

Economic Analysis of Projects: A Tool for Informed Financing Decisions

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Key points

- ▶ In the 1950s, the economic analysis of projects (EAP) became a mandatory practice for donors, in addition to the financial analysis of investments, to assess the expected impacts for the community. At the time, there was an opposition between a planned approach to development and market-driven welfare maximization.
- ▶ The repeated criticisms of the relevance of EAPs and their economic prism put an end to the obligation for donors to use them. With the changes in the modalities of cooperation and the empowerment of borrower countries, EAPs simply became an option for these investments with external financing.
- ▶ Yet EAPs remain a useful tool, complementary to other approaches based on qualitative and biophysical criteria. They are also necessary for the consideration of systemic financial risks. They have the merit of fostering political dialogue, the development of a vision of the future, and reflection on the cost of inaction. They contribute to the preparation of projects and, ultimately, to the performance of their implementation. They can also inform reflection in terms of physical flows.
- ▶ However, revitalizing EAPs requires respecting good practices for their construction and use, and a continuous search for methodological improvements.

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What is an economic analysis of projects (EAP)?

An economic analysis of projects, referred to as a socioeconomic evaluation in administrative issuances, “allows to assess the benefit of an investment for the community, by analyzing the welfare gains and the costs it entails for the community. It must simply provide objective elements of analysis in terms of the opportunity of an investment and its different alternatives, and enable a comparison between several projects” (France Stratégie 2023).

It differs from financial analysis (used by lenders concerned about recovering their loan), budget projection (integration of recurrent investment costs), and environmental and social analysis (although it does use many of its calculation techniques). The objective of an EAP is to quantify the collective benefit of a project (overall, does this project provide value to the community?) and its distribution among the members (Who will benefit the most? Will people lose out?). It measures the value, if possible monetary or monetized, of the costs and benefits for each stakeholder affected by the project, and integrates the social and environmental dimensions in the assessment of the impacts and dynamics generated by this project.

There are various methods based on common principles to identify:

- The appropriate duration (the horizon of the project)
- The technical scope of the investment (for example, a power plant but also its transmission line)
- The total number of people affected, sometimes in the vicinity of the project area, sometimes far away, sometimes at the global level (for example, greenhouse gases emission)
- The series of financial and economic flows and impacts, including the externalities, to quantify their cost or benefit
- The value given to the future, reflected by a discount rate
- The vision of a future without the project (counterfactual scenario)

Economists use these different elements to calculate the discounted sum of the flows and effects valued in order to obtain the economic Net present value (NPV). They also calculate the economic Internal rate of return (IRR) associated with the project (meaning the discount rate making the economic NPV equal to zero).

Development of EAPs and criticism

In the History of economic thought, the EAP was developed during the Cold War, with an opposition between the proponents of State intervention in investment and the proponents of leaving it up to the private sector. It was refined through the investment planning operations for the economic development of recently decolonized countries and for post-war reconstruction in Europe.

From the 1950s onwards, the focus on assessing the economic performance of an investment was supported by: (i) the vigorous debate over the factors driving development and the blockages; (ii) leadership within institutions to disseminate the assessment methods, in particular at the World Bank with figures such as Myrdal

and Currie; (iii) the requirement of accountability towards taxpayers and public decision-makers (Alacevich 2016). One would have thus thought that EAPs were firmly established in the landscape. However, there was subsequently much debate over the tools, in particular the relevance and use of synthetic economic criteria (IRR, NPV) and, ultimately, the role of *ex-ante* evaluations.

A first point of criticism concerned the theoretical weaknesses of the cost-benefit analysis, which is based on “reference prices” (known to be manipulable) instead of observed market prices (and a full understanding of the knock-on effects). The second criticism was of the very essence of *ex-ante* project appraisal, stressing that many development projects would not have come about if the scale of the problems involved had been known. Consequently, if it is not possible to assess the actual collective costs, why want to decide on the basis of assessments known to be structurally partial and biased? Finally, the thinkers of EAP were accused of lagging behind market theory, as they overlooked factors such as the externalities, information imperfections, and the problems of valuing time, nature and human life.

The decline of EAPs among donors

In the 1990s, the conjunction of the existence of “white elephants” (oversized or irrelevant projects), largely responsible for the over-indebtedness of countries of the Global South, and the sudden stop in public investment in infrastructure during the Structural Adjustment Programs (SAPs) contributed to undermining the interest of EAPs, which would ultimately serve only to support project initiators with their projects. EAPs would now appear to be in decline in the vast majority of funding agencies, although they remain in place in Ministries of Finance as a tool for prioritization, rather than validation, for the allocation of limited public funds.

Several reasons account for this decline, including:

1. The problems of assessment techniques that are not properly resolved or are insurmountable. This is especially true for the “weak sustainability” inherent to the approach (in principle, an EAP is based on the assumption that “everything has a price”, even if it is incalculable). The unpredictability and uncertainties over behaviors mean that the utility, supply and demand curves are largely unknown and are dependent on too many assumptions.
2. The construction of counterfactuals (the future without the project) is subject of controversy. This can be seen during debates on the future uses of limited natural resources and on consumption patterns: How will they change spontaneously? Will there be changes in behavior likely to reduce the potential interest of the project compared to a trend scenario?
3. Donors escape the need for any impact assessment when their counterparty is the legitimate representative of the collective interest of the recipient community and has made a sovereign decision over the project. This is also the case when the form of the project, whether institutional or budget support, makes it difficult to assess the precise effects.
4. The clients are more empowered and are faced with a diversified offer: they are more assertive with their decisions and profit from the competition between donors. The economic rationale becomes secondary to the financial investment.

5. The economic model of donors and their procedures give priority to risks rather than returns, which is not conducive to maintaining EAPs. For donors, respecting their business plans results in EAPs being considered at best as an unnecessary cost in terms of time and money, at worst as an obstacle.

order to inform the decision-maker about the specific nature of the activity.

The construction of a baseline scenario “without the project” often appears difficult or artificial, but if there is financing, it means that there are transactions, consumption and production, with expected impacts. A second recommendation would be to explicitly describe what the future would be without the project, showing the breaks in trends considered inevitable, and those which would result from the implementation of the project (What assumptions? What changes? What consequences?). This approach is already used for the calculation of climate impacts.

Why and how to revitalize the use of EAPs?

The economic analysis of projects nonetheless remains useful for public authorities when they make their financing decisions, if only because it makes them consider the direct and indirect economic issues of an investment and its connections with the social and environmental aspects. So, why not use it?

The following recommendations are mainly intended for development finance institutions which, unlike the majority of public administrations, are not obliged to conduct economic analyses of their investments.

EAPs as useful input for the design and implementation of projects

Beyond a fetishism for figures (economic IRR and NPV), which has undermined the credibility of methods of economic analysis, it is important to note the productive nature of the analyses required for an EAP. They require financiers to compare their viewpoints, between the defense of financial interests and a mission to fight poverty and serve the general interest. An EAP is simply a source of input among others, which has the merit of asking the right questions: For whom? Why? What effects (intended or unintended)? What impacts and on whom? Who loses and who benefits? What happens if nothing is done? What value should be placed on the future?

There is consensus about the multi-criteria nature of financing. Therefore, while indicators on amounts, margins, carbon emissions, biodiversity conservation, strengthening governance, and so on, are all essential in the *ex-ante* evaluation of a project, why not use economic IRR and NPV which provide useful input for taking account of its relevance for collective wealth and the reduction of inequalities?

This does not contradict the validity of a risk analysis or an institutional, sociological or environmental analysis, for example. However, the relevance of conducting risk analyses without any analysis of the expected output of the operation can be questioned. They are both inextricably linked.

Finally, the turn-around time for analyses, dialogue and consultation for an EAP may seem long, but it often saves time during implementation, and thus accelerates disbursements. The *ex-ante* analytical work improves the overall *ex-post* performance.

Justify and explain the impact of inaction

Changes in the nature of projects (more humanitarian, budget supports, technical assistance, environmental project instead of classical infrastructure) do make it more complicated to conduct an EAP. A first recommendation is necessary: if there is no EAP, the reason for which it is impossible to conduct it needs to be clearly explained in

Include EAPs in a fruitful dialogue with partners

An EAP provides a framework for the objectivation and relativization of impacts. It is a tool for dialogue between the people affected, between the donor and client, and between parliamentarians and administrations. It is above all a process of consultation that can prevent misunderstandings over the objectives and expected benefits, in particular when the counterfactual is developed. It can reveal hidden interests or unvoiced expectations, as it requires collecting and comparing a great deal of information, consultations and surveys. The analysis thus mobilizes well beyond statistical institutions and borrowers. It includes all the stakeholders in the discussions over the realities experienced or perceived in the countries of operation. It also provides the opportunity to explain the trade-offs.

Modernize the practice, enhance financing decisions and improve the implementation

The synthetic economic NPV and IRR criteria (even with variants) are not sufficient to answer all the questions, but the utility of an EAP will achieve greater recognition if it is applied under conditions that make it productive for investment decisions. To this end, conducting an EAP requires a verification of certain conditions:

- The assumptions must be discussed with the beneficiary
- The counterfactuals must always be explained, even if there is no NPV and IRR
- The comparisons between the investment options must be made with similar contexts and methodologies
- Economic NPV and IRR must be developed when the terms of an investment have been decided, but can also be calculated to evaluate variants
- Physical flows may be required in addition to the monetary flows included in the NPV.

Enhance EAPs with new lines of reasoning

Economic research is advancing in the field of climate and pro-nature “transitions”. The relevance of approaches in which nature is assimilated to capital is currently the subject of heated controversy. Many studies use satellite accounts in physical units (and no longer monetary). These physical data, associated with social accounting matrices, can be used to calculate the biophysical footprint. These studies can serve to revive interest in economic analyses

that do not aggregate all the values, but retain the physical flows up to the cost-benefit analysis, to ultimately establish an assessment of the project in both monetary and physical terms.

Instilling and strengthening an economic culture open to the various schools of thought on development economics should thus contribute to the return to a more systemic, useful and reasoned practice of the economic analysis of projects during their appraisal.

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