

The need for rigorous project appraisals

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The abrupt deferment of The Keretapi Tanah Melayu (KTM) double tracking project is certainly one of the most courageous and welcome decisions from our new Prime Minister thus far and we expect more decisions of this nature from him. This decision is significant not so much for its size and cost, being the most expensive single infrastructure venture. Rather, it is because of the vital and far-reaching consequences and effects that would have followed.

There is no denying that the project is large in size and value. It would have cost the government between RM14.5 and RM20 billion to implement it, which would be equivalent to about 18 per cent of the original total development expenditure for the entire Eighth Malaysia Plan. It is large compared to the allocation for the country's agricultural development expenditure (RM6.2 billion) and is almost four times the original allocation for the development of the health subsector (RM5.5 billion) for the same period. The cost of the project is as large as the allocation for education and training for the entire Plan period. In short, one can easily imagine the extraordinarily high "opportunity cost" of the project measured in terms of the value of other development projects that would need to be shelved had the railway double-tracking project not been deferred.

The rationale for the deferment is the need to prioritise the implementation of all the development projects based on socio-economic considerations. Given that the project is low in terms of priority listing, it is only appropriate that its implementation be postponed until such time as it may be considered a priority project.

Looking at priorities, the prime minister must have had very clear and strong reasons for the project to be postponed. Nevertheless, various questions may be raised. What are the approaches and methodology as well as the criteria used in evaluating the socio-economic viability of the project? Have the concerns and interests of all the stakeholders been taken into consideration? How are the benefits and costs of the project being evaluated? Have other similar and competing development projects been evaluated in order to assess its relative viability?

Ideally, all development projects, or at least major ones similar to the railway double tracking project, need to be evaluated just as vigorously and comprehensively in order to ensure the optimum allocation of the limited resources, as well as to provide maximum benefit to the economy, and more importantly to society, in terms of enhanced income and welfare. Wrongful implementation of a socially and economically non-viable project as costly as the railway double-tracking project, while rejecting more feasible ones would be disastrous to the economy. Hence the need to avoid, mistakes in making policy decisions.

For this, one needs to conduct a full and comprehensive social cost-benefit analysis of all major development projects. This will at least involve three phases of analysis, namely financial, economic and social.

The financial analysis is basically a project feasibility analysis normally undertaken by private businesses. The value and prices used are normally those prevailing in the market. The investment criteria adopted include internal rates of return, net present value and the pay-back periods of the project. A project is considered viable if the internal rate of return is higher than the cost of the capital, that is the interest rate of the loan to finance the project. Similarly, the project is deemed feasible if its net present value is positive.

However, more often than not, the market fails to reflect the real costs and benefits of a project to the economy as a whole. This is basically due to distortions caused usually by market interventions which prevent the free play of market forces. Thus, prices do not reflect the true scarcity of a product or service in the economy.

To rectify the shortcomings, a development project needs to undergo another stage of analysis i.e. the economic analysis. The process evaluates a project based on its real and overall contribution to the economy as a whole using a set of "efficient prices" to reflect the true costs and benefits of the project. This is done by transforming the market prices used in the financial analysis into what is sometimes called shadow prices, surrogate prices or economic accounting prices.

To differentiate the difference in valuation between the analyses, a simple illustration is in order. Assume that a car with a c.i.f. price of RM25,000 is imported into the country. Now, assume that the car is slammed with an exorbitant tariff of 100 per cent. Hence the domestic price of the car would be at least RM50,000.

The value of the car is now RM50,000, which is to be adopted in the financial analysis. However, under the economic analysis approach, the value is much lower i.e. RM25,000 or its foreign exchange equivalent. The latter is a better measure of the true value of the car to the economy as a whole. It represents the amount of resources in terms of the foreign currency equivalent that the country needs to spend in order to import the car into the country.

Alternatively, if a similar car is produced domestically, the value of the car would still be RM25,000 even though the cost of manufacturing the car domestically is still RM50,000. The RM25,000 difference represents the amount of foreign exchange saved by producing it domestically.

The conversion from financial analysis to economic analysis would involve an enormous amount of work if all the shadow prices were to be worked out individually for every development project. To simplify the process, all market prices are converted into shadow prices by multiplying each of them with its corresponding standard conversion factor. The latter represents the ratio between market and shadow prices applicable to an economy. As for Malaysia, these standard conversion factors are compiled in a planning document entitled the "National Parameters for Project Appraisal in Malaysia". If these national economic parameters are adopted in the economic analysis (if they are undertaken at all), then it will result in a selection of a set of development projects that are economically optimal, given the resources available. Though this approach of project evaluation was intended to be adopted in preparing the Third Malaysia Plan, it is however doubtful if it had ever been adopted.

Project evaluation does not simply end once the economic analysis is completed. Economic analysis, though considered a considerable improvement over financial analysis, has its own shortcomings. One critical shortcoming is that it does not explicitly incorporate the distributional aspects of the benefits of the project so as to be consistent with the distributional objectives at the macro-level planning. All project benefits are implicitly assigned equal weight regardless of to whom they accrue - the government, firms or private individuals, rich or poor. In an economy like Malaysia where distributional issues are considered as a major contention among its nationals, and where fair and equal distribution of the country's income and wealth is crucial for achieving national integration, the distributional effects of a development project need to be explicitly incorporated into the project analysis. For this, the economic analysis needs to be expanded to incorporate the

social (distributional) aspects of the project. Hence the need for a "social" project analysis.

Therefore, all project benefits (and costs) warrant a different weightage depending on the distribution objective concerned. These include distribution among income groups, ethnic groups, regions, etc. Benefits that accrue to lower income groups, less progressive ethnic groups or regions are normally assigned a higher weightage compared to that of the higher income groups, and more prosperous ethnic groups or regions. This relates to distribution among contemporaries (intra-temporal distribution). The other category of distribution involves distribution between the present and future generations (inter-temporal distribution). Data for the different types of distribution weights are available in the planning documents mentioned earlier.

The socio-economic analysis to evaluate the viability of a development project as explained above appears to be too ambitious and complicated and allegedly, its usefulness is sometimes being questioned. Furthermore, it requires a pool of experienced professionals to undertake this exercise - something that is in short supply in the public sector planning agencies.

However, we need to start somewhere in this aspect of development planning. It is not enough to talk about project priorities in general terms only. It has to be based on a systematic and sound planning framework to ensure the viability and sustainability of the project.

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