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SOCIAL ASPECTS OF PROJECT FINANCING BY INDUSTRIAL DEVELOPMENT BANKS 1/

by

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CONTENTS

SOCIAL [illegible] BY [illegible]

Industrial development finance companies (DFCs) have traditionally been expected to appraise the technical, financial and managerial aspects of projects they finance. This in itself is a considerable task. Yet, particularly in recent years, DFCs have frequently been called upon to extend their appraisal methods to include systematic treatment of the social aspects of projects as well. The literature and the development plans of many countries mention an array of factors all of which have been labeled "social". These factors go beyond the narrow financial returns on capital employed by a project and include such considerations as the impact on aggregate real consumption in the country, regional development, income distribution, employment, and the promotion of small industries and entrepreneurial talent. Given the many demands placed upon DFCs, it is fair to ask why they should concern themselves with non-commercial criteria, i.e. real economic returns as well as even less quantifiable social impact criteria.

I. The Case for Social Evaluation by DFCs

It must be recognized that the effectiveness of any DFC is to a large extent a function of its basic appraisal capacity in treating adequately the engineering, finance and management aspects of their projects. But there are a number of reasons why a DFC should go beyond this traditional focus and incorporate social considerations as well. Perhaps the most basic one is simply that if the DFC does not have an eye out for the social desirability of the project it finances, there is no guarantee that its financing will make a real contribution to development. The notion that a project can in principle be quite profitable financially and yet not be desirable from the point of view of the

economy as a whole is nothing new. What is perhaps somewhat new is the realization that these differences can really matter in practice and can affect the overall character of a country's development.

In the early post-war period it was very common for countries to base their industrialization strategy on import substitution. So long as governments could restrict the entry of competing imports, projects which could not have competed in the international market could nevertheless be highly profitable and indeed show rapid rates of growth. But in a number of countries the growth has not been lasting and -- looking back -- it can be seen that their industrial growth was attained at a very high cost in terms of the broader objectives of development such as higher levels of real consumption, more employment and a more equitable distribution of income. A series of country studies carried out under the auspices of the Development Center of the O.E.C.D. has documented in detail what policy-makers in some developing countries had already began to recognize; namely, that financial profits and rapid gains in industrial ouput may be quite misleading as real indices of development.

Disenchantment with the strategy of import substitution without regard to costs has certainly strengthened the hand of those who feel that financial evaluation is not an acceptable substitute for economic or social evaluation. But it has not answered the argument frequently heard that -- while social evaluation may be both necessary and desirable -- the proper institution for carrying out such evaluation is government itself.

There is much to be said for this argument. It is the government, and not the DFC, which lays down policies and guidelines for industrial development. Furthermore, whatever impact DFCs may have is a limited one as they may finance only a small proportion of overall industrial capital formation. Finally, many governments have some form of licensing or approval of industrial projects; thus,

[illegible] is in a position to [illegible] . [illegible] have a role in [illegible]

The problem is that in many cases, governments or established policies, or approved projects, without adequate knowledge of the actual costs/benefits of their decisions and any financial institution that truly seeks to be developmental, has to give thought to the developmental impact of its decision. It is the rare government indeed which has sufficient time or sufficient information when a project is licensed (or otherwise vetted) to make an informed judgment on the likely efficiency of the project in attaining social aims. In most cases, projects are judged only against a rough checklist of social desiderata: Is ownership domestic ? Is the project in a "priority" industry ? How many jobs are to be created ? Where will the plant be located ? What are the net foreign exchange savings/earnings ? And so forth.

It would be naive, of course, to assume that a DFC could adopt and follow social criteria in its project assistance which are consistently contrary to the government's own criteria. At the same time, it is often far from easy for a DFC to know exactly what the government's objectives are, particularly if they are not internally consistent. Governments are not monolithic. Policies normally reflect a compromise among various interests. Tariff policy is a good illustration of this phenomenon. A systematic review of the effects of tariff policy in seven countries carried out under the direction of Bela Balassa has confirmed what one would expect:

> The high variability of effective rates of protection cannot be considered the result of deliberate decisions. Rather, in the countries in question the system of protection is a historical result of actions taken at different times in response to the then existing situation and the pressures exerted by special interest groups. 1/

1/ Bela Balassa and Associates. The Structure of Protection in Developing Countries. Johns Hopkins Press, Baltimore, 1971, page 32.

It is precisely because [illegible] that the discipline of explicit social evaluation is necessary. Without this discipline it is all too easy for vocal interest groups to appeal on whatever particular objective happens to be in fashion that year.

Rigorous application of economic and social criteria by DFCs could of course bring them difficulties. First, by judging a project on these grounds the DFC could be accused of second-guessing and frustrating government intentions. What does a DFC do when it judges a project as being non-developmental when such a project has governmental approval? This is a tough problem although it is hard to believe that if the analysis is credible, sensible governments will not be open to knowing and learning from that analysis.

Second, DFCs which are used to operating with reference to commercial and financial standards may have another problem. If a project is commercially attractive but is deficient on social grounds, rejection could mean a loss of business that would not be considered desirable by the shareholders. However, most DFCs, including the predominantly private ones will recognize that a reputation of genuine concern for development, even at some short-term cost to themselves, will serve them well in the longer-term. Moreover, good social analysis can be good business. A project which depends for its financial viability on continued special privileges or protection is vulnerable to change in government policy. At a minimum, social analysis can illuminate the degree of exposure a project has on this account and perhaps alert the DFC to dangers it might not otherwise have appreciated fully.

<u>What Has Been Done So Far?</u>

On the basis of the IFC's experience in the more than 40 DFCs in some 35 countries plus many others that we have had contact with, we would have to conclude that the DFCs' explicit social evaluation of industrial projects has

been, with some notable exceptions, rather limited in the past. There are of course substantial differences of degree to case, but the typical so-called economic evaluation of a project was based on one or more of the following considerations:

(a) the project is in a branch of industry (or region) given priority in the country's Development Plan;

(b) the project will earn (or save) a stated amount of foreign exchange;

(c) the project will create a stated number of new jobs.

All of these "considerations" have obvious shortcomings. The first ignores the possibility that there may be both good and bad projects -- from a social point of view -- even in a priority industry. The other two indicate, at best, certain project characteristics but cannot serve as guide to social desirability as there is not juxtaposition of benefits in relation to the costs.

Partial Indicators

A number of other project characteristics -- sometimes referred to as "partial indicators" -- since they were designed to substitute for a more comprehensive form of social evaluation -- have been used by DFCs to gauge social desirability: value added to capital ratio, exports to sales ratio, investment to employment ratio etc. Though no one would claim partial indicators are capable of predicting precisely a project's social worth, the implicit presumption used by DFCs was that they are good enough to distinguish those projects which are socially desirable from those which are not. In analysing the suitability of these indicators, we have not yet been able to assemble conclusive evidence, but such evidence as we do have does strongly suggest that social analysis based on partial indicators may be of little use as a guide to action. Over the past year the WMG has undertaken a series of studies of the economic characteristics of projects

in the project [illegible] rate of return calculation to [illegible] social desirability. In the first two of these studies -- one in India and one in Korea -- the ranking of projects by rates of return has been compared with the ranking by various partial indicators. Such commonly used indicators as investment per job created or exports as a fraction of total sales were not reliable as a guide to the observed rates of return. The Table below shows the simple correlation coefficients for the partial indicators tested in the Indian study (42 projects which were examined in detail). Only one of these indicators is statistically significant (at the 95 percent confidence level): the value added/capital ratio. And it explains only about 30 percent of the observed variation in economic rates of return.

Partial Indicator	Correlation Co-efficient
Value Added/Capital Ratio	0.315
Investment/Employment Ratio	-0.207
Profits to Capital Ratio	0.138
Capacity Utilisation	-0.084
Exports to Sales Ratio	0.054
Rate of Asset Formation	0.012

If these first results are substantiated in further studies, the conclusion to be drawn would be important: just as financial evaluation is no substitute for social evaluation in the circumstances prevailing in many developing countries, so too seem the usual partial indicators deficient as decision tools. Since many DVCs do in practice justify departures from strict financial self-interest on the basis of formal or informal reference to such partial indicators, their efficiencies as a guide to action matter. In this sense the need for DFCs to undertake systematic social evaluation based on techniques of cost/benefit analysis may be justified not merely on the grounds that it would help them to do something new but also that it would help them to do more efficiently what

[illegible] which were less a[illegible]. [illegible] involved supposed social advantages. Examples included government-backed projects for which financial prospects were not too bright; [illegible] in backward areas; and new projects involving greater than usual risks either because of technical or managerial or other uncertainties. It would be hazardous to generalize about the fate of these projects. In fact it is by no means easy in all cases to identify which projects these are, since DFCs are understandably reluctant to acknowledge cases in which their standards may have been modified. Nevertheless, in at least some of these cases, it is doubtful whether the social gain -- either forecast or actually attained -- has justified the financial risk which was taken.

The point is that there is no _a-priori_ assurance that government-backed projects; projects in backward areas; projects promoting small industries or new entrepreneurs; etc. are either socially _desirable or undesirable_. While their striking characteristic may place them high on the list of the country's development plan, their ultimate justification has to measure up against a systematic social evaluation.

Effective Rate of Protection

As a first step towards systematic social evaluation, the WBG introduced about three years ago a number of DFCs to the use of a specific technique for economic evaluation: the effective rate of protection. This technique, in the form it was then presented, focussed principally on the effects of trade policy[1]. By taking into account the effects of tariffs and taxes both on outputs and inputs of the project, the calculation could identify projects which enjoyed much greater protection than was apparent from simple comparison of the domestic sales price for project output with the price of competing imports.

The experience so far with this technique has brought to light a number of problems. Some of these problems are specific to the particular technique, but others are of more general interest. One of the latter type is the difficulty

1/ The calculation, as proposed, called for the comparison of value added in domestic prices for the first year of full capacity operation with value added measured in terms of international prices for the same year.

encountered in [illegible] the relational prices for commodities which the project would not actually buy or sell overseas. Even if a commodity were traded, there might be problems in deciding which price to use from among those applying to a large number of only slightly differentiated products, particularly if some seem to be offered at "dumping" prices. Quality differences can cause considerable practical difficulties and, even for a well defined product with no quality problem, there may be several prices prevailing at any one time reflecting different delivery amounts or conditions. Actual or suspected marginal cost pricing by foreign suppliers and transfer pricing among branches of multi-national firms complicate the picture further.

In light of this rather formidable array of difficulties, it is perhaps surprising that the calculations have been possible at all. But, by and large, they have been. Yet the fact that the results are so sensitive to variations in international prices had certainly limited their credibility as a basis for decisions. There is, therefore, a need for further work in this area, even though the problems are daunting. It may well be unrealistic to imagine that price estimates and price forecasts for industrial products can ever be prepared in the same systematic fashion as is now applied to some of the major primary commodities. But it should be possible to reduce the present level of uncertainty by disseminating expert knowledge on the determinants of price levels and movements for closely related groups of industrial products and by identifying the product attributes which are critical in determining price relationships among closely related products.

Economic Rate of Return

There are two further drawbacks associated with the use of the effective protection methodology. First, when employed as a static indicator, yielding production efficiency for the year that a project reaches full capacity

utilization, the costs of production during [illegible], the [illegible] capacity build-up as well as economies of scale in later years were ignored. Secondly, even as a static measure, the result was not easily difficult to interpret for a variety of reasons including the possibility that domestic value added may be grossly inflated due to excess profits. Nevertheless, our experience suggests that the employment of this methodology has had the effect of creating an awareness of the relevance of social project analysis and comparative efficiency. We are building upon this experience and, in searching for a social appraisal tool which is both devoid of some of the above shortcomings and suitably tailored to the operational needs of DFCs, we have recently introduced a number of DFCs to the economic rate of return concept. This is not the place to elaborate upon this methodology. It should suffice to say that the concept is relatively simple, but it is a dynamic one and does permit an assessment of social costs and benefits during a project's life.

III. Problems in Utilizing Social Evaluation

One general problem which we have observed is the tendency for quantitative social evaluation to be done at the very end of the appraisal process. On occasion it has even been done after the investment decision has been made ! Of course when evaluation is done in this way there are terrific pressures on the analyst to make the numbers come out "right" or, if they do not come out "right", to find some plausible reason why they should be ignored in the case at hand.

If the DFC is serious about the use of social evaluation, it will be in its own interest to introduce such evaluation at a very early stage in the appraisal process. If a project shows up as clearly questionable on the criteria employed, then questions can be raised before the DFC has committed so much time (and possibly its prestige) to the project that a negative decision is not feasible. If raised at an early stage, such questions may also suggest possible modifications,

including a change in factor proportions in favor of more labor intensive design, which would help matters without scrapping the project altogether. Perhaps the project can be delayed for a time until a larger scale of operations would be appropriate. Perhaps a product line which is not attractive can be dropped in preference for others which are attractive.

It would be misleading, however, to give too much emphasis to the possibility of design modification based on social considerations. In the first place, DFCs often operate in a competitive environment where project sponsors, faced with proposals for substantial change in project design, may simply go elsewhere for finance. Secondly, if changes suggested by social considerations are not financially profitable, is it realistic to expect the DFC to persuade project sponsors to accept such changes ? Probably not. Still there will be cases where the alternative suggested may have little financial impact one way or the other. For example, a sponsor may propose purchase of machinery for transport of goods within his plant when less capital-intensive methods would not be significantly more expensive. While the financial difference might be small, the difference in the employment effects might not be.

Apart from the general objections to social evaluation -- that government should do it, that it violates shareholders' trust, that reliable price information is unavailable, and so forth -- there are a number of other problems which arise in connection with the application of social cost/benefit evaluation, even if a DFC is fully committed to giving it a try.

Compensation for Risk

One of these obstacles concerns risk and the way DFCs can compensate themselves for risk. The financial viability of a DFC rests on the capacity of its clients to repay. For loans, as distinct from equity investments,

the DFC does not share in the surplus earned by the firm over and above that which is required for repayment. Therefore the immediate financial interest of a DFC making a loan is dependent on the surplus earned by the firm only to the extent that the anticipated surplus increases the firm's debt servicing capacity and thereby reduces the risk of default. Of course the financial attractiveness of the project - as measured, for instance, by a financial rate of return - will be related to the expected debt servicing capacity, but the relationship need not be at all that close. For expansion projects in particular, the cash flow from existing operations can provide a buffer which is available for repayment even if the expansion itself does not generate the revenues expected. Thus, confronted with two projects with similar prospects, the DFC which has but one lending rate, will naturally prefer the project put forward by a well-established firm, since the secure revenues of that firm reduce the DFC's risk. For similar reasons, the borrowers with more secure collateral will be preferred.

This phenomenon often works to sharpen the conflict between a DFC's financial interest and its social responsibilities. Many of the projects which may be socially desirable - because they encourage new enterpreneurs, provide employment in backward areas, and so forth - will also be quite risky. Yet in practice DFCs have little opportunity to compensate themselves for these risks. Lending rates are often pegged at a single level. When different rates are permitted it is the more risky clients - precisely because they are thought to be socially desireble - who are usually granted concessionary rates. Since under these circumstances DFCs have no financial incentive to undertake socially-oriented business, quotas or targets may be set in some

arbitrary way [illegible] in the DFC to [illegible] such business. In theory, the DFC might [illegible] by acquiring equity in risky operations which were expected to be financially profitable. But in practice the equity market [illegible] developing countries, especially for unseasoned securities, is too [illegible] developed to make this an attractive option.

There are, in principle at least, ways in which the sharpness of this conflict between a DFC's financial and social interests may be diminished. Lending rates might be raised. Concessionary rates might be abandoned, or, if maintained, the burden they impose on the DFC might be lifted by government provision of discount facilities or subsidies related to the volume of business done at concessional rates. This is an area which requires further thought and perhaps even experimentation. It may be that some DFCs have already had experience along these lines.

Divergence between Financial and Social Returns

An extreme case of conflict between financial and social interests arises when a project is socially desirable but, under prevailing policies, cannot be expected to earn sufficient revenues to service a loan. For example, such a conflict could arise in a project which must pay going wage rates despite the fact that there may be considerable unemployment or underemployment. Since the DFCs associated with the WBG have not done systematic social evaluation of projects in the past, we cannot say whether this type of conflict is important in practice. If it were to arise, the logical action for the DFC would be to bring the case to the attention of government. Indeed one of the potential benefits of social evaluation by DFCs is that it could bring to light specific government policies which may - quite unintentionally - be inhibiting socially desirable projects from going forward.

[illegible] tion by [illegible] any economy where private sector [illegible] responsible for initiating investment proposals. If the signals [illegible] by potential project sponsors are not in line with the signals required to encourage efficient and socially desirable development, then many potentially valuable projects may never be put forward at all. DFCs are likely to be much more effective as a screening mechanism - weeding out those projects which do not measure up both financially and socially - than as a promoting mechanism in situations where financial signals act to discourage socially profitable investments.

Measuring Performance

Any DFC, regardless of its ownership, which monitors its own performance with conventional financial yardsticks, will face a problem in determining what standards of performance are satisfactory when many of its activities are not reflected in its financial accounts at all. This is a problem which we in the WBG are having to face more and more frequently as we expand our support of large publicly-owned DFCs which perform a wide range of functions apart from commercially-oriented term lending. We have not yet had enough experience to draw many general conclusions, though it does seem clear that conventional financial indicators such as debt/equity ratios and measures of return on capital lose much of their significance in such situations. It is hard enough to measure the real economic and social cost/benefits of a specific project. How does one make similar measurements relative to the totality of a DFC's operations?

Techniques to [illegible]

Perhaps the major obstacles faced by DFCs which would like to give greater weight to social aspects in their project financing are the absence of a practical technique for judging projects' social desirability and the lack of suitably trained staff to implement such a technique if it could be found. The issue of techniques for social evaluation of investment projects is one of the "growth" areas of modern applied economics. Indicative of the current situation is the thickness of a volume recently published which purports to be a selective sample of the more useful papers to appear on the subject of social cost/benefit evaluation in 1971 alone. Criticism of "partial indicators" is likely to fall on deaf ears unless it is possible to cut through the thicket of competing techniques and to provide practitioners with a method of evaluation which is both understandable and easy to use.

What DFCs want, if our experience is any guide, is a technique which is simple, easy to apply and flexible enough to meet the needs of projects which vary widely in size, importance and availability of basic data. Without in any way minimizing the importance of responding positively to this demand, it is perhaps appropriate to note that the demand itself reflects a certain misunderstanding. Social evaluation, like financial evaluation, is not a set of calculations but rather a method of approach, a perspective from which to view a problem. There are, therefore, many different ways to reach the same conclusion about a project's social desirability and the skilled analyst will see them as alternative means to the same end.

Having said this, one must nevertheless acknowledge that the present proliferation of social cost/benefit techniques has generated a certain amount of confusion and has given ammunition to those who argue that the

state of the art [illegible] analysis a project that [illegible] agree, this argument goes, that [illegible] do.

The series of case studies relating to earlier of the portfolios of several DFCs associated with the IFC constitute a useful antidote to this kind of pessimism. In five countries in different parts of the world[1/] it has proved possible to calculate economic rates of return on an average of about 25 projects per DFC. Manpower input for these calculations - not counting the efforts of the firms themselves - was normally of the order of 10 to 20 man days per project. Since these evaluations concerned projects that were already in operation, a fair part of the time was spent reconstructing project operations on the basis of old accounts of the firm in question. Evaluations done during the process of normal project appraisal would presumably require much less time.

Moreover, the results of the calculations have by and large appeared to be remarkably insensitive to some of the parameters for which the proper theoretical method of evaluation is none too clear. One example is the cost assigned to unskilled labor: the so-called shadow wage rate. In most of the studies, the results of the rate of return calculations have not been significantly altered by reasonable variations in the guess made as to what the proper shadow wage rate might be. There have been individual projects for which the change has been more than a few percentage points, but even in these cases it was rare for such variaton to cast in doubt the basic attractiveness (or unattractiveness) of the project.

The essential point is this: if the aim is only to separate projects into broadly defined groups, i.e., to weed out the serious mistakes and

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1/ Korea, India, Turkey, Tunisia and Iran. A study in Nigeria is now in progress.

economic [illegible] theory [illegible] evaluation of most medium-scale industrial projects.

"Efficiency" versus "Impact".

The criteria for distinguishing between acceptable and unacceptable projects will depend on the objectives which are sought. In our own work we have found it convenient to distinguish between "efficiency" calculations and "impact" calculations. An "efficiency" calculation measures the gains and losses of output attributable to a project on the assumption that the project does not affect levels of domestic prices or output of other domestic producers. When this assumption applies, it is usually appropriate to use international prices to value those inputs and outputs of the project which can be traded internationally. Hence the calculation secures an assessment of the project's potential competitiveness in international markets. As an international institution the Bank has a clear interest in determining whether or not projects are up to this test.

But, in practice, projects may very well affect domestic prices (and hence consumption) or output levels. An "impact" calculation would take this into account. A common reason for a project to have such an effect is the existence of governmental restrictions on trade, either through quotas, prohibitive tariffs, or flat prohibition. When restrictions are expected to continue through the life of a project, it may be quite inappropriate to use international prices as measures of economic cost. For example, if a steel-using project is to be implemented in a country which prohibits the importation of steel, the real economic cost of steel may be higher than

the cost of imports. This could present a DFC with a real dilemma. The project might be "potentially efficient" (i.e. would be a good use of investment resources if steel imports were permitted) and yet have an expected "impact" (i.e., taking into account the higher cost of purchasing domestically produced steel) which is not attractive. Should the project be "penalized" for trade restrictions over which it has no control? That is what rejection would entail. Should the project be accepted irrespective of its expected effects including the further encouragement of costly domestic steel production?

Other Social Objectives

In principle cost/benefit techniques can take into account other objectives than simple increases in real consumption over time. But to do so requires assigning numbers to notions which are almost never expressed quantitatively. It may be easy to agree that income generated in a backward region or among poorer income groups is more desirable than income accruing to more privileged groups, or that it is preferable to assist new entrepreneurs rather than established ones, but it is far more difficult to agree on specific weights to be used to reflect this social preference. It is an open question whether, in the absence of guidance from government on what numbers to use, a DFC would do better to stick to consumption-based criteria, i.e., the economic rate of return in its cost/benefit analysis - allowing for other criteria by way of ad hoc departures from its normal standards - or if an attempt should be made to modify the basic cost/benefit calculation itself. For a number of practical reasons, our preference has been for the former approach.

One reason is that all these concepts are unfamiliar to many DFCs. There is a worldwide shortage of skilled project analysts familiar with

the training [illegible]. This is not surprising since the whole discipline is relatively new. Accordingly, there is a great need for training. Various institutions are attempting to meet this need, but despite these efforts there is still much to be done.

IV. Recommendations for Future Action.

The issues raised in the discussion are summarized in a series of questions and possibilities for future action along the following lines:

(1) How does one make the case for systematic social evaluation of projects by DFCs?

In many ways this requirement is a prerequisite for all other constructive action. The aim should be to persuade decision-makers both in industrial development banks and elsewhere that social evaluation is both feasible and necessary. Specific action might include

- further case study work documenting the practical consequences for development if social aspects of projects are not considered
- continuing efforts to make known case study work which has already been done.

(2) How can the financial cost to DFCs of employing economic and social criteria in project financing be reduced?

Here the greatest potential is almost certainly to be found in policy reforms which lessen the discrepancies between financial and social objectives. Among the most valuable reforms would be those which tend to bring prices for labor and capital goods more nearly in line with their real social values. But measures designed to enable DFCs to more adequately compensate themselves for risks taken in support of socially desirable projects could be important as well.

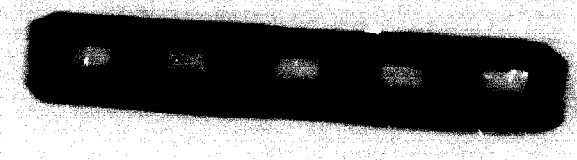
(3) How can new yardsticks be developed to assess the contribution of DFCs to development?

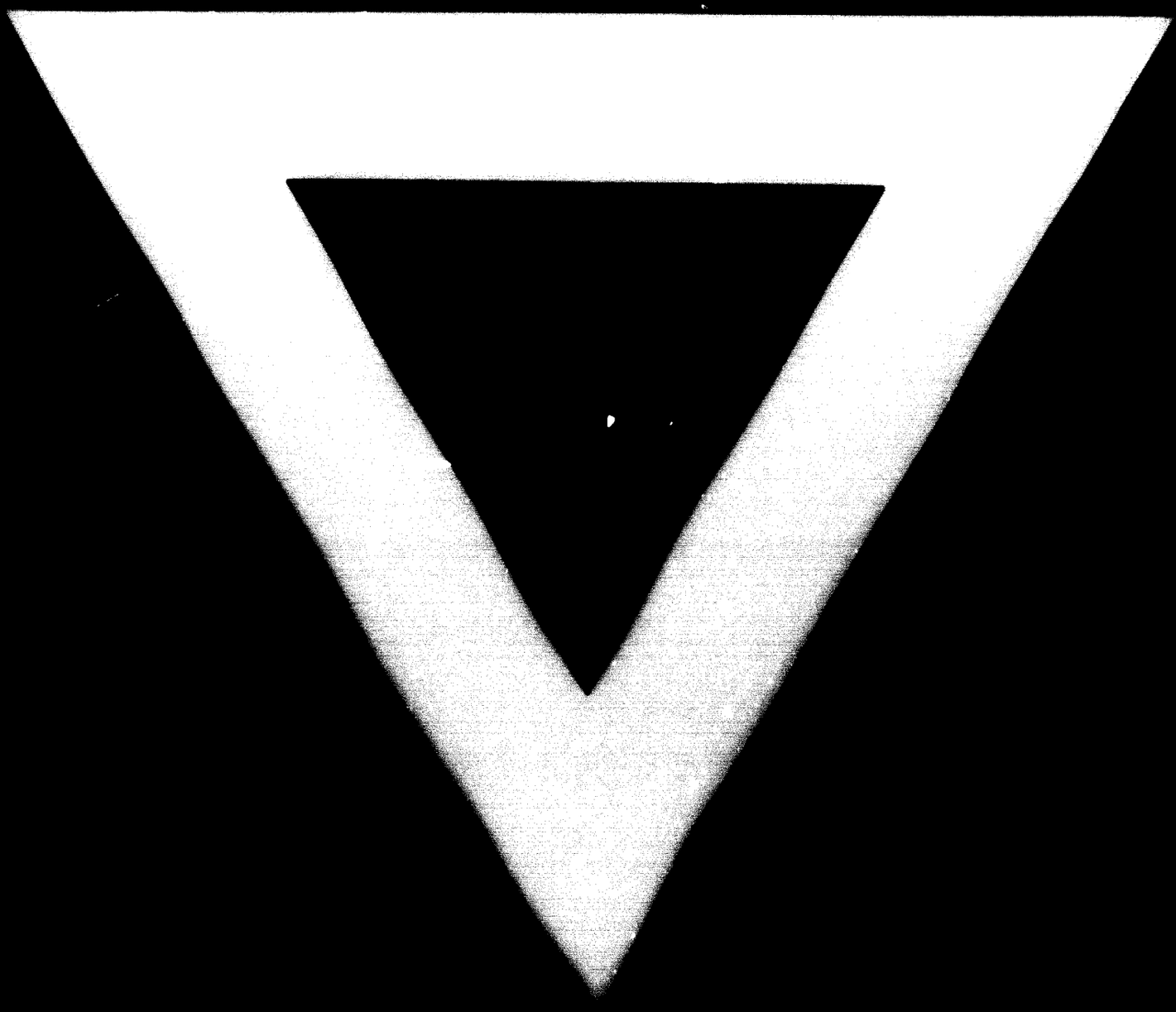
Yardsticks which supplement conventional financial criteria are needed. If DFCs are expected to pursue both financial and social objectives simultaneously, but their performance is measured by indicators appropriate mainly for financial objectives, then there is a danger that neither set of objectives will be pursued efficiently.

(4) How can the implementation of social cost/benefit analysis by DFCs be made easier?

More empirical work needs to be carried out to determine the effects of various short-cut methods on the accuracy of the end result in social cost/benefit analysis of industrial projects. The aim should be to develop short-cuts which can be used in less important projects and in projects where the end result is so clear cut that further refinement is not necessary. Intensified training efforts will also be required.

In conclusion, it is perhaps worth re-emphasizing the point made at the very beginning of this paper. Social evaluation of projects is but one aspect of project appraisal. To be effective it has to build upon a satisfactory appraisal of managerial, technical and financial aspects of the project. Social evaluation does not, therefore, displace the traditional disciplines of industrial development banking; it merely adds another dimension.





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