

Research Report No. 95

Conflicts of Interest and the Quality  
of Project Information

by

Gordon C. Winston

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Professor Gordon C. Winston, a former Senior Research  
Advisor at the Institute, is Associate Professor of  
Economics, Williams College, Williamstown, Mass., USA

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OF PROJECT INFORMATION

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## CONFLICTS OF INTEREST AND THE QUALITY OF PROJECT INFORMATION

### INTRODUCTION

This note has the modest aim of suggesting certain changes in evaluation of investment projects which are at once administratively feasible and, in creating a more coherent set of investments, important for economic growth. The unifying element is that these suggestions all deal with deficiencies in the quality of information - the information on which those who evaluate projects must base their decisions.

In the actual evaluation of projects, planners (and loan and aid officials) simply can't know enough about the projects they are asked to evaluate and what they do "know" they too often can't trust. And, any difficulties that might plague a central planner will be made more serious by the existence of multiple, parallel project-evaluation (sanctioning) agencies in Pakistan <sup>1/</sup>. The problem of project information has four basic dimensions, all of which seem amenable to

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<sup>1/</sup> Pakistan Industrial Credit and Investment Corporation (PICIC); The Industrial Development Bank of Pakistan (IDBP); The Central Investment Promotion Coordination Committee (CIPCOC); The Provincial Governments; and The Planning Commission.

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straightforward and attainable (if not always popular) administrative remedies; remedies, importantly, that depend on recognizing the economic incentives created by the present administrative system.

II. DISTORTED REPORTS AND CONFLICTS OF INTEREST

Feasibility reports provide the basic project information to a sanctioning agency and they must be written by someone. Ignoring until later the question of the technical and intellectual competence of these authors, a very basic difficulty with the quality of the information presented to the sanctioning agency is generated by simple conflicts of interests. The process of project generation and execution typically involves six distinguishable steps participated in by foreign firms:

Preliminary studies,  
Feasibility study,  
Engineering report,  
Construction,  
Initial management,  
Continuing raw material or technical control.

At each of these stages in a decentralized planning system, i.e. one where not all conceivable information is fed in to inundate the sanctioning agency - there is examination of alternative designs for the project

and selection from among them.

Since the agency makes its project selections largely on the basis of a consultant's feasibility report, a very important question is whether the same firm or organization is responsible for this report AND one or more of the later steps in project development. If the same firm writes the feasibility report and does, say, the construction, it will have an evident and sometimes quite strong incentive to bias the feasibility report in favour of the alternative version of the project that will yield the highest profits in construction. If the firm is a potential manager of the completed project at a profitable fee, the feasibility report may stress a complicated, foreign-management-intensive technology. And so on <sup>2/</sup>. In feasibility reports for technically complex projects, the opportunities (and temptations) for biasing the projects structure in the directions most profitable to the consultant-construction-management firm are numerous and significant. In many instances, overt dishonesty may not be so much at issue as optimism or pessimism in considering the set of alternative ways to put the project together.

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<sup>2/</sup> To these steps could be added arrangements for licensing fees and royalties; for personnel selection; etc. An interesting paper by Vaitzos [1] considers these in a different context.

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If the alternatives chosen consistently favour a design profitable to the consultant, they can add up to produce a very misleading, if nominally "honest", overall evaluation. The cost to society of this biased information is that of choosing projects and techniques that maximize foreign construction costs, foreign management, technical fees or imported raw-material inputs <sup>3/</sup>.

Offsetting this, of course, is the benefit of economies of learning by doing on the part of, for instance, a consultant-construction firm which may allow it to work more efficiently at one stage of a project (for instance construction) because of the information gained in association with that project at an earlier stage (e.g., as initial consultant). Or in another sequence, this might be the justification for giving the consulting stages of a project to a construction firm -- that the firm knows from construction of previous projects what the relevant variables are in this sort of undertaking. In light of these economies, it is possible that the cost to society of sacrificing expertise at more than one stage of the project is greater than the benefits of less biased information on which investment projects can be judged. But this seems doubtful. It is, obviously, a question of fact and one that is sufficiently important to suggest a

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<sup>3/</sup> Estimates of the seriousness of this in Columbia can be inferred from [1].

detailed examination of a number of past projects, some where there was and some where there was no overlap in these stages of preparation and execution. It should be possible to evaluate the seriousness of both scale economies of this sort and incentive distortions. What little evidence we have suggests that it is serious, indeed [1].

### III. INCOMPETENCE

There is a regretably strong conviction among those who use consultant's reports that many are done by organizations that are simply incompetent to do the evaluations they have contracted to do. This is an almost inevitable result of the heavy demand that the developing countries' planning mechanisms collectively place on the world's scarce consulting talents. Not much can be done to increase high quality supply, but it is hoped that with an appropriate specification of ground rules of project feasibility studies like those proposed below, consultants would be given less discretion and, therefore, less room for exercising incompetence. Even with these safeguards, however, there, would remain some firms now doing repeated consulting and writing of feasibility reports whose evaluations should be avoided on the basis of past experience.



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### IV. CONFLICTING OR INAPPROPRIATE BASIC ASSUMPTIONS

As things work now, a firm or consultant initiating a project for approval has very nearly carte blanche on what he assumes to be the economic environment in which the project will operate. This environment includes most of the important variables like sales, volume, prices, foreign competition, raw-material costs, taxes, technical agreements, etc. Not only will various of the assumptions about the environment often be "wrong" by some reasonable standard, but equally important, between different projects they will almost always be inconsistent and incomparable. So projects are being judged by different rules. Furthermore, there is no general requirement that these economic assumptions ever be made explicit. Some elements of the economic environment (demand, technology, competition, foreign technological agreements) are inevitably unique to a particular project or a small segment of industry, but others (the prices of capital, unskilled labour, foreign exchange) should be uniform for the economy or for large segments of it and should be used in evaluating all projects. These prices should be published by the Planning Commission as their best estimates of the appropriate scarcity prices of basic factors and required by law (and for sanction) for all projects.

These estimates might be in error by a healthy per cent (from the "actual" shadow prices -- if those could somehow be known), yet still bring considerable improvement in project selection by better reflecting the factor scarcities in Pakistan. Perfection isn't the goal; simply a marked improvement. But even if these shadow prices were just as bad (as a reflection of economic scarcities) as the prices being used now, uniformity itself would be a virtue -- in the critically important dimensions of saving foreign exchange and creating jobs, all projects would be judged by the same criteria.

Finally, these prices would have to be used at the outset of the project study. The sanctioning agencies could not put them in at the last, comparison stage, since by then the technique of production would have been decided and decided on the basis of inappropriate prices.

Beside input prices, the other element of the economic environment that should be specified to the project generators by the Planning Commission is the level of tariff and tax-protection burden under which the project will operate. At present, it is often possible to assume a nonexistent tariff to increase the value of the output in a feasibility report. This makes nonsense of any meaningful evaluation of projects since any project can be made attractively profitable

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by an appropriately favourable assumption about tariffs, import bans, scarcity premia or demand. Note that this applies, in reverse, to the cost of imported inputs (which can be lowered by concessional imports) and re-enforces the need for all such inputs to be valued at a more realistic shadow price for foreign exchange. For very large projects, it might be desirable to insist that alternative shadow prices be considered such as might emerge from the installation of the project -- but this is a refinement taken care of the large part below.

### V. CONSIDERATION OF ALTERNATIVES -- SENSITIVITY ANALYSIS

Unless the planning agency is entirely centralized in its function -- generating all projects internally -- there should be systematic examination of and choice between alternatives at many stages in putting a project together -- prior to a sanctioning agency's consideration of the project. These decisions will be both technical and economic. It is incompatible with decentralized planning to ask that all such alternatives be presented for re-evaluation by the sanctioning agency. Yet, failing that, the agency cannot know i) which alternatives have been simply overlooked and which have been dismissed only after some consideration, or ii) what costs attach to alternatives that may

better satisfy the (hopefully) somewhat different social criteria of the sanctioning agency.

A useful if partial answer to these uncertainties is "sensitivity analysis" -- which is simply a systematic way of asking the question: "what difference does it make?" Sensitivity analysis of the price, for instance, of unskilled labour would ask the question-- "If unskilled labour were 10 percent (or 5 or 40 percent) more or less expensive, by how much would the profits of this project be changed?" If the answer is "not by much" then that variable need not be given further attention. If on the other hand, the analysis shows that the project will stand or fall on small variations, then a more careful examination of the reasonableness of the assumed price of unskilled labour is called for. The sensitivity of other prices can be examined in the same way; the price of the product; the price of the inputs, etc.

#### VI. CONCLUSION

So long as the sanctioning agencies must approve all investment projects, it seems reasonable that they can exercise a good deal of collective discretion in determining the information standards on the basis of

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which they will approve projects. In this respect, they are in that unique and fortunate group of government information-gathering organizations that can force the presentation of proper information to them as a prerequisite for the granting of their favours.

From their position of considerable strength the sanctioning agencies can refuse to consider feasibility reports that do not:

i) adhere to the specified shadow prices of major factor inputs throughout the report, except for

ii) use of sensitivity analysis on the basic assumptions of the report including, importantly, these Planning Commission dictated shadow prices, assumed raw-material and sales prices and sales volume,

iii) eliminate incentives to distort project appraisals to get higher profits at another stage by allowing no firm to serve at two stages in the same project. Collusion and/or fictitious differentiation of firms would still yield some duplication (and duplicity) but probably in markedly reduced degree.

These recommendations leave the questions of consultant quality and honesty. While it smacks of Star Chamber, the only plausible suggestion for dealing with these is a blacklist of consultants. If the considerable temptation to use such a

blacklist for international political purposes were resisted (the threat to cut off all, say, US consultants might be tempting in negotiating with AID) and if the list were given prominent circulation among planning groups in other developing countries, it could develop into a formidable weapon for competent evaluations.

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