

ECONOMIC ANALYSIS RETROSPECTIVE

2003 UPDATE

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FOREWORD

This report is a follow up to the retrospective report published last year that reviewed the quality of economic analysis of ADB-financed projects and programs processed in 2002 entitled *Economic Analysis in 2002: A Retrospective (Retro 2002)*. The report presents an updated assessment based on the projects and programs reviewed in 2003, focusing on two aspects. First, it provides a preliminary assessment of the responsiveness so far to the recommendations of Retro 2002. It is also to determine if changes move broadly in the right direction and to provide clarifications accordingly. Second, the report critically reviews the quality of analysis in respect to project rationale and alternatives—the two areas being the critical link in the analytical chain.

The key to strengthening the articulation of project rationale and improving alternative analysis lies in systematic and careful problem diagnosis both at country and sector level and at project level. Country and sector analysis is an essential step to identify key problems, their causes and effects, and the basic rationale for a project and its objective. Project-level appraisal, in turn, helps to revalidate the project

rationale and assessment of project feasibility and economic viability. Indeed, project-level appraisal is preconditioned on the choice of a particular operation. So, in order to improve the quality-at-entry, ADB needs to further strengthen country and sector studies leading to the preparation of operational program and subsequently, individual projects.

Economic Analysis Retrospective: 2003 Update (Retro 2003) also presents an assessment of how the Economics Research and Operations Support Division (EREA) could more effectively support the regional departments, through prioritizing its work program and activities, with the view to provide more relevant and value-adding advisory assistance.

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I. Introduction

ECONOMIC ANALYSIS RETROSPECTIVES PRESENT an assessment of how well economic analysis is applied in the identification and development of projects and programs. The retrospective's purpose is to promote learning and knowledge sharing among ADB staff for conducting meaningful analysis that will inform project design and implementation. Indeed, economic analysis should influence ADB operations to do the right thing and do it the right way—two critical aspects of project quality-at-entry.

*Economic Analysis in 2002: A Retrospective (Retro 2002)*¹ provided a comprehensive review of economic analysis practices in 2002. It emphasized adopting a broad perspective of analysis that goes beyond mere rate of return estimations. To enhance the value of analysis, *Retro 2002* highlighted that economic reasoning should be applied early in the project cycle. Accordingly, it presented specific recommendations for improving both the content and conduct of project economic analysis.

The *Economic Analysis Retrospective: 2003 Update (Retro 2003)* provides an updated assessment. It draws on insights from EREA's interactions with regional departments during reviews of public sector loan proposals, as well as Country Strategy and Program (CSP) papers, sector studies, and Project Preparatory

Technical Assistance (PPTA) reports during 2003. This update brings out two fundamental messages. First, it reiterates a point strongly emphasized in the *Retro 2002* that economic analysis goes well beyond rate of return estimation. Economic analysis extends through all stages of the operational cycle. Country- and sector-level appraisal is an essential step to identify key problems, their causes and effect, and consequently the basic rationale for a project and its objective. Subsequently, project-level appraisal helps to revalidate the project rationale and assess project feasibility and economic viability. Second, and as a corollary, strengthening quality-at-entry requires significant improvements in analysis at both country/sector level and project level. Indeed, project-level appraisal is preconditioned on the choice of a particular operation, hence the importance of country- and sector-level appraisal to help identify options for solving problems. The more clearly defined a problem and its causes are at the country and sector appraisal stage, together with the objective for a possible project, the more focused project appraisal is likely to be.

Retro 2003 is organized into five sections. Section II summarizes the main features of the cohort of loan proposals reviewed in 2003 and presents a preliminary assessment of the responsiveness so far to the recommendations made in the *Retro 2002*. The main

¹ You may contact EREA Assistant Chief Economist for copies of *Retro 2002*.

finding is that the recommendations of *Retro 2002* remain relevant to 2003's projects. Section III focuses critically on how well project rationale was articulated and how thoroughly were alternatives considered. Ascertaining the economic rationale and exploring plausible options are among the necessary and crucial first steps to the overall quality of project analysis. The main recommendation is that project analyses should focus on the real underlying problems, and not take investment solutions for granted. Section IV reports findings from focus group discussions of regional department staff in February 2004 and on measures to

continue improving the quality of EREA's service delivery. The discussions emphasized that EREA should focus on increasing the relevance and value-added of its work. Section V concludes and provides recommendations that stress the scaling up of economic analysis at country and sector levels. The key recommendation of this retrospective review of 2003's operations is that ADB should strengthen its economic studies at the country and sector levels, focusing more on identifying social problems and their causes, investigating all feasible solutions, and providing the basis for further study at the project level.

II. Economic Analysis in 2003: An Overview

A. Approach to *Retro 2003*

Retro 2003 reviews 63 loan proposals for public sector projects and programs (Table 1) to assess the quality of the economic analysis in these documents. The loan

documents included in *Retro 2003* refer to proposals that reached Management Review Meeting (MRM) stage during the period, November 2002 to December 2003. *Retro 2003* also draws on reviews of PPTA reports, CSP papers, and sector studies.

The loan proposals reviewed for *Retro 2003* were distributed relatively evenly among sectors. Energy, transport and communications sectors account for 27% of the total number of loan proposals. Agriculture and

Table 1. Composition of Loan Proposals by Sector and Modality¹

| | <i>Retro 2002</i> | | | | <i>Retro 2003</i> | | | |
|--------------------------------------|-------------------|------------|-----------|------------|-------------------|------------|-----------|------------|
| | Loan Amount | | Proposals | | Loan Amount | | Proposals | |
| | \$ mn | %Share | No. | %Share | \$ mn | %Share | No. | %Share |
| By Sector | 6,399 | 100 | 84 | 100 | 5,685 | 100 | 63 | 100 |
| Agriculture and Natural Resources | 757 | 12 | 18 | 21 | 385 | 7 | 12 | 19 |
| Energy | 917 | 14 | 9 | 11 | 825 | 15 | 6 | 10 |
| Finance | 1,088 | 17 | 10 | 12 | 498 | 9 | 5 | 8 |
| Industry | | | | | 170 | 3 | 1 | 2 |
| Transport and Communications | 1,871 | 29 | 14 | 17 | 2,397 | 42 | 11 | 17 |
| Social Infrastructure | 930 | 15 | 20 | 24 | 812 | 14 | 17 | 27 |
| Multi-sector | 199 | 3 | 4 | 5 | 456 | 8 | 5 | 8 |
| Others | 638 | 10 | 9 | 11 | 144 | 3 | 6 | 10 |
| By Modality | 6,399 | 100 | 84 | 100 | 5,685 | 100 | 63 | 100 |
| Investment Project | 4,095 | 64 | 59 | 70 | 2,660 | 47 | 38 | 60 |
| Quick-Disbursing Program | 1,247 | 19 | 12 | 14 | 714 | 13 | 8 | 13 |
| Sector Development Program | 772 | 12 | 9 | 11 | 987 | 17 | 9 | 14 |
| Sector Investment | 265 | 4 | 3 | 4 | 1,320 | 23 | 7 | 11 |
| Others | 20 | 1 | 1 | 1 | 5 | 0 | 1 | 2 |

¹ The number and value of loans referred to are the proposals under development that have been reviewed by EREA in 2003. They do not correspond to the loan approvals in the year.

Source: Project Processing Information System and EREA Staff.

natural resources comprised 19%, while social infrastructure (health, education, urban development, water supply and sanitation) accounted for 27% of the total. The balance (27%) consists of loan proposals in finance, industry, multi-sector and other projects not classified elsewhere. In terms of lending modality, investment project loans (60% of the total number of loan proposals) continue to be the dominant lending

instrument. Quick disbursing program loans together with sector development programs accounted for another 27% of loan proposals.

B. Summary of *Retro 2002*

Many of the issues raised in *Retro 2002* arise again in *Retro 2003*. *Retro 2002* emphasized the need for ADB staff

Box 1. *Retro 2002* Recommendations

| Stage in Operational Cycle | Recommendation |
|----------------------------------|---|
| Country Strategy and Programming | (i) Macroeconomic and sector studies should guide selection of prospective operations and lending modalities |
| | (ii) Clarity of economic rationale needs strengthening |
| | (iii) Key economic price estimates should be prepared and updated by program economists |
| PPTA Design and Implementation | (i) Scope of economic analysis should be clearly defined in terms of reference of the economist |
| | (ii) Analysis of alternative needs to be routinely applied |
| | (iii) Preliminary identification and measurement of economic benefits based on a "without project" scenario needs strengthening |
| | (iv) Sensitivity analyses need to provide better insight on key variables that affect project outcome and therefore should be monitored during implementation |
| | (v) Sustainability analysis needs to routinely examine financial, fiscal, and institutional implications of projects |
| Loan Fact-Finding/Appraisal | (i) The Report and Recommendation of the President (RRP) should clearly document approach taken in economic analysis and assumptions for Management decision-making |
| | (ii) Senior staff needs to send the right signals to project teams to pay greater attention to establishing a sound economic basis for projects |

Source: EREA Staff.

involved in country operational programming and project processing to recognize that economic analysis goes beyond the limited perspective of rate of return estimation. It is a broader concept that includes country and sector contexts, economic rationale, market demand, and the analysis of feasible alternatives. Economic analysis from these perspectives help to assure that the right choice of intervention is made. To assess the robustness of a project's economic viability, economic analysis must also analyze risk, financial and fiscal impact, and sustainability.

Retro 2002 identified a number of areas in the project cycle where economic analysis needed strengthening. A summary is provided in Box 1.

Retro 2002 observed that there was insufficient attention paid to establishing a sound economic rationale for a project. The link between country/sector strategies and individual projects was often weak; the need for public sector (as opposed to private sector) intervention or the role of ADB was usually not justified; and the choice of lending modality was usually not explained. Project concept papers were also often not sufficiently developed at the CSP stage. Hence, the economic rationale was established as project preparation progressed.

At the technical assistance (TA) implementation and later stages, alternative approaches to addressing the specified development problem were often not

investigated. This was identified as one of the weakest aspects of economic analysis. Only 30% of the proposals reviewed included specific considerations of alternatives. There were also weaknesses in identifying a counterfactual, the so-called "without project" scenario, that plays an important role in identifying and valuing project economic benefits. A related issue that was also not well established was the relationship between project investment and outcome.

In many economic analyses, sensitivity analysis was limited to a mechanistic exercise that gave little information on the robustness of the project results. As a result, the analysis did not serve its key purpose, that is, to provide insight for identifying critical variables for monitoring during implementation. Project sustainability analysis also lacked systematic examination of the financial, fiscal, and institutional implications of projects. For many projects, for example, the possibility of inadequate maintenance of project facilities (especially after project completion) was usually not recognized as a risk.

C. Responding to the Recommendations of *Retro 2002*: A Preliminary Assessment

Retro 2002 made a number of recommendations for improving the scope and conduct of economic analysis. It was not expected that all of these recommendations would be immediately adopted because changes in approaches and processes take time to implement. Yet, as changes are under way, there is a need to assess

whether changes move broadly in the right direction, and to provide clarifications accordingly. Therefore, there is a need to assess how the practice of economic analysis in 2003 incorporated and responded to the recommendations of 2002. There is also a need to highlight new initiatives and good practice to encourage learning and knowledge sharing.

QUALITY ASSURANCE. Partly in response to *Retro 2002*, several regional departments introduced measures and processes to enhance and assure project design quality. Some measures are formal, such as Quality Assurance and Facilitation meetings introduced by South Asia Regional Department (SARD), to ensure that proposed project designs are based on sound technical, economic and financial analyses. Others are informal in the form of peer consultation or review. These are significant initiatives, signaling senior staff's commitment to improving project quality-at-entry. The effectiveness of these initiatives will need to be assessed. As will be discussed in Section IV, Economics and Research Department (ERD) will be actively involved in working with country and project teams at the early stages of the operations cycle.

ECONOMIC RATIONALE. The rationale for a project comprises three levels of inquiry: the problem diagnosis, the articulation of public sector intervention, and the role of ADB in the intervention along with choice of lending modality. The rationale for a project needs to be outlined at the project concept stage when it first enters the CSP, firmed up during TA

implementation, and ultimately carried forward to the RRP stage. The rationale for projects at the CSP stage has generally been weaker than in the RRP in all sectors and across all regional departments. This may reflect a more limited understanding of key issues at the CSP stage. Lack of sufficient sector studies prior to identification of specific operations is perhaps a critical contributing factor. Better linkage to sector issues in the CSP would therefore help clarify the basis for the project's rationale. (See Section III for detailed discussion.)

Some measures were instituted to help operations staff increase their understanding of economic and technical issues and improve their capacity in problem diagnosis. This will likely help to improve their ability to formulate a sound project rationale. For example, South Asia Agriculture, Environment, and Natural Resources Division (SAAE) organized a week workshop on agribusiness subsector analysis, which provided staff with an overview of the nature of agribusiness subsector and some essential analytical tools for problem diagnosis.

DEMAND ANALYSIS. *Retro 2002* stressed that demand and market analyses are the cornerstones of identifying and quantifying the project benefit stream. In 2003, for example, demand forecasts for energy projects usually included high-low scenarios to test the sensitivity of demand uncertainty on project viability. There were a few good practices in the area of market and demand analysis in other sectors. **FIJ: Alternative Agriculture Project** included a detailed analysis of

export markets—overall market prospects by commodity, market structure, marketing channels, and related infrastructure. The analysis supported identification of key bottlenecks in the marketing system that needed to be addressed, so that Fijian farmers could effectively realize the benefits of shifting to alternative farming. **BAN: Second Primary Education Program** presents another good practice analysis of demand-side factors affecting school attendance, particularly girls' attendance. The analysis helped to refine a stipend scheme as part of the Program design. Thus, the Program considered both supply and demand-side measures to meet the objective of increasing school attendance. Demand and market analyses can help to understand behavioral responses to project interventions and therefore contribute to improving the optimality of project design.

ALTERNATIVE ANALYSIS. Comprehensive analysis of alternatives are not routinely applied or reported in RRP. Typically in physical infrastructure sectors (transport, power and water supply), alternatives were considered and assessed in technical terms and limited to capital investments. Policy options (vis-à-vis investment) were rarely considered. Even in the case of methodology, there is room for improvement in terms of clearly presenting technical options and applying sound analysis. For example, in the case of **BHU: Rural Electrification and Network Expansion**, an alternative analysis should have been carried out for electrification of villages at different distances from the power grid because diesel generation may have been a better

option in cases where villages were far from the grid. Also, comparison of alternatives based on life cycle costs was inappropriate because this approach does not factor in growth in electricity demand. In the case of **CAM: Greater Mekong Region Transmission**, the least cost analysis compared options on the basis of marginal costs at the customer class level. This approach does not take into account that marginal cost varies by voltage level and that consumers in a customer class may take power at different voltages, especially industrial and commercial consumers. Also, marginal cost should not be looked at a single value because it varies with time of day, time of year, and geography. It would have been preferable if the conventional approach of comparing present values of the alternatives were adopted in the least cost analysis.

Given the network characteristics of infrastructure operations, a specific infrastructure investment must be clearly established as part of the least-cost network development plan. This requires analysis and clear presentation of the plan at sector level and further clarification of investment options at project level. During 2003, three road sector loans were processed in India: **National Highway Corridor (Sector) I, Rural Roads Sector I, and Chhattisgarh State Roads Sector Development**. The road subprojects under consideration were part of the Government's strategy to improve road infrastructure and were identified as priority projects by the government planning agency. However, most were rehabilitation efforts where alternatives were limited to a choice of engineering design standard.

In the case of agriculture and social sector operations, analysis and reporting of alternatives was generally weak, although there were a few good practice cases during 2003. For example, **LAO: Northern Community-Managed Irrigation** presented three mutually exclusive alternatives that were compared in terms of investment, operating cost, and returns. However, analysis of alternatives need not be restricted to technical options, as in the case of **TAJ: Education Sector Reform**. A discussion of lending modality can provide insights into different approaches for addressing a specific development issue. As Tajikistan had just begun to stabilize from a protracted civil war, the environment was not deemed yet appropriate for a program or sector development program loan. There was still a need to establish a better understanding of the sector, develop an initial information base and institutional capacity, and coordinate donors prior to embarking on more comprehensive policy reforms. A project loan was therefore selected.

Alternative analysis in policy-based lending operations still needs to clearly specify feasible policy options, while considering technical and political factors. The analysis needs to consider the costs of adjustment of the competing policy options and their impact on the medium term fiscal framework. Also, as discussed in *Retro 2002*, a program under consideration may be one of a sequence of operations to support an overall reform agenda, and the focus of the alternative analysis should also be one of understanding what was achieved so far and what will be the impact of subsequent phases. However, this approach is rarely considered.

Overall, the analysis of alternatives needs significant improvement. *Retro 2002* presents broad, sector wise outlines of what may be addressed in the analysis of alternatives. Further assessment is provided in Section III.

VALUING COSTS AND BENEFITS. *Retro 2002* recommended that program economists prepare and update country estimates of key price variables such as shadow exchange rates and shadow wage rates. These estimates are important to both project analysis and policy analysis. To date, program economists for Azerbaijan and Mongolia have done so using the abbreviated methods. For policy analysis, estimates using this method are inadequate and a more sophisticated analysis is required, such as the one found in the *Guidelines for the Economic Analysis of Projects* (February 1997). Nevertheless, the initiative on the part of these two economists is recognized and there is a need to encourage more program economists to engage in shadow price analysis as part of their economic and sector work.

On the other hand, there have been several instances of project economists using unsubstantiated and unverified shadow exchange rates and shadow wage rates. In these instances, the project economist used a shadow exchange rate and shadow wage rate from other RRP's for the same developing member country (DMC) on the basis that the RRP was recent and assuming that the values of these parameters are also recent. It is often the case that the same approach was used in the earlier RRP and thus it is possible that the

parameter values are out of date. Therefore, it is important that shadow exchange rate and shadow wage rate parameters be recalculated each year.

In another instance, three agriculture and rural development projects were processed in Mekong Department (MKRD), but it was found that the methodologies for market price analysis were not consistently applied across these projects. With the assistance of EREA staff, Mekong Agriculture, Environment and Natural Resources Division (MKAE) prepared a staff study to develop a consistent database for commodity market prices for the Greater Mekong Subregion for future use.

SOME INNOVATIONS. *Retro 2002* noted initiatives where project teams tried different approaches for analyzing project distribution impacts and assessing project sustainability. Many such initiatives continued in 2003 and new ideas were experimented with. A few such initiatives could be considered for wider application. **PRC: Fujian Soil Conservation Project** applied a qualitative method of poverty impact assessment to identify channels of effect and further develop measures for project-level poverty monitoring. **VIE: Central Highland Health Project** used a benefit

incidence technique and household survey data to assess *ex ante* how project interventions will result in more equitable access to the provision of health services and more equitable distribution of project benefits. **PAK: Punjab Public Resource Management Program** was the first policy operation that built its fiscal implication analysis through a Medium Term Fiscal Framework (MTFF). The MTFF presented a clear and transparent account of the total resource envelope for province-wide policy reforms. Indeed, the introduction of MTFF was part of the policy recommendation under the Program.

During 2002 and 2003, EREA staff continued to build awareness among regional department staff of the need to develop a broader perspective of economic analysis. Nevertheless, the transition from simple awareness to effective application of the principles of economic analysis seems to be still far off. There are challenges for ensuring that country and sector studies are linked closely to project-level analysis. There are also challenges to foster more effective teamwork among staff of different disciplines and work units. As noted in the *Retro 2002*, much of the effort for quality improvement needs to come from attention and interest of senior staff in the regional departments.

III. Project Rationale And Analysis of Alternatives: Further Assessment

RETRO 2002 PROVIDED A DETAILED ASSESSMENT OF the practices of project rationale and alternative analysis, and concluded that this part of economic analysis was a weak link in the analytical chain. As noted in the above, the analysis of these two areas remains weak. This section provides a further critical assessment, focusing on two aspects. First, it identifies key weaknesses in articulation of project rationale and alternative analysis. Second, it highlights the two most critical reasons why such analytical weaknesses remain and, accordingly, makes suggestions for addressing them.

The continuing attention to the issue of project rationale and analysis of alternatives is mainly due to its significance on two accounts. First, from the development viewpoint, unless a project has a clear rationale and represents the most effective means to address the real problem, its effectiveness is in doubt. And second, from an analytical perspective, a project proposal silent on rationale or alternatives implicitly assumes that it does the right thing, does it the right way, so that it will add value. Is this true? How so? Compared to what? Economic analysis questions this implicit assumption and examines critically whether and how projects bring value. Of course, in this

analytical process, economic analysis itself also adds value to project design.

A. Major Weaknesses

As highlighted in *Retro 2002*, articulating the role of public sector involvement and choice of the form of aid is part of the broadly defined analysis of alternatives. Based on project proposals reviewed in 2003 and in the previous year, the following set of major weaknesses is noted.

First, many project proposals do not clearly demonstrate why public sector involvement is called for. All ADB-supported public sector operations must have some economic rationale. The nature of the economic rationale needs to be explicitly and clearly stated. Government involvement can generally be established where there are identifiable failures in the market, which arise in the case of public goods, externalities and imperfect information, or to redistribute income, wealth, or benefits from public expenditure.

In articulating the economic rationale of a project on either efficiency or equity grounds, government failure also has to be considered. Government failure can be worse than market failure. Indeed a number of ADB-supported projects appear to aim at addressing the failures of government in producing, financing, and regulating the provision of public services. Establishing a clear economic rationale becomes all the more significant in such cases.

Second, many project proposals do not explicitly indicate why a particular form of aid is adopted. What is the basis for choosing a particular instrument for supporting an operation among all available instruments (for example, investment loan, sector loan, policy loan, technical assistance, policy dialogue)? After the form of aid is determined at country programming, the appropriateness of the modality does not seem to have been critically reexamined at the time of project preparation. This highlights the importance of economic and sector work preceding project preparation.

Third, where alternatives are considered, they refer primarily to technical, structural and capital investment options. Other plausible non-structural options are not explicitly considered. For example, one option for reducing flood damage is to move people and property out of harm's way; another is to ensure that people living in floodplain are aware and bear the full costs of the risks they face. Detailed analysis of policy, institutional, or investment alternatives can take place only during a feasibility study, but such analyses are not well done, and sometimes are ignored completely. Furthermore, when alternatives are considered at PPTA or an earlier stage, the reasons for choosing a particular investment over other investment alternatives are not discussed in the final project document.

Finally, there are cases where project proposals do not distinguish rationale, objective, and justification. The three terms are often used interchangeably. Box 2

Box 2. Project Rationale, Objective and Justification: Which is Which?

- **Rationale** – why the government should do this, and why the private sector will not. In the ADB context, it also includes the mode of foreign assistance—why a project loan is the best choice of assistance, relative to a sector or policy loan.
- **Objective** – the expected or intended outcome of the project. The objective of a new road, for example, could be to reduce transportation costs.
- **Justification** – whether the project is worth doing. A project could have a clear objective and a sound rationale, but still not be justified if the costs exceed the benefits.

Source: EREA staff.

provides a brief clarification on the three terms. From the perspective of economic analysis, the three notions seek to address distinctly different analytical and operational concerns.

B. Likely Reasons for the Weaknesses and Some Suggestions for Improvement

There may be many reasons why project rationale is often not well established and alternative forms of aid and government interventions are not fully considered. Two critical ones are noted below. Suggestions for improvement are also proposed. The idea is simple: first, focus on problems, and then look for solutions. Reversing the problem-solving sequence is the cause of these weaknesses. Solutions are proposed before problems are clearly understood.

INSUFFICIENT PROBLEM ANALYSIS. A primary factor in the analytical weakness of project rationale and alternative analysis seems to be lack of prior and critical analysis of problems and the real causes of the problems. For example, in urban and rural water supply and sanitation, the poor state of these basic services is commonly identified as the social problem. Improving quality and quantity of basic services is often stated as the objective of many projects in the sector. But what are the real causes of the problem? Why have the quality and quantity of basic public services deteriorated? Are they merely due to lack of capital investment for capacity expansion, or lack of adequate operations and maintenance for the existing capacity? What about institutional, organizational or incentive concerns with public service providers, or other public policy concerns? And what about demand-side causes?

Lack of critical problem analysis likely leads to projects that only address some symptoms and effects of the problem rather than its real causes. Also, lack of clear identification of the real causes of a problem could result in proposing inappropriate solutions. **IND: Second Renewable Energy Project** proposal is a case in point. The stated objective of the project was to alleviate power shortages by financing environmentally friendly energy projects. However, the proposal failed to note that much of the demand-supply gap was caused by inefficient energy policies, and therefore, there may be other ways to bring demand and supply into balance. Nor did it explain the role of the public sector when there was growing investment by the private sector in renewable energy.

Problem analysis takes place at the sector and project level. At sector level, careful sector studies assess critical constraints to sector development, including policies, institutions, and investment; investigate the real causes and related market and government failures; and then identify plausible options to address the real causes with well-specified objectives at the sector level. Problem analysis at project level in turn will reexamine a project concept, sharpen the problem definition, and explore options to address the problem at hand.

VIE: Central Highland Health Project presents a good example showing that prior sector studies and further project analysis effectively support project preparation. A comprehensive study on *Human Capital of the Poor in Vietnam* was carried out in 2001, which assessed trends in the health and education status of the poor during the reforms, and identified supply- and demand-side constraints that the poor face in seeking such services. The study found increasing inequality in health care and education provision, and proposed public sector operations on equity grounds. Project analysis identified options to achieve the project's objective of improving the poor's access to health services.

Prior sector studies are critical to developing future projects with sound objectives and economic rationales. This point is well understood, but often is not followed. Project proposals enter country programs without prior sector studies. In reviewing CSPs/CSP Updates in 2003, EREA found that many

project concept papers did not specify clearly the objectives, with economic rationale vaguely defined or not indicated at all.

TAKING INVESTMENT SOLUTIONS FOR GRANTED. A second set of causes of insufficient attention to alternative analysis is that investment solutions are taken for granted. All too often proposals for PPTA studies state as their objective, “to prepare an investment project suitable for ADB financing.” This is followed by a broad description of the scope of the ensuing project. PPTA implementation, at best, will result in identifying a couple of technical alternatives within the broadly defined scope. Non-investment solutions are unlikely to be considered. A broad analysis of alternatives should occur during prior economic and sector work. Often though, a thorough analysis of investment and non-investment options can occur only during a feasibility study.

There is nothing fundamentally wrong with this project preparation practice, of course, if it has been clearly demonstrated that lack of investment is the real cause of a problem. However, as noted earlier, many project concepts are based on insufficient problem analysis, and so it has not been established that lack of investment is the real cause. In such cases, it would be worthwhile to go back and to examine further the nature of the problem and its real causes.

When investment solutions are taken for granted, non-structural options are often not explored. When considered, they become add-ons to investment-focused projects. It is common that investment projects

resort to including small components of consulting services, technical assistance, and capacity building, as an after-thought in an attempt to address the real causes. By not seriously considering different options and only faint-heartedly including some non-investment elements, the error of omission could well turn into an error of commission.

As noted above, the key to improving the analysis of project rationale and project alternatives is to change the perspective from one that focuses on investments to one that focuses on addressing the underlying problems. This perspective change helps to appreciate the real value of public service-related investments and also to reorient the focus of subsequent analysis. For example, **BAN: Participatory Livestock Development Project** is no longer viewed just as a series of small technical packages to be adopted by farmers, though increased adoption rates are a key objective. The real problem the project addresses is the need to improve the efficiency of service delivery, by exploring alternative approaches and determining their comparative efficiency and effectiveness. **PAK: Sindh Social Service Delivery Program** is not merely about throwing money at social problems. It is about building capacity at local community level to ensure that basic public services are timely and effectively provided, and analyzing alternative ways to build local capacity.

Exploring and documenting the pros and cons of all plausible options has another important value added—to enable the decision-makers to make more informed decisions. For example, **UZB: Amu Zhang**

Irrigation Rehabilitation Project proposes to rehabilitate upland irrigation system for grain production, with the project objective of reducing rural poverty among upland farmers. The cost of the rehabilitation option is large. Of course, there may be other and possibly cheaper ways to achieve the poverty reduction objective through, for example, relocating upland farmers, or encouraging crop diversification. But rehabilitation is the government's preferred option. By assessing and presenting the costs and benefits of the two alternatives, the government at least can understand the cost implications of their preference. In the **NEP: Kathmandu Valley Water Authority Project**, the original draft RRP presented only one alternative for improving management of water supply in Kathmandu. The revised RRP discussed two additional options of meeting the objective of efficient management of Water Authority. This enriches the information content for decision-making.

ADDITIONAL CONSIDERATIONS. At project preparation stage, moving away from the investment-solutions-only mentality has immediate implications for PPTA design and implementation. In addition to redefining the problems and examining the real causes, the PPTA team needs to be creative and cast a wide net in order to identify all the plausible alternatives. This is to be done by all team members of the PPTA team, including economists during the initial analytical stage of PPTA implementation. Engaging economists at an early stage of PPTA implementation helps in improving cause and effect analyses, demand analysis, identification of alternatives and economic rationale

identification. Economists often are called in at later stages, to perform a perfunctory cost-benefit analysis of the already decided project option(s).

Quality of problem and options analysis varies across RRP. Even if RRP include a reasonably good discussion of problems in a sector, the link between problems identified and the proposed intervention (how it is going to tackle the problems) is not always clearly discussed. In this respect, inclusion of problem tree diagram would be useful to clarify the causal links. Although the New Business Processes indicated this requirement, it is typically not done in practice. In addition, the RRP may be revised to include specific sections on Economic Rationale of the Project and Consideration of Alternatives including the choice of operational modalities.

Finally, there may be need to review the purpose of all project decision meetings. Currently, at these meetings, Management pays a lot of attention to development impact or monitoring indicators. *Retro 2003* makes it clear that unless a project demonstrates itself clearly as addressing the real cause of a development problem and doing it the right way, there will be no point in talking about development impact or monitoring indicators. Therefore, project decision meetings should also be the venue where Management and senior staff verify the economic rationale and alternatives to investment solutions, and thereby establish that the project design maximizes value-added.

IV. Further Improving EREA's Service Delivery

THE PRINCIPLE OF DOING THE RIGHT THING AND doing it the right way applies to EREA as much as it does to the rest of ADB. Last year EREA, through a survey, asked its clients if it was doing its job the right way. This year, EREA sought client perceptions not only on the issue of EREA fulfilling its role in the right way, but also on the matter of EREA doing the right thing.

In February 2004, EREA facilitated focus group discussions among regional departments to listen to their views on how EREA could further improve its operations support in economic analysis. Five sector directors and eighteen mission leaders or project economists participated in these sessions.

In general, the discussions validated the results of last year's survey. Consistent with the results of the survey, the early and informal interactions of EREA staff with operations were appreciated. The participants also believed that EREA's inputs might no longer be useful in the later stages of project processing, and thus the timing of the assistance is crucial.

A. EREA's Role as Perceived by Clients

The question of when EREA should get involved is invariably linked to the participants' concept of economic analysis. The results of the survey last year

provided a clue on the mindset of operations colleagues, when they indicated that EREA should get involved early. While the participants in the discussions sometimes started with the bureaucratic, if not mechanical, notion of economic analysis as the activities necessary to fulfill the contents of the *Guidelines for the Economic Analysis of Projects*, the discussions always resulted in the recognition that the need for economic analysis pervades the project processing cycle. The activities associated with economic analysis ranged from the conceptual issues at the PPTA stage to the technical details at the appraisal and evaluation stages.

EREA's perceived triad of roles emerged in these discussions. First, the Division is an "auditor"—checking the soundness of the economic analysis and influencing quality-at-entry through its comments at appropriate stages. A variant of this audit role is the "certifying" or "clearing" function that assures the acceptability of analysis. In these cases, EREA is seen as an authority in judging the soundness of economic analysis.

Second, EREA is ADB's "think-tank," focusing on cutting-edge approaches and tools in economic evaluation. It should study development assistance issues together with other divisions of ERD. EREA is therefore more than an authority in economic analysis; it provides the substance and impetus for innovation as well.

Third, and reflecting the above two views, EREA staff are extension agents. Having an overall view of

documents from operations, EREA staff is in the best position to distill insights from operations and disseminate the lessons. Their responsibilities include building the capacity of the client departments for economic analysis.

B. EREA's Work Program

The insights from the discussions helped to prepare EREA's 2004-2006 work program. After identifying the challenges which the Division is mandated to address and taking note of the strengths and constraints of the Division, EREA staff redefined themselves primarily as extension economists who:

- Work with country and project teams by reviewing operations papers primarily at design stage, and by providing advice for strengthening the economic basis of ensuing operations;
- Conduct adaptable research by distilling insights from operations and bringing in fresh ideas from the development literature, and disseminate research output through good practice papers;
- Support staff learning by developing and delivering learning programs to raise the awareness of economics among colleagues in operations and encouraging consistent application of economic principles and methods.

The suggestion for EREA to get involved early supports the focus on the initial stages of the project cycle. The

explicit inclusion of development issues in research and the increased focus on learning programs were other propositions mentioned in the focus group discussions.

EREA's evolving work program reflects its continuing effort to be client-responsive. A key insight learned from the focus group discussions is that EREA has to be relevant and must add value. Therefore, EREA has adopted relevance and value-added as two criteria to guide work priorities and to ensure the effectiveness of partnerships with regional departments. For example, project completion report (PCR) and project performance appraisal report (PPAR) drafts will be excluded from formal reviews. Instead, EREA will develop a user reference guide on economic reevaluation for use by regional departments and Operations Evaluation Department (OED) when preparing the PCR/PPAR. In addition, EREA will provide advice for PCR/PPAR teams to address any analytical and methodological issues prior to PCR/PPAR missions.

Although a retrospective and updates of it are published annually, acts of retrospection and introspection need to be performed continuously by EREA. As needs change, the role of EREA necessarily adjusts. Ultimately, EREA hopes that its services result in more than cosmetic enhancements to project proposals and genuinely add value to the quality of project design.

V. Conclusions and Recommendations

RETRO 2003 REVIEWED THE ECONOMIC ANALYSIS practices in 2003 with the view to provide a preliminary assessment of how the recommendations of *Retro 2002* had been addressed. *Retro 2003* also critically examined how project rationale and analysis of alternatives could be strengthened. Key findings and recommendations are summarized in the following.

A. Efforts to Improve Economic Analysis Need Further Strengthening

Overall, awareness of the need to adopt a broader perspective on economic analysis is growing. There are also notable initiatives in regional departments, responding to specific recommendations made in *Retro 2002*. For example, a few country economists now provide estimates of country economic prices. Several sector divisions pay closer attention to sector analysis in the processing of new projects. More project proposals present an explicitly detailed basis for quantitative analysis including financial sustainability and fiscal impact analysis.

More active and conscientious efforts are called for to improve the quality of economic analysis, since many of the major weaknesses that were identified in 2002 have remained in 2003. Good initiatives must be sustained and good practices widely applied. In this

regard, we note that regional departments recently introduced various measures for quality enhancement early in project preparation. It is hoped that such department-wide initiatives become the norm to improve the quality of projects at entry.

B. Rationale and Alternative Analysis is a Critical Link... yet still a Weak Link

Articulation of project rationale and consideration of alternatives are critical links in the sequence of economic analysis and constitute the groundwork for subsequent analysis. *Retro 2002* concluded that this part was a weak link in the analysis chain. Many proposals do not clearly demonstrate why public sector involvement is called for, why a particular set of interventions is proposed as the chosen option, or why a particular form of aid is adopted. Where alternatives are considered, they primarily refer to technical, structural and capital investment options. Other plausible (and non-structural) options are not explicitly examined. There are cases where project proposals do not distinguish rationale, objective and justification—three building blocks for a project proposal. Drawing on the project proposals reviewed during 2003, *Retro 2003* maintains the previous Retro's assessment, while recognizing good practice examples from 2003.

The key to strengthening the articulation of project rationale and improving alternative analysis lies in systematic and careful problem diagnosis. Project identification and preparation have to address explicitly a series of analytical

inquiries. What are the social problems? What are the real causes? What are the critical areas that require public sector involvement? What are the plausible options to address the real causes? How can ADB support the public sector involvement?

C. Strengthen the Link between Project Level Analysis and Country/Sector Studies

The suggestion for systematic problem diagnosis does not imply overloading the stage of project preparation, although that is what has been happening. The experience indicates that insufficient country- and sector-level analysis and overloaded project preparation are not a satisfactory situation and it has to be redressed. It calls for *strengthening economic studies at country/sector level that identify social problems, research the causes of the problems, investigate options, and provide the basis for analysis at project level*. Sector level analysis should analyze the institutional appropriateness, political-economy issues, and feasibility for project operations.

The recommendations to scale up the economic analysis at country and sector level are not new. In fact, the same recommendations were highlighted in the “Report of the Task Force on Improving Project Quality” issued in January 1995. The project-level findings in this retrospective once again underscore that ADB should undertake a comprehensive and critical review of the quality of country strategy and sector studies. The results of this ADB-wide review will determine how such studies could be undertaken more effectively in the future to inform project identification and support project-level analysis. As ADB continues to evolve in adopting country-focused programmatic approach to development assistance, the need to strengthen country/sector studies that underpin project operations cannot be overemphasized. Clearly, all these will significantly contribute to fulfilling the renewed development agenda of managing for results.