoretical issue. The practical issue was brought

to a head by two developments in the late 1980s. One was the long-standing problem posed by economic analysis in the least developed countries (particularly the smaller ones). In countries with a small number of different traded goods (such as many of the poorest countries of Africa), a foreign exchange numeraire can provide an overly sensitive yardstick and pose practical problems for the project analyst (e.g., in finding tradable substitutes for nontradable project outputs such as teff in Ethiopia, white maize in Somalia, or galvanized iron pipes in protected industries in Bangladesh). The second development was the increasing involvement with investments in the social sectors of education, health, population, and nutrition, in the natural environment, and in projects involving institutional and organizational change. In these applications, foreign exchange as a unit of account made little sense.

### Domestic Price-Level Denomination and the SER

Related to the numeraire was the issue of whether to denominate benefits and costs at the level of domestic prices or at the level of border prices. Following Little and Mirrlees (1969, 1974) and then Squire and van der Tak (1975), the international development banks had chosen from the mid-1970s to use a border price-level denomination. For agricultural and industrial projects, border pricing allowed a direct comparison with international standards for efficiency and competitiveness. Because all impacts had already been traced to foreign exchange, the choice of denomination simply boiled down to the way the exchange rate was brought in to convert from foreign exchange to local currency. In practice, it involved a decision of whether to use the official or the shadow exchange rate to convert the foreign exchange values that otherwise already had been shadow priced by the foreign exchange tracing process (for a more extensive treatment of this and related issues, see the discussion in Ward and Deren, 1991, chaps. 10–12). Border pricing thus involved the use of the official exchange rate in making this conversion into local currency.

The biggest problem with border price-level denomination was that it obscured the implications of the differences between pairs of financial and economic prices. Financial prices, obviously, occur at the domestic price level. If economic prices, in turn, are stated at the border price level, then the differences between each pair of financial and economic values will include both a “domestic distortion” and the “border distortion” that affects all items in the economy, and it will be difficult to visualize the separation between foreign

exchange and other distortions. The economic value for unskilled labor, for example, would reflect not only the transfer payment received by such labor as a result of a minimum wage law that exceeded the workers' opportunity cost; it also would include an accounting of the transfer payment involved in the difference between the official and shadow exchange rates. If, on the other hand, all economic prices are shown at the domestic price level, then the border distortions will be displayed as part of the traded goods values (by applying the SER to the CIF and FOB values), and the nontraded goods will more clearly show the impact of the domestic market distortions affecting them. It is possible for a sophisticated economic analyst to separate these impacts when using border prices, but — in practice — the border price denomination made it difficult for the economist to explain the implications to policy makers and to the engineers who design the projects.

### Presentation of Distribution Impacts

The changed approach to distribution analysis is linked to the change to a domestic price-level denomination. Domestic-price level denomination of the numeraire allows financial and economic values to be directly compared and for "transfers" to be deduced from those differences. For example, in a WTP numeraire denominated at the domestic price level, the shadow price for unskilled labor for a manufacturing project in a market affected primarily by a minimum wage law that increases equilibrium wage costs by 50%, the income of the laborers newly employed in the without-project case will be two-thirds of that in the with-project case. The other third will be a "transfer" payment *from* the financial cash flow (of the loan and equity participants in the project) and *to* those laborers. Similarly, the difference between the official and the shadow exchange rate will represent a transfer between project loan/equity participants and other actors in the market for foreign exchange: the Central Bank, Treasury (via tariff-based protection measures of the exchange rate and covering resulting Central Bank losses), other importers/exporters, and so on. In the aggregate analysis of the project, all of these differences will add up to the difference between the financial cash flow and the economic cash flow for the project. The Jenkins approach (1994) summarizes these differences in a Prou/Chervel-type presentation table, rather than in a social rate of return. The Jenkins approach represents the culmination of a long process of development of distribution analysis. It is a simplified approach that at the same time is clearly linkable to the economics pricing process.

In an early case study from the Dominican Republic, Ward and Burnett (1978, revised by Bazzaz in 1986) had demonstrated rudimentary methods for building an “impact distribution table” by observing the differences between financial and economic values. Their analysis had been influenced strongly by the work of Prou and Chervel in France in “the Method of Effects” (see Bussery, 1973, and Chervel & LeGall, 1978) in the 1970s. By the early 1990s, Glenn Jenkins and colleagues at the Harvard Institute for International Development (HIID) had generalized this form of distribution analysis to a large number and range of projects, demonstrated its robustness and value in analyzing project sustainability and the project’s impacts upon poverty alleviation, and made it a standard part of the approach to project economic analysis taught and used at the Harvard Institute for International Development (see, for example, Andreou et al., 1989, 1991; Jenkins, 1994; Jenkins & Shukla, 1991). With the early-1990s focus upon poverty and sustainability becoming more important, the Jenkins approach to distribution analysis struck a chord with the guidelines drafters (see Whitlam, 1993). This work and the draft of a forthcoming book on project economic analysis by Jenkins and Harberger that was made available to the guidelines drafting teams thus has had a strong influence upon the writing of both the World Bank and the ADB guidelines.

The methods of Little and Mirrlees, of UNIDO, and of Squire and van der Tak all had provided for a form of income distribution analysis involving the application of income weights rather than Prou/Chervel-type distribution tables. Squire and van der Tak had made the income weighting exercise a part of the “social analysis” (leading to a social rate of return) that made adjustments to the “economic analysis” (leading to an economic rate of return), which in turn was adjusted from the “financial analysis” (which led to a financial rate of return to all resources). Colin Bruce (1976) had provided World Bank staff with guidance on calculating and using country economic and social parameters in project analysis. The methods triggered enormous controversy within the World Bank in the late 1970s and early 1980s; and the last application of social weighting in a World Bank staff appraisal report occurred in 1982. Shortly thereafter, Harberger (1984) raised the issue of targeting basic needs *versus* using distributional weights. Social analysis (involving the use of income distribution weights) in the World Bank experienced a quiet death in the 1980s, as the bank shifted its attention toward the fiscal and debt crises and to related work on economic adjustment in the member countries. The attempt to apply social analysis in ADB had fizzled much earlier and had never been

a serious part of ADB's project analysis methods. The proposals to use the Jenkins approach to distributive analysis would resurrect the "social" analysis and ostensibly present it in a form that would make much greater use of its information content. Perhaps the most important element of that information content is that it facilitates the analysis of the sustainability of the proposed investment by allowing analysts to see more clearly who is positively and who is negatively affected by the undertaking as currently proposed.

### Missing and Incomplete Markets

The two "manuals" that influenced development project appraisal from the early 1970s — those of Little and Mirrlees (1969, 1974) and the United Nations Industrial Development Organization (UNIDO, 1972) — both were directed at the analysis of *industrial* projects. They did not seek to deal with the issues posed by "missing and incomplete markets," as the traditional market failure areas came to be called from the late 1980s. The basic economic pricing problem faced in industrial projects was that of distortions created by inappropriate government policies — particularly in the trade and taxation areas — rather than the absence of markets in which the impacts could be valued. The fundamental issue addressed in those texts was the appropriate degree of "partialization" of investment analysis away from the microeconomic and macroeconomic policy environment in which the project was to be placed. The markets, for the most part, were "complete," but they were distorted by government policy. The guidelines that resulted from this view tended to leave out in the cold the project analysts in those sectors dealing with traditional "market failures" (as opposed to the "government failure" implied by inappropriate policies). This included all the "soft" sectors, such as health, education, population, nutrition, basic research, environment. It also focused on the minor part of the issues facing the public utilities sectors: in these sectors the problems are to ascertain the actual demand and willingness to pay for the large-scale systems being planned, and to deal with the risks posed by asset fixity, asset specificity, and the information issues associated with up-front expenditures that lock you in and reduce the possibilities for "learning by doing."

The new guidelines place much more emphasis upon sectors other than the "directly productive" sectors of industry and agriculture. Both banks have extended the discussion in their respective guidelines of three areas related to project analysis in missing and in-

complete markets; they now include (a) more focus on least-cost and cost-effectiveness calculations, (b) more guidance on estimating WTP and WTA values in area where markets do not exist, and (c) a bit more focus on “making markets” and on making markets work better, in addition to the now traditional approach of substituting government activity in place of malfunctioning or missing and non-existent markets.

Both sets of guidelines propose to provide much more detailed instruction on measurements of “productive efficiency” (least-cost and cost effectiveness analysis) as opposed to the “allocative efficiency” that pure cost-benefit analysis is supposed to address. In turn, both sets of guidelines will be much more helpful to the staff of the banks and of their client governments in investment programming and budgeting — part of the broadening of the economics work of the Banks that now seems inexorably related to their macroeconomic and adjustment work.

Work on valuing the environment had progressed substantially during the late 1980s and early 1990s. All of this work had involved use of willingness to pay and willingness to accept compensation (Bard & Pearce, 1991; Dixon & Hufschmidt, 1987; Dixon et al., 1994; and numerous others). Variations on these methods increasingly were being applied to health, environmental health, and education (see, for example, work by Barnum, 1987, and Wells, Xu, & Johnson, 1994). The social sectors had grown to occupy approximately one-half the lending programs of each bank and were expected to grow further. As these had been exempted from economic rate of return calculations in the past, the implication was that more than half of the portfolios would not be subjected to economic rate of return analysis in the future. Thus, as a practical matter, it was important to demonstrate that a willingness-to-pay numeraire could be as good as a foreign exchange numeraire, and that when “truly nontradables” (drinking water, education, health, environment, etc.) dominate in the project accounts, a willingness-to-pay numeraire will usually prove more practicable. (Differences between the numeraires and approaches of Little and Mirrlees [1969, 1974] and those of UNIDO [1972] had dominated the project analysis literature in the 1970s. Lal [1974] provides an excellent summary of the theoretical critique. The text of Ward and Deren [1991] summarizes the debate in non-technical language, and their “Technical Notes” relate the practical issues back to the theoretical debates.)

Isolated groups within the banks are beginning to struggle with the pragmatic issue of instructing staff on how to identify and design

“market-making” as opposed to “market-substituting” investments. Market-making interventions look for first causes of missing and incomplete markets and attempt to deal with the cause (the neoinstitutionalist approach to market failure; see the following section) rather than intervening to deal with the welfare-reducing effect (the structuralist approach to market failure). For example, tradeable permits for emissions of air pollutants attempt to make a market in pollution control by using public monitoring to provide “information” and by defining and enforcing tradable instruments that are salable in secondary markets. Similarly, IFC (International Finance Corporation) and others successfully worked with private investors to develop capital markets in lesser-developed countries (LDCs) from the 1970s. The resulting integration of these markets into world markets via the “emerging markets funds” has increased capital availability to selected LDCs at least five-fold and has been one of the most potent development forces of the past 30 years, greatly reducing the need for government to assume the role of primary investor for a wide range of investments (including some infrastructure). The broadening and deepening of capital markets in LDCs has, at the same time, changed the nature of market failures across a broad front, including, for example, increasing the “contestability” of markets and thus affecting the kinds of trade and competition policies that make sense.

Though this clearly already is an issue in the private-sector development operations in which the World Bank has been engaged for a number of years and which ADB is now beginning to undertake in the transition economies, it is only passingly dealt with in the drafts of each of the guidelines. Lyn Squire and his staff in the World Bank are currently doing formative work on what they are calling “public-private counter-factual” — that is, asking the big questions about whether the proposed investment activity is properly a public-sector undertaking. Similar discussions are beginning to be heard in the Economics and Development Resource Center at ADB. The added sophistication required to take such a creative approach may well imply that high-level microeconomic analysts will be needed at critical points in the organizational structure of both banks, a topic that is currently under discussion in some circles.

## PARALLEL DEVELOPMENTS AND UNFINISHED BUSINESS

The real world in which projects are appraised is complex and will not stand still while analysts study it and devise durable theories

and prescriptions. Three parallel developments suggest that the current revisions of the guidelines in the banks may represent only a partial and short-term fix, and that more fundamental issues will overtake the revised guidelines within a few years, namely, (a) staffing, organization, and management issues; (b) increased complexity of the operating environment; and (c) evolving theories of development, of the public sector, and of investment decision making (some of which were discussed in Part 1).

### Staffing, Organization and Management

The change in approach to economic analysis in the two banks resulted partly from the view that the new approaches would be easier to conduct and to explain/interpret. This was important because of changes in organization and staffing of the banks as well as changes in managing the conduct of project economic analysis. Both banks have moved to forms of a “task management” system — explicitly in the case of the World Bank, more implicitly in ADB — for managing the appraisals, in which the project economic analysis is increasingly done by consultants, usually working under terms of reference (TOR) provided by the project officer.

Interviews conducted by this author with ADB staff during March 1995 indicate that consultants play an increasingly important role in project economics work in that bank. In some cases, economic analyses conducted by consultants in project preparation technical assistance work are placed with little or no alteration into the appraisal reports; in other cases, they are revised by ADB staff; and in still others, ADB staff completely redo the analysis. Similarly, a recent survey of task managers in the World Bank conducted as a part of a training needs assessment by Alfred Thieme, Jr., and Yahaya Doka revealed that only 15% of World Bank task managers actually prepare the economic analysis of projects themselves, 71% had selected consultants to prepare the analysis, and 74% had actively supervised the consultants who prepared the economic analysis. Both banks feel pressure to develop “generalists” to manage the task of investment analysis, and both rely increasingly upon outsiders to actually conduct the project economic analyses. This implies both an increasing role for consultants and an increasing need for the banks to make their guidelines available to the consulting community and to the client governments.

## Complex Operating Environment

The operating environment of the two banks — and particularly the World Bank — is recognizably more complex than it was 20 years ago when the previous approach to project economic analysis was being formulated. Two dimensions of that complexity are relevant to the present discussion.

The first dimension of complexity is the political environment in which the banks now work. There is much more interference from developed-country governments, particularly the U.S. government; and there is much more criticism and calling to task by non-governmental organizations and other organized interest groups both inside and outside the developing member countries. As a result, the number of issues that must now be addressed in appraisal reports — in addition to financial and economic rate of return analysis — often overwhelms task managers. These issues include not only environment and public-sector resource generation but also women in development, poverty alleviation, beneficiary participation, sustainability, and NGO involvement — at the same time as internal administrative resources allocated for the analysis of investment operations are being reduced year by year. It is not just in the area of project economic analysis, but in all of the above areas, that task managers long for simple and workable guidance from their managers on acceptable forms and degrees of analysis.

The second way in which complexity has increased is the reduced degree of *partialization* in the application of economic analysis to investments. Indeed, this may provide an important part of the explanation for the politicization and increased objectives discussed above. The very concept of a project represents a partialization — for example, as an *incremental* addition to an enterprise or to a sectoral investment program. Perhaps the most fundamental concept in project economics is the incremental comparison of some fundamental *structure* like a firm, an investment budget, or a national economy “with” the proposed project versus “without” that project, where the project represents the “increment” to the structure. The original Little-Mirrlees (1969) approach presented in their Organization for Economic Cooperation and Development (OECD) manual moved toward a reduction in the degree of partialization, for example, taking broader objectives such as income distribution and fiscal constraints into account and *not* assuming that trade and taxation policy were fixed and thus outside the domain of the project econo-

mist. Their original counsel involved integrating project analysis and policy advice by using free trade equilibrium as the beginning point in deriving all shadow prices — as economic policy advice to less developed countries in the 1960s and 1970s almost always involved trade liberalization. In 1972, the UNIDO guidelines challenged the realism of the OECD manual degree of departialization; and their arguments ultimately led Little and Mirrlees (1974) to back off a bit on this aspect of their shadow pricing advice. Thus, the version of Little and Mirrlees from which Squire and van der Tak (1975) began their own prescriptions left open the option of partializing the analysis in those cases where the project analyst had already concluded that a particular policy distortion was invariant with respect to the proposed project. Among project practitioners, the issue of whether to assume trade and taxation policies as invariant with respect to the project began to be labeled (perhaps confusingly, given the use of these same terms in related discussions of optimal taxation) as “first-best” versus “second-best” border pricing. (The possibility of each project analyst making different assumptions about which policies could and could not be changed in consort with project operations, incidentally, introduced an inestimable degree of indeterminacy into the process of estimating shadow prices, because — in principle — there is a different set of shadow prices for every alternative policy mix.)

By the 1980s, it had become clear to the World Bank that “structure” was *the* problem — for enterprises (particularly public enterprises), for budgets, and for macroeconomic and microeconomic policy environments. Incremental tweaking of fundamentally flawed structures would no longer work. Indeed, the second-best approach to investment decision making had, in many cases, simply added to these distorted and fundamentally weak economic structures. By necessity, the focus of investment operations shifted away from increment and toward structure. Structural and sectoral adjustment operations and policy content of project loans became the essential focus of the banks, particularly the World Bank. Thus, though they continue to maintain the guise of being essentially external organizations providing project funding, the banks are now intimately involved in the microeconomic and macroeconomic management of many of the client countries. And because economic management cannot be separated from governance and socioeconomic organization, in the minds of many analysts, the recognition of economic complexity forces a linkage with the political and social environment.

## Evolving Economic Theory

The theory underlying the economic analysis of development projects derives from two other bodies of economic theory: (a) the theory of development, and (b) the theory of the public sector. The 1990s seem to be leading to changes in these two bodies of theory that may be as important in coming decades as the theoretical developments in the revolutionary decade of the 1950s were in creating the “technical economics” that have come to dominate economic science since then. Current changes in theory and practice are driven by a number of recent developments.

First, there is the growing recognition that — with recent developments in capital and financial markets — capital flows via private investment dwarf the flows from official development assistance. The key to these private flows seems to be the political, economic, and social environment of the respective flow-receiving country (see Ito & Krueger, 1995; World Bank, 1991, 1993). The “new growth theory” and its argument that “divergence” of incomes may be the norm fits well within this same body of thought (see Diamond, 1990; Romer, 1986, 1989). That is, those countries or regions that create the “right” economic environments will diverge upwards, and those that do not will experience the opposite fate.

Second is the arrival of what may be called “the neoinstitutionalist revolution” and its effects on development project thinking (see, e.g., Hoff, Braverman, & Stiglitz, 1993). In the emerging view, “projects” and other public-sector interventions (programs and policies) are increasingly designed to make markets work rather than to substitute public activity for failing markets. Thus, much greater focus is placed upon the analysis of institutions and upon the role of “information” and “rules of the game” that markets need in order to function effectively. (See Dahlman, 1979, and Schmid, 1978, for excellent and relatively early analyses of these issues. Dietrich, 1994, provides a contemporary discussion.) This focus is a natural extension of the structural adjustment processes of the 1980s in the less developed countries; and it becomes a much more obvious factor as the international development banks move into the transition economies in the 1990s, where institutional and related behavioral changes are key elements of private-sector development.

## CONCLUSION

Obviously, guidelines alone are not the answer to project quality problems. Organization and management systems are probably more

critical. Task forces working on the project quality problems in both banks have stated this explicitly as an issue; it now falls to management to evaluate and decide how to deal with these related points. After organizational and management issues, the next matter is the knowledge and skills of those actually doing the cost-benefit analysis. Much of the analysis is now done either partially or completely by short-term and long-term consultants. It will be critical that the banks work with these consultants to help them understand what the banks want done and to effectively manage the process of doing it. The implication is that management systems that include long-term and short-term consultants must somehow be worked out. An additional implication is that the market for consultants with an understanding of these approaches to cost-benefit analysis is much enhanced.

Both sets of draft guidelines reflect major changes and improvements over previous guidelines. Though neither is yet perfect, even in terms of today's knowledge, they nevertheless represent good exercises in what is possible within a complex and, indeed, frequently politicized environment. However, given the dynamic environment in which the respective guidelines are being implemented, it is quite likely that another major revision will be needed — whether or not undertaken — before the turn of this century.

## NOTE

1. In this article, "World Bank" will refer to the International Bank for Reconstruction and Development (IBRD) and its soft-loan affiliate the International Development Association (IDA), and will not include the Multilateral Investment Guarantee Agency or the International Finance Corporation.

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