

Economics without tears

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The Economic Appraisal Trap

An economist, an accountant and a mathematician all turn up for a job interview. The HR Director starts each of them off with an impossibly easy question – what does 2+2 equal? The mathematician doesn't hesitate and says 4. The accountant hedges his bets and says, 'four. Give or take 10 per cent, but about 4'. When asked the same question, the economist stands up and closes the door. He moves over to the interviewer's side of the desk, leans in and whispers to her: 'what do you want it to equal?'

There's an alarming degree of truth in that joke. I am thinking in this instance about the Economic Appraisal that most destination developers have to undertake at some stage. For the uninitiated, the Economic Appraisal (capital E, capital A) is not to be confused with a genuine economic appraisal, an altogether more worthwhile exercise, or an economic impact analysis (which is almost as pointless but in a completely different way).

How Does It Work?

The underlying principle is this. When a destination proposes a capital development it should be able to demonstrate that it represents value for money. The costs and benefits of the project should be compared to those of a realistic set of alternatives. This should provide evidence that the proposed solution is the best way forward and the most effective use of resources.

The cornerstones of an Appraisal are objectives, assumptions and options.

What are the objectives of the organisation? What assumptions must be made about what can and cannot be done? What options exist for advancing those objectives within the constraints set by the assumptions?

Next, you need to do a cost-benefit analysis. For each option, you calculate a discounted cashflow over, say, fifteen years. This will take in the capital cost of the development, along with all of the cost and income streams generated over the foreseeable future. The net present value of each option then generates a neat single figure for each option that can be compared to all of the others.

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To their credit, even the beancounters can appreciate that not every aspect of an investment decision can be measured in pounds and pence. So there is a final stage which tries to capture these 'non-quantifiable' costs and benefits. These are what the economist would call externalities, or what some of us might call the 'fluffy' bits that can't really be valued (e.g. benefits to education, public access, social inclusion, etc.). Treasury's response to this dilemma is something called the weighted decision matrix. The arithmetic for scoring options in the matrix is pretty straightforward. It

sounds like a terribly rigid way of measuring the immeasurable, but economists – as a rule – do not take 'fluffy' things lightly!

So Why Doesn't it Work?

Taken together these elements constitute the Economic Appraisal. It all sounds very rigorous in theory, but here's the rub: It isn't all that hard to make an Economic Appraisal say just about anything you want it to say.

All you need to do is structure your objectives and assumptions so that the option you like is bound to come out on top. If there is an alternative that is more efficient (but not as exciting) you can just 'assume' it away or claim that it doesn't deliver your objectives. The Appraisal then becomes a cosmetic exercise designed to support a foregone conclusion. My friend Brian (a reformed accountant) used to say, "it's not really lying, it's just wiping your feet on the truth a little". Nowadays, we might say that one option is 'sexed up' at the expense of the others.

Unfortunately, the potential damage done by cosmetic Economic Appraisals is much worse than a bruised sense of ethics. If there really is a better alternative out there, you can bet that someone will spot it. Eventually, someone will come along – whether it's a new manager, a new director, or a new consultant – with a fresh point-of-view and no baggage from previous decisions and will ask 'why are we pursuing option x, when we could just as easily achieve our objectives more cost-effectively through option y?'. By

then, however, if the Economic Appraisal has already received a stamp of approval from the relevant funding agency, few people would have the stomach to risk a sudden change in tack. The voices of reason are very quickly censored and the result is an organisation divided or a partnership in trouble.

The real problem is not that this sort of thing happens – it will always happen – but rather that: (a) there is no real response to it, and (b) the funding system actually encourages it.

The Challenge Process – Or Lack of One

To see why this is, let's imagine that the Director of the National Museum of Widgets wants to develop a new extension – a £10 million shiny glass box that no doubt looks terrific in the artist's impression. Our Director will need to demonstrate that all other alternatives have been considered and discarded. His challenge is to ensure that no other option comes through the Appraisal looking better than the one he's already got his heart set on.

In the museums and heritage world a sure-fire way to kill off alternatives is to raise the spectre of some danger to the collections. If there is a more modest alternative to a large new extension, simply say that it will endanger the collections and strike it from the list. Who's going to challenge that assumption?

I once met an economist at one of these funding agencies to discuss an Economic Appraisal that he was checking. The suggestion on my part that there were viable options that were not included in the report he was checking made him fidget in his pew. He was quite explicit: his job was to review the document submitted and ensure that the numbers stacked up.

He was not responsible for questioning the objectives of the organisation, much less suggesting alternative options. Ignorance really is bliss. It's not a crime to be misled.

However, even if an assessor can sense that something is amiss, he is in no way qualified to challenge those types of assumptions. At best, he can ask for 'independent professional assessment'. This means asking for an assessment by the other UK expert in historic widgets who will no doubt be just as excited by the idea of housing them in a shiny glass box. Independent? Yes. Professional? Sure. Objective and unbiased? Not so sure.

A Question of Timing

This all paints a fairly bleak picture for the whole Appraisal process. However, there is a place for genuine (little "e", little "a") economic appraisals. In terms of the mechanics, a real economic

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appraisal is virtually the same as a cosmetic one. The difference between the two is subtle, but crucial and is all about timing.

A real economic appraisal works when the developer genuinely doesn't know what to do next. In other words, the appraisal is done when all of the options are on equal footing and the question – 'where do we go from here?' – is still a valid one. An economic appraisal at that stage can be a powerful instrument. If you don't do the appraisal when all options are open to you, if you wait too long and work up one solution more than the others, then forget it. It won't help you.

This raises the second and more alarming problem with Economic Appraisals: the funding process indirectly encourages the use of cosmetic rather than real appraisals. With the competition for limited public funding getting more intense, public funding agencies need to ration the amount of project development funding that they can provide. So before signing any cheque (no matter how small) they tend to ask for more and more detail about the proposed project. As a result, the organisation develops a scheme up to a point where the public agency is excited enough to release some development funding. Eventually, the organisation will submit an application for major capital funding and only then will the public agency demand a complete Economic Appraisal.

But by then it's too late. Too many people will be signed up to a single idea. Reputations are at stake. Too much financial and emotional capital has been invested to allow a real economic appraisal to upset the apple cart. By now only a cosmetic appraisal will do. That's when a good economist comes in handy. At least he can ask the right questions.

What's the best option for the way forward? What do you want it to be...?