

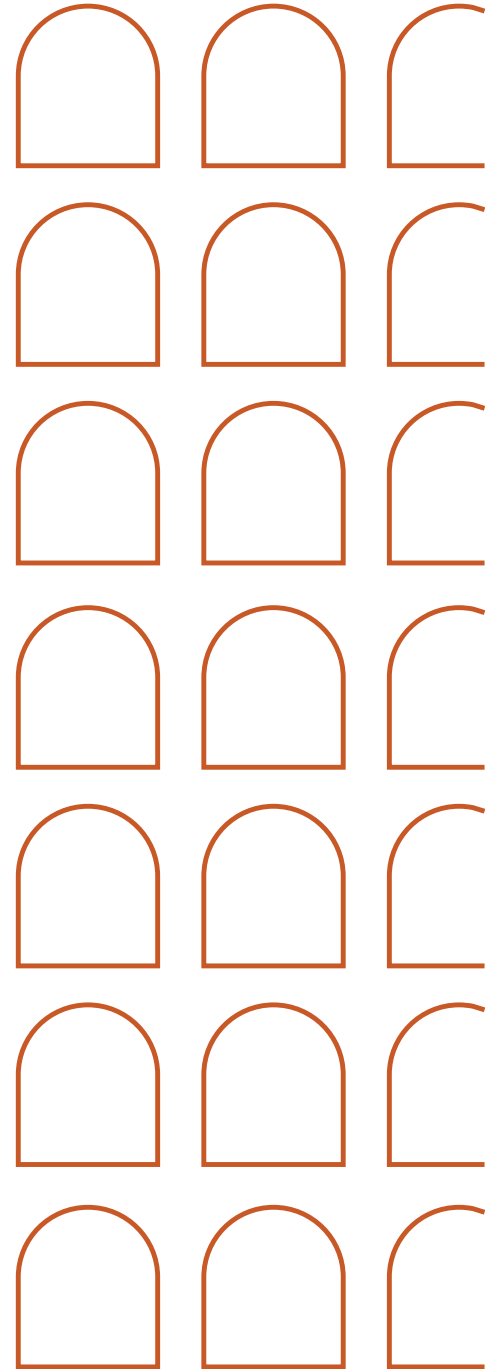
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POLICY ANALYSIS

MARKET EFFECTS IN DEVELOPMENT FINANCE'S IMPACT ASSESSMENT

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EXECUTIVE SUMMARY

Development finance institutions and international financial institutions are increasingly being asked to deliver ‘market-level impact’ through their operations. This paper explores how these institutions consider market effects in their impact assessment systems. We present the two dominant conceptualisations of market effects, narrow and broad, with the various channels used for their realisation. We discuss how these views intersect with those on market distortions and concessionality and outline how impact assessment systems handle market effects in practice. We conclude by arguing that institutions should be more considerate of broad market effects in their impact assessments.

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1. INTRODUCTION

International Financial Institutions (IFIs) and bilateral Development Finance Institutions (DFIs) play a critical role in driving global development by supporting the private sector. However, they still provide only a small fraction of public and private investments in developing countries.¹ Given the scale of the development needs, IFIs and DFIs are increasingly being asked to deliver 'market-level impact' through their operations.

This paper explores how DFIs and IFIs conceptually handle issues related to market development in their impact assessment systems. The key question it addresses is whether market effects, sometimes referred to as catalytic or systemic effects, are incorporated in project assessments.

The discussion on the role of markets in driving economic development has a long history in economics (see ADB, 2020, for an overview). Views will often be informed by arguments around institutional quality, economic efficiency, inequality, or the role of government policy in addressing known market failures related to externalities or knowledge spillovers. There is a broad consensus that development requires efficient markets, an effective state, and strong institutions (Acemoglu & Robinson, 2012). However, the definition of what is an 'effective market' and attitudes to the role of the state are not unanimous and have evolved over time.

From a development finance perspective, at the most basic level, markets are means to an end. **We argue that investors aiming to create development impact** (hereafter

referred to simply as 'impact') **should consider and assess the impact of their operations on two levels: client level and market level.** Market level effects have the potential to propagate beyond the client, the entity that received the investment, as the result of a change in behaviour or processes, such as the introduction of new standards or innovation in product development. 'Market impact' is unlikely to be neutral; given the role of markets in development, it should be considered during project impact assessments, especially among institutions that have a markets-based vision for economic development.

Assessing the market effects of an investment requires institutions to take a broader view on how impact is achieved. Competitive pressure is arguably the defining feature of well-functioning markets and key to the assessment of whether they can deliver socially optimal outcomes. The prices generated by market interactions are most effective at conveying socially useful information when markets are competitive. Distortions to competition therefore form a significant part of our focus.

The link between competition and productive efficiency is well-established in economic literature (Caves and Barton, 1990; Nickell, 1996; Pavcnik, 2002; Schmitz, 2005; Cole et al, 2005; Fabrizio et al, 2007). This relationship includes a selection effect, where low-productivity firms selectively drop out of competitive markets, and a treatment effect, where competition has a direct causal effect on firm productivity, acting as if it were an input in its production function.

¹ Gross fixed capital formation in Low-and Middle-Income countries is around USD 12tn per year. World Bank data for 2022, Gross fixed capital formation (current US\$), <https://data.worldbank.org/indicator/NE.GDI.FTOT.CD>.

While recent evidence suggests that the latter effect is stronger (Backus, 2020), implicit in both approaches is the idea that competition is a coercive force affecting behaviour in the market. We argue that the projects supported by DFIs and IFIs have the potential to trigger such responses, especially when financing is additional, thus market structures or institutions that attenuate competitive pressure should also affect the expected strength of impact.

We consider other channels by which market effects may also be realised, such as demonstration effects. While related to competition, demonstration effects are broader and often rely on the knowledge created in the market by the introduction of new technologies or the adapted use of existing technologies in new domains.

Indeed, some schools of thought characterise markets primarily as knowledge ecosystems. They see the fundamental economic problem to be coordinating the decisions of many private individuals among whom there is diffuse knowledge (Hayek, 1945). Markets and price signals emerge as a way to enable the coordination of actions taken on private knowledge.

Much of that knowledge is tacit; it derives from direct experience and is not codifiable or transferrable in formats like blueprints or operating manuals (Howells, 2002). Markets therefore have a 'learning' function, competition being the procedure by which facts are uncovered (Hayek, 1968). This is particularly important in developing countries, where there is greater uncertainty around the production functions of various goods, and therefore greater social value in "learning what one is good at producing" (Hausmann and Rodrik, 2003). Although under these conditions, the socially optimal degree of competition may not be equivalent to that in developed markets.

DFIs and IFIs regularly highlight the innovative nature of the projects they support, usually by identifying how, at the margin, various expected outcomes go beyond prevailing market practice. However, if an impact assessment approach does not account for market effects, it becomes difficult to distinguish innovation owing itself to a standard process of competitive pressure in a well-functioning market from that addressing a market failure or imperfection. The latter kind of project is more likely to drive impact in the long run and requires outlining a theory of change that addresses the identified market failure, rather than focusing on what may merely be novel to the market.

The market level aspects of impact finance have received a smaller share of development institutions' attention compared to issues like indicator harmonisation, results management, or measurement system design. Examples of the latter include the DFI Working Group's 'Harmonised Indicators for Private Sector Operations (HIPSO)', the Centre for International Development and Training's 'Management for Development Results (MfDR)', and the 'Operating Principles for Impact Management (OPIM)'. One reason for this could be that to analyse the potential market effects of a project, DFIs and IFIs would have to take a view on issues that are sometimes controversial, such as market structure, and economic and corporate governance. From a practical perspective, it is more difficult to take this approach compared to another, such as alignment with the Sustainable Development Goals (SDGs), which has market impact as but one objective from a much longer list of options.

We believe that these aspects are nonetheless critically relevant to the future of DFIs and IFIs, and the impact finance industry more generally, for two reasons.

The first is the dizzying growth of the impact investing industry; some estimates suggest that over 3,000 organisations now manage assets valued at over one trillion US dollars (GIIN, 2022). While few in number, DFIs and IFIs account for an outsize share of these assets, especially in developing countries and emerging markets.

DFIs and IFIs therefore have a central role in setting standards in a now diverse investor market. Investors range from lighter touch funds, which invest with some exclusion restrictions or positive environmental, social and governance (ESG) screening criteria, to intensive operations that attempt to estimate the causal impact of their projects using sophisticated ex-post evaluation techniques. This landscape would be enriched by some clear thought leadership on market effects by the largest incumbents.

The second reason is the relevance of market effects to several ongoing debates in the policy community that will have repercussions on the impact finance industry and developing countries.

Economic research has taken a renewed interest in the macroeconomic and distributional consequences of market power. Recent work on the United States has argued that increases in market power have driven a rise in markups and profitability and a decline in the labour share of income over the past four decades (De Loecker et al, 2020). Theoretical papers have also argued that the efficiency costs of monopoly distortions are orders of magnitude greater than previously thought (Baqae and Farhi, 2020).

The debate about industrial policy and the role of government in supporting new

technologies, particularly in the green space, has been reignited with the announcement of subsidisation programmes for strategic industries in many advanced economies (see the 'Inflation Reduction Act' of the United States Government in 2022 and 'A Green Deal Industrial Plan for the Net-Zero Age' of the European Commission in 2023). Aspects of these programmes have been singled out to be in violation of World Trade Organisation rules (Scheinert, 2023). Whether these developments are a response to climate change or whether they presage a shift to a new economic paradigm has yet to be determined.

Our contribution is to present the key concepts and issues related to market effects in impact assessment, not yet described in a single paper, and provide details on their implementation in practice at DFIs and IFIs. **We conclude that while many DFIs and IFIs recognise the importance of market effects, there is much room for a more formalised treatment that improves consistency across projects and institutions.** We rely on public documentation available on DFI and IFI websites and a set of interviews conducted with impact economists representing different institutions.²

The paper proceeds as follows: Section 2 briefly outlines how impact assessment systems developed over time, along with a description of their archetypes; Section 3 describes how DFIs and IFIs conceptualise market effects, and how this intersects with their attitudes to market distortions and concessionality; Section 4 explores how market effects are incorporated in practice in the impact assessment systems of various DFIs and IFIs; and Section 5 offers some

² We are grateful for the views offered by participants from the International Finance Corporation, British International Investment, the African Development Bank, IDB Invest, the European Investment Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, JP Morgan Development Finance Institution, Proparco, Acumen, and ILX Fund.

concluding remarks on future directions for work in this area.

2. THE DEVELOPMENT OF IMPACT ASSESSMENT SYSTEMS

The intellectual origins of today's impact assessment systems are arguably in the development of cost-benefit analysis (CBA) as a decision-making tool. CBA had its beginnings in the attempts of early 18th century French engineers to assess the incremental benefits of road improvements. The introduction of the concept of consumer surplus in the mid-19th century gave CBA its modern economic foundations (Jiang and Maggraf, 2021).

These techniques remained marginal until the 1930s and 1940s when they were applied by the US government in the evaluation of public water projects, such as flood control. Later, the insights of welfare economics were incorporated into CBAs to give social CBAs. The popularity of their use for project assessment continued to grow, including in other areas like education, public health, and urban regeneration, and they were eventually adopted by the World Bank to evaluate project impacts (Hirschman, 2002; Little and Mirrlees, 1990).

One limitation of CBAs is the difficulty of incorporating intangibles in calculations. Analyses of market effects will likely be rooted in unquantifiable aspects such as market dominance and competition, governance standards, and prevailing market practices. CBAs are also less useful at estimating efficiency gains and losses when markets are distorted along several dimensions and in opposite directions when it comes to costs or revenues.

Up until the 1990s, it was common among DFIs and IFIs to focus on the direct and indirect impacts of a project by utilising CBA-type analyses that statically compare

outcomes with and without the project. EBRD then became the first IFI to incorporate systemic effects on market processes in its methodology for assessing the development impact of its interventions (Kilpatrick, 2020). This approach instead emphasised the broader, dynamic effects of investments that "may induce important reactions outside the boundaries of the project but which may not be easily captured by the comparison of equilibriums 'with and without the project'" (Carbajo and Kominek, 2010). We term these 'market effects'.

EBRD's methodological approach was a function of the historical moment when it was established, and the goal of supporting post-Soviet economies' transition from planned to market systems. It also reflected an operating model that was to deploy mainly commercial financing to improve market functioning, rather than concessional funds to improve social outcomes.

While the operating model of IFIs, including the EBRD, has changed since then, not least because of the growing importance of concessional funding to support green projects, the emphasis on 'broader' project impacts endured and spread across the development finance space. IFIs and DFIs are generally seen to operate on the basis of the catalytic effect they can have on private sector investments in target countries (Lemma, 2015).

Impact assessment tools share many characteristics across IFIs and DFIs, but direct comparisons are difficult as they evolve in response to internal dynamics within institutions. Mechanically, they may have different arrangements for integrating their ex-ante assessment, monitoring, and evaluation functions (Mabuza et al, 2023). Conceptually, they may place different weights on the various dimensions of

economic development when appraising projects.

When it comes to market effects, a recent survey of a subset of IFIs and DFIs suggested that they “adopt a partial view of impact and, in some cases, an extremely narrow approach [...] which precludes any indirect or systemic impact” (Oxford Policy Management, 2020). It also noted the general absence of rigorous results chains through well-articulated theories of change. These conclusions would likely be less categorical today as many institutions have since moved towards recognising market effects in their assessment systems (see Section 4).

2.1 Impact assessment system archetypes

The main archetypes of impact assessment frameworks are: (a) ‘impact targets’, (b) ‘impact rating’, and (c) ‘impact monetisation’. Each postulates an impact thesis, assesses impact ex-ante and monitors progress during implementation.³ Frameworks differ mainly in how they are used to assess ex-ante impact and the degree to which they impart clarity, comparability, and credibility to impact claims. They are not mutually exclusive, as all three frameworks can be integrated into a single system at a given institution.

a) The ‘**impact target**’ framework asks that the investor sets targets for indicators across a portfolio or specifically to each investment. These targets are often expressed through some type of reach indicator, such as the number of beneficiaries. Baseline data is collected at origination, targets are set in agreement with the investee and later monitored during project implementation. This approach is most

widely used by private institutional investors and is often a good starting point for communicating impact, as impact targets are clear and credible. However, comparability across geographies and industries is difficult without normalising per unit of invested capital, and that itself raises the question of whether the scale of certain kinds of impact, such as in the green space, has a quality of its own. It is also unclear how the ‘**impact target**’ framework might capture qualitative aspects that do not readily lend themselves to mono-dimensional characterisation, such as market effects.

b) The ‘**impact ratings**’ framework asks that an overarching impact scoring system is introduced, capturing multiple dimensions covering stakeholders, environmental effects, and other criteria as deemed important. The ratings approach establishes a scale, usually with typologies or benchmarks, which can be numeric or qualitative. Market effects can be more readily incorporated into such a system through the addition of some qualitative or subjective component. This approach is widely used among IFIs and many DFIs, usually alongside elements of the ‘**impact target**’ framework. Score comparability across projects allows for more sophisticated portfolio construction, while investors can tailor the rating system to emphasise specific aspects over others. However, it can be hard to interpret and compare scores across institutions as they primarily inform internal decision-making. This significantly complicates the public messaging of achieved impact. The impact ratings framework also requires a benchmarking exercise that may be

³ This Section is adapted from IFC (2019).

challenging to new or innovative industries.

- c) The 'impact monetisation' framework asks that social returns are measured in financial terms, offering greater comparability as impact is assigned a monetary value. Social CBAs or economic rate of return (ERR) calculations fall under this framework. This approach is sometimes used by DFIs, IFIs, and investors looking to facilitate communication between the impact and investment industries. Estimating different externalities and weighing the relative benefits to each stakeholder in a single calculation can be a complex technical task, although it may provide clarity on the generated impact. It is highly sensitive to model assumptions, which raises questions around credibility when those assumptions are not borne out by reality. It is also practically impossible to incorporate market effects into this framework.

3. DFI AND IFI CONCEPTUALISATION OF MARKET EFFECTS

There are two main views, the 'narrow' and the 'broad', among IFIs and DFIs on defining the market effects of a given project.

The 'narrow' view argues that the relevant market, when assessing a given project, is the client's set of relationships with external parties. Here, market effects capture the changes resulting from a project in the localised sense, where the client's immediate relationships drive shifts in decision-making processes or outcomes. Some DFIs and IFIs refer to such effects as 'indirect impacts'. Common examples include strengthening forward or backward linkages or improving services provided to consumers.

The 'broad' view argues that the relevant market when assessing a given project is the client's industry and inter-industry relationships. Here, market effects capture the changes in decision-making processes or outcomes among parties with which the client has no immediate relationship. Examples include the replication of a productivity-enhancing change to a production process.

Approximately, the narrow view is more consistent with a notion of impact that centres on clients and incremental change on the micro level, while the broad view centres on markets and change at the system level.

A DFI or IFI need not necessarily adopt one approach and may choose to apply a different lens depending on the nature of the project. But the balance at a given institution will usually favour one over the other, which has implications on which market characteristics are deemed relevant for inclusion in project impact assessments (see Section 3.2).

The narrow approach seems more commonly used among DFIs while the broad approach seems more commonly used among IFIs, although the distinction is not clear cut. This could be because not all DFIs have explicit objectives on market impact defined by their shareholders. For example, IFC and EBRD define the specific attributes of well-functioning markets and develop a theory of change around how market effects can contribute to those

attributes.⁴ Institutions like BII, on the other hand, assess market effects in a pragmatic and less systematic way, focusing on how they would address market failures and lead to desirable outcomes for target beneficiaries. Also, DFIs are much smaller in scale compared to IFIs and therefore they may be more cautious about their ability to drive-market level changes.

3.1 Channels for achieving market effects

IFIs and DFIs recognise multiple channels by which market effects may be realised, mainly competition, demonstration effects, and regulatory reform.

Competition and demonstration channels

The competition channel centres on how players in a market respond when a competitor changes their behaviour. This usually involves responding in a way that enables a recovery of the competitive edge. This channel features more prominently among institutions adopting a broad view of market effects. For example, EBRD sees competition as a key channel whose obstruction should be subject to scrutiny. IFC also emphasises competition, though views it as merely one of the valid channels for market effects, and therefore neutral to impact if there is a credible case for another channel.

Institutions such as AfDB argue that the importance of competition is contingent on the development levels of a given investee country. While important for long run outcomes, market effects through competition may be less important in the early stages of development. In some cases, competition is seen as subordinate to the provision of essential goods if they must be

provided through dominant players in the market. This is a recurring consideration for fragile states in particular. BII offers a different but somewhat related perspective; the competition channel is important primarily in scenarios where the market is moving from an uncompetitive to a competitive state.

The difference between the competition and demonstration channels is not always well articulated by IFIs and DFIs. This may be because the two overlap in some cases, especially when focusing on dynamics within a given industry, and a competitive impulse is often necessary for demonstration effects to materialise. Conceptually, demonstration effects are broader in scope and nature.

Demonstration effects can generate knowledge spillovers beyond the immediate market in question and its incumbents; they are strongest when considering general purpose technologies or generalisable production techniques. A useful historical example is the development of interchangeable parts in the 19th century, which started in the manufacture of firearms and spread to watches, followed by bicycles, sewing machines, farm equipment and finally automobiles (Allen, 2011).

In contrast to the positive externality of demonstration effects, competition is almost always seen by market incumbents as a negative externality. Demonstration effects change the long run payoffs associated with a given technology or industry as a whole, while competition forces a short-term business response among incumbents to protect profitability. This suggests that the response associated

⁴ For example, IFC Article of Agreement N. 1 states the Corporation will “seek to stimulate, and to help create conditions conducive to, the flow of private capital, domestic and foreign, into productive investment in member countries”, <https://www.ifc.org/content/dam/ifc/doc/2023/ifc-articles-of-agreement-en.pdf>.

with demonstration effects is likely to be more replicative or symmetric than with competition, where a wider range of responses are possible, like changing price, quality, quantity, or otherwise.

The difference is also apparent when defining the relevant market in which effects are expected to materialise. Competition requires identifying a market where there is a certain level of product substitutability between competitors, while demonstration effects allow for a much broader definition that breaks down barriers across markets.

Competition and demonstration may even be at odds in a given project. For example, working with a dominant player looking to introduce a new, potentially transformative technology into an economy might be negative for competition, but positive in demonstration terms if the technology proves to be viable for other industries in the economy.

Almost all DFIs and IFIs refer to demonstration effects as part of their narratives for innovative projects, regardless of whether they adopt a narrow or broad view of market effects. However, institutions that take a broad view are more likely to try to systematically capture demonstration effects in project impact assessments, making a link to sectoral or economy-wide theories of change.

Regulatory reform channel

DFIs and IFIs also recognise the regulatory reform channel for market effects. This is conceptually straightforward and tends to be articulated relatively consistently across institutions. However, it is of much narrower applicability as it is relevant mostly for institutions that have a policy mandate or access to donor funds for capacity building activities.

Regulatory reform can create new markets or improve the functioning of existing ones through the introduction or modification of specific regulations or, in some cases, a revamp of the entire regulatory framework for a given sector. DFIs and IFIs both adopt the broad view of market effects when considering regulatory reform. Common examples include developing regulations for renewable energy or introducing regulations on the issuance of certain types of securities. Less common examples include strengthening the regulatory framework of competition authorities or unbundling sectors that are vertically integrated, especially in the presence of a public utility in the chain.

3.2 Views on market distortions and concessionality

DFIs and IFIs take different opinions, both in kind and degree, on how to approach the assessment of projects that either risk having anticompetitive effects, benefit from protectionism and state-subsidies, or benefit from concessional finance provided by the institution itself. We argue that the reason for these differences derives partly from their different conceptualisations of market effects.

Anticompetitive effects

The risk that a project has anticompetitive effects is highest when IFIs and DFIs support a dominant player in a given market. There are two perspectives on how this should be dealt with.

The first perspective sees anticompetitive effects through the lens of compliance and risk management, where an institution runs reputational risk by supporting a client that may engage in anticompetitive behaviour. This takes a legalistic stance on monopolisation, without necessarily recognising the weaknesses in governance

that allow for anticompetitive abuses in the first place. These could include an ineffective competition authority or institutional susceptibility to rent-seeking behaviour. This perspective is more commonly held among DFIs, or institutions with a predominantly narrow view of market effects. Accounting for anticompetitive risks in impact terms would require looking beyond, and in some cases far beyond, what is happening at the level of the client and their immediate network. This would be difficult to do unless broad market aspects are formally integrated into the impact concept.

The second perspective sees anticompetitive effects through the lens of impact, where monopolisation can potentially inhibit long run market development by, for example, enabling market practices that foreclose the entry of new competitors or the expansion of existing ones. This perspective is more commonly held among IFIs, or institutions with a predominantly broad view of market effects.

The absence of clearly articulated positions on how to assess projects with dominant players is therefore noticeable, especially among institutions emphasising the competition channel for market effects. What often follows is an ad-hoc approach where the risk of reinforcing market dominance will be weighed against the potential benefits achievable by working with a large, dominant player, such as having significant reach or improving industry practices. This approach may be a function of the complexity of assessing dominance, which cannot be based on simple metrics like market shares when defining the relevant market itself is a challenge. An e-commerce platform might account for the vast majority of online retail sales, but a relatively minor portion of retail sales overall.

Having a dominant position could also simply reflect factors that DFIs and IFIs would consider favourably or even encourage, like having high productivity in an increasing return to scale industry, or effective cost control through superior logistical efficiency and planning. Assessing dominance means analysing barriers to entry, buyer power, dynamic effects, and, particularly in the case of state-owned enterprises, state aid policies. These issues are typically dealt with by highly specialised branches of legal and economic practice.

Institutions might factor in this complexity to the initial choice of which view of market effects to adopt. Smaller institutions may not have the resources to deal with these issues, in an ad-hoc way or otherwise, except for the most visible projects. This could induce selection into a narrow conceptualisation of market effects that is more operationally workable. Institutions operating in less developed countries may also accept working with dominant players as unavoidable, given the small number of potential private sector counterparts.

State-subsidies and protectionism

Economic research has long-established the significance of protectionism's welfare losses (Fajgelbaum et al, 2020; Kutlina-Dimitrova and Latakos, 2017; Feenstra, 1992); policies include tariffs, quotas, and subsidies, among others such as local content requirements. DFIs and IFIs generally see these policies as distortionary, but, again, there are two prevailing perspectives on how they should be dealt with.

The first views protectionism through the lens of financial risk. The focus is on assessing the extent to which a project's returns depend on government support by simulating scenarios with and without tariffs and subsidies. This perspective sees

protectionism as essentially neutral to impact considerations, except in the loose sense of raising the risk if a given development outcome is not sustained following sector liberalisation. The approach is more commonly held among institutions with a predominantly narrow view of market effects. They are disposed to take government policies as given since they are also unlikely to have a policy mandate that allows them to try to address market distortions. This could induce selection into the more operationally workable narrow conceptualisation, in a similar way to that described for anticompetitive effects.

The second perspective approaches protectionism through the lens of impact and attempts to capture welfare losses in the final analysis. Common techniques include incorporating subsidies and tariffs in an impact monetisation framework tool such as ERR, or conducting a counterfactual analysis that assesses international competitiveness in the absence of protectionist policies. Applying this lens may also require an analysis of the political economy of protectionism, including the direction of travel on the reform or expansion of tariff or nontariff barriers.

This outlook is more commonly held among institutions with a predominantly broad view of market effects, recognising that subsidies and tariffs have economy-wide distortionary effects beyond the immediate project under consideration. Institutions may still choose to trade-off the positive and negative outcomes of a project, but this is done in a more codified way than for anticompetitive effects. This may owe something to the fact that protectionist policies, with some exceptions like non-tariff trade barriers, can be easily verified and quantified, allowing for methodical incorporation into impact assessments.

Concessional finance

The label 'concessional' is used to describe transaction terms that are markedly better on price or tenor than those available in the market. Drawing a line between concessional and non-concessional terms is not always straightforward as DFIs and IFIs operate on the principle of additionality. In effect, concessional funds are subsidies administered by DFIs and IFIs.

There are greater similarities among DFIs and IFIs in their treatment of concessionality compared to anticompetitive effects or protectionism, likely because most institutions have formally or practically adopted the Enhanced Blended Concessional Finance Principles for DFI Private Sector Operations. These stipulate that access to concessional terms should be linked to well-defined impact objectives, while subsidisation should be kept to the minimum required to bring a project to bankability.

Impact objectives eligible for concessionality are almost always linked to perceived market failures, especially situations in which markets underinvest in projects with positive externalities. The Blended Concessional Finance Principles do not, however, deal with the potential risks concessionality might pose to market development.

Institutions that adopt a broad view of market effects are more likely to consider the distortive potential of subsidisation either in their impact assessments outright, or in parallel assessments specific to concessionality. This is sometimes done by conducting an analysis of deployed concessional resources to estimate 'grant-equivalent' amounts when instruments such as guarantees or concessional loans are involved. This approach is informed by the attitude that, ultimately, market effects

depend on a functioning price mechanism, and excessive subsidisation could inhibit market development in the long run if unsustainable market behaviours take root. Such an example was outlined in a recent study suggesting that programmes aimed at developing the solar power market in Africa were undermined by public messaging that suppressed price information and skewed market expectations of what was commercially plausible (Emery, 2023).

One difficulty faced by DFIs and IFIs is that many concessional resources have conditions attached by their donors. It is not always the case that those conditions align with an institution's impact concept and view on market effects. This challenge will likely grow with the increased deployment of concessional resources in the sector, especially as some opinions shift towards seeing DFIs and IFIs as providers of global public goods (World Bank, 2022).

4. IMPACT ASSESSMENT SYSTEMS IN PRACTICE

4.1 Outcomes and processes

When it comes to designing impact assessment systems, **investors can define project objectives in terms of outcomes or processes. Outcomes focus on what is being achieved, the processes on how outcomes are achieved.** Common examples of outcomes include the number of beneficiaries reached, carbon emissions saved, loans extended, or similar. Common examples of processes include corporate governance structures, production techniques, decision-making mechanisms, or similar. Incorporating processes into the system is more easily done in an impact ratings framework, than an impact target or monetisation framework (see Section 2.1). Although most DFIs and IFIs have such a framework, they differ on the question of

outcomes versus process, at least partly due to their conceptualisations of market effects.

Institutions that adopt a narrow view are more likely to have an impact assessment system that primarily focuses on outcomes. This produces a definable set of targets as aspects like 'decision-making processes' are seen as too nebulous to guide how project success should be defined at origination. **Institutions that adopt a broad view of market effects are more likely to allow for, or even insist on, the consideration of processes as part of impact assessments.** Outcomes may still be defined, and indeed a subset of project objectives may look identical in the two approaches.

However, the 'processes' approach is distinguished by the ability to incorporate aspects that may be difficult to pursue explicitly and capture in project outcomes, like good governance. The underlying assumption is that social welfare is maximised when markets are allowed to function within a sound governance structure. In other words, better processes lead to better outcomes, though it may not be obvious what those outcomes are at origination. Assessing changes to processes also allows for a calculation of net, rather than gross, impact. This is especially relevant for institutions that integrate considerations around anticompetitive effects or protectionism, where there could be a trade-off between positive project outcomes and negative market distortions. In practice, most IFIs 'net out' such effects implicitly, rather than explicitly as part of the score calculation.

The primary challenge with a 'processes' approach is the time lag between implementing a project that aims to change behaviours, such as corporate governance reform, and observing results that may come long after project completion. This complicates attribution (see Section 4.2) and

raises the question of whether it is possible to align a project's impact monitoring with its life cycle.

The 'outcomes' approach presents challenges of its own, particularly when it comes to attribution in the presence of exogenous shocks. Though changes to processes may take a while to be absorbed, there is less need to target short term outcomes, which may vary for reasons unrelated to the project.

4.2 Indicator usage

The project ratings of DFIs and IFIs depend on the ability to predict impact ex-ante and monitor results ex-post. One issue is how the views of institutions on 'narrow versus broad market effects' and 'outcomes versus processes' determine the use of qualitative or quantitative monitoring indicators in their impact assessment systems. **An approach to impact that focuses on broad market effects and processes is more likely to allow for the extensive use of qualitative indicators compared to one that focuses on narrow market effects and outcomes.** There are two reasons for this.

The first is that the concepts associated with broad market effects and processes, such as the behavioural changes that follow corporate governance reforms, are near impossible to measure directly and quantitatively. There is general agreement among economists that governance arrangements, knowledge spill-overs and institutional quality are important for development, but less agreement on whether or how these can be observed or measured. Broad market effects allow for the recognition of impact that may not be associated with a specific project outcome indicator. Impact economists assessing such projects have to make qualitative, and occasionally subjective, judgements about these topics and develop theories of change

that may not be quantitatively verifiable but are rooted in a general understanding of what drives long run market development.

The second reason is attribution issues related to level or rate changes in market-level indicators. Disentangling a project's market signal from independent processes in the market would likely demand an intensive technical effort that puts it beyond the resource capacities of many institutions. A workable alternative in practice is to combine, ex-ante, project level indicators with plausible theories of change based on sectoral empirics. A selection of the most visible projects might also be subject to comprehensive ex-post evaluations that factor in project-level client reporting with developments in the wider market.

Internal governance arrangements may also influence the way project indicators are selected. An institution may define a quantitative threshold condition to establish the veracity of ex-ante impact claims, even though broad market effects and processes may be an important part of that institution's impact concept. The stated reasoning for this is to impose internal discipline in recognising market effects only when they are credible. But defining credibility in quantitative terms means that otherwise sound narratives around market effects may become unnecessarily de-emphasised and dropped.

The widespread use of the SDGs by the impact investing industry may affect project indicator selection within DFIs and IFIs. Private sector impact investors often define the quantitative measures of impact aligned with the SDGs. These are viewed as more 'defensible' before investors and regulators than qualitative indicators, which require the judgement of impact economists. Conflict of interest considerations are relevant, but this may lead to a situation where the impact investing industry focuses on outcome-

based and quantitative impact, rather than processes-based and qualitative impact, though the latter may be more important for long term development.

4.3 System incorporation of broad market effects⁵

Broad market effects feature more prominently in the impact assessment systems of IFIs compared to DFIs. This arguably follows from IFIs' often explicit mandate to drive development more generally in investee countries rather than in specific domains. IFI investment volumes are only a small fraction of foreign direct investment and portfolio flows to recipient countries; a smaller fraction still if total investment is considered. IFIs would not be able to impact the development trajectory of a given country without targeting broad market effects.

Institutions that account for market effects typically assign them a weight within their impact ratings framework. Identifying how these weights factor into project ratings is not always straightforward as systems are designed to be flexible enough to handle different kinds of projects across different sectors. IFC's AIMM system has the clearest weight assigned to broad market effects, where 50 per cent of a project's score depends on market outcomes. The system defines market typologies and assesses projects according to their potential to catalyse change in relation to the stage of market development.

The weights assigned by other institutions may differ by sector, product or project. For example, AfDB assigns a high weight to 'private sector development' outcomes, which include broad market effects. This

weight usually varies around an anchor percentage of approximately 60 per cent of a project's score. The latest version of AfDB's impact assessment system, ADOA 3.0, formalised market effects as part of the score, whereas previously it was mostly a narrative point. This latter point is also true for ADB's current system for ex-ante assessment of development impact for private sector operations, which recognises market effects, though their precise weight is unclear.

IDB Invest's DELTA system assigns fixed weights to broad market effects, termed 'systemic effects', through its 'contribution to social and economic development' score category. Ratings are calculated in a way that means market effects will factor more strongly into the final score of projects targeting such effects, versus those that do not.

EBRD's Monarch system places broad market effects at the core of its impact concept and so does not assign them a specific weight. Potential market effects are identified, from which a theory of change is established linking project outcomes to the wider market. In principle, all high-scoring projects should have market effects.

BII's system recognises the broad market effects, termed 'catalytic effects', of certain investments under the 'productivity' assessment category. These effects are not central to the assessment but can improve a project's score significantly, in some cases by over 50 per cent of the baseline on the productivity category. Market effects are not assigned a specific weight. Worthy of note on the BII approach is that it takes an additive approach to market effects by only bringing a project's score up. Most IFIs

⁵ This Section is based mostly on these documents: 'BII – Impact Score 2022-2026 Strategy Period (2022)', 'AfDB – ADOA General Framework 3.0 (2022)', 'IDB Invest – IDB Invest's Impact Management Framework: Managing a Portfolio for Impact (2020)'. Information on IFC's AIMM is from the relevant pages on the website, www.ifc.org/en/our-impact/measuring-and-monitoring.

instead adopt an averaging approach to market effects, where their absence can bring a project's score down after the different components are combined. The latter approach implicitly perceives that the complementarities between different kinds of impact are limited. The upper bound of a project rating will be determined by the highest scoring component, rather than the sum of all components.

5. CONCLUDING REMARKS

The starting point of this paper was to contribute to ongoing debates on the purpose of impact finance by focusing on the oft-overlooked issue of how DFIs and IFIs think about market development in their operations. We provided a definition of the different conceptualisations of market effects and their channels, how they intersect with views on potential impact-related issues, and how those ideas are put into practice in impact assessment systems.

We conclude by outlining some points about how this work relates to the wider impact investing industry, arguing that DFIs and IFIs should be more considerate of broad market effects in their impact assessments.

There is a discernible tension between public and private impact investors when it comes to the implications of broad market effects, particularly the risks of anticompetitive effects. This is arguably due to the fundamentally different aims of each group's shareholders. Public impact investors likely maximise impact subject to a minimum return requirement, while private impact investors likely maximise returns subject to a minimum impact requirement. It is a common assumption in much of the impact investing industry that private investors do not need to sacrifice returns to achieve impact. The phrase 'doing well by doing good' has been in use since at least

the 1990s (Geismer, 2022) and has been adopted by proponents of impact investing to argue that impact and returns are not only compatible but complementary.

Investing in a dominant player in a given industry may be a sound business decision and deliver impact but it brings risks to market development if dominance is a result of rent-seeking behaviour or inadequate regulatory frameworks that are unable to enforce against anticompetitive behaviour. As a result, investments that are financially lucrative pose no reputational risk and achieve impactful outcomes at the client-level but may yet have negative market effects.

Often, when private investors talk of market effects, they refer to the market for funding, upstream from the project, rather than the investee company's market itself. A question for future discussion is whether private impact investors would be willing to recognise broad market effects and 'processes' as key to their objectives. This would require a change to some of the practices that have taken hold in the industry, such as the use of SDGs a tool for defining and monitoring impact. The predominantly quantitative indicators of the SDGs may give private investors a simple way to aggregate outcomes, compare projects and tell their shareholders an intuitive story about impact. But this approach misses some of the factors that are decisive for long run market development, such as improving decision-making processes and changing behaviours through better governance.

Among public impact investors, greater discussion is required on how, and what aspects of, market effects should be incorporated in impact assessment systems. Excluding issues such as competitive neutrality, the abuse of monopoly power or protectionism from

consideration is difficult to reconcile with a market-based vision for economic development.

Broad market effects and 'processes' are challenging to capture in impact assessments that often have to be done on short timelines as part of an institution's investment approval process. But economic development is a complex process that rejects easy characterisation; focusing on narrow market effects and 'outcomes' merely shifts the complexity outside the field of consideration. This could result in a failure to account for policies that impede long run development and are obscured by a limited number of successful outcomes in the short run.

Where such omissions are a function of limited resources to account for broad market effects, DFIs and IFIs would do well to better cooperate on devising common guidelines that inform project impact assessments. This would improve the legibility of the issues under consideration by providing a list of criteria or questions for the project to address.

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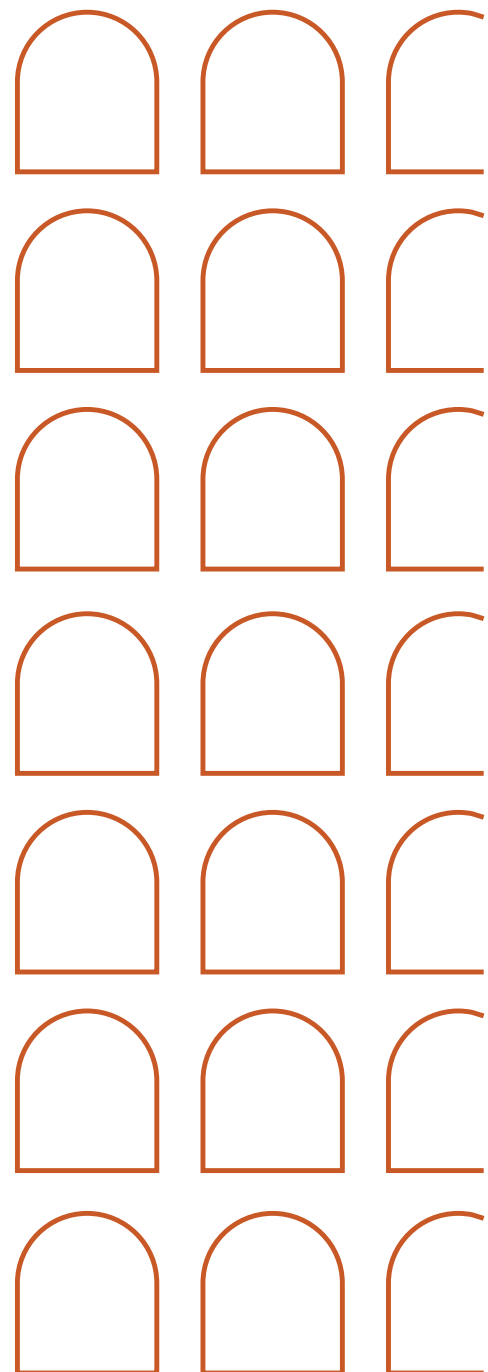
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