

Session 2.2

Economic Rationale of Projects

**Introductory Course on Economic Analysis
of Investment Projects**

6 May 2008

The views expressed in this presentation are the views of the author/s and do not necessarily reflect the views or policies of the Asian Development Bank, or its Board of Governors, or the governments they represent. ADB does not guarantee the accuracy of the data included in this presentation and accepts no responsibility for any consequence of their use. The countries listed in this presentation do not imply any view on ADB's part as to sovereignty or independent status or necessarily conform to ADB's terminology.



Economic Rationale of Projects

Basic Questions:

- Why public sector interventions?
Justifications
- Does the project crowd out private investments?
- Does the project have the proper mix of
 - Investments
 - Policy Reforms
 - Institutional Capacity Building



Market Failures:

Deviation from free market solution

Market failures justify public interventions in the economy

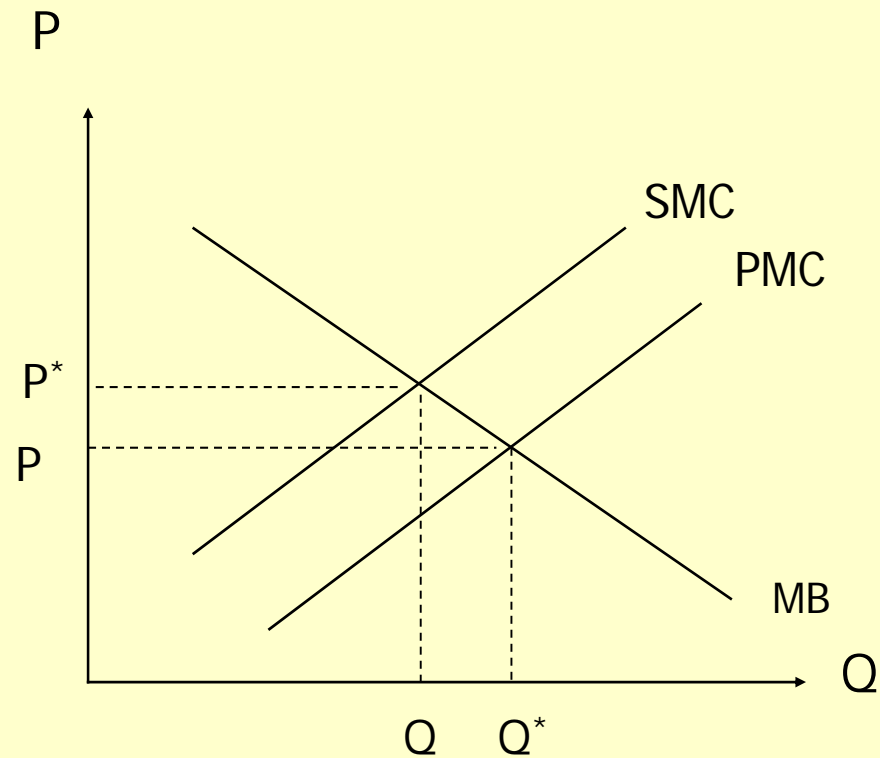
- Externalities
- Public goods
- Imperfect markets
- Information failures
- Coordination failures

Equity Issues: Market does not guarantee equitable distribution

Merit Goods: Intentional government failures



Externalities - Negative



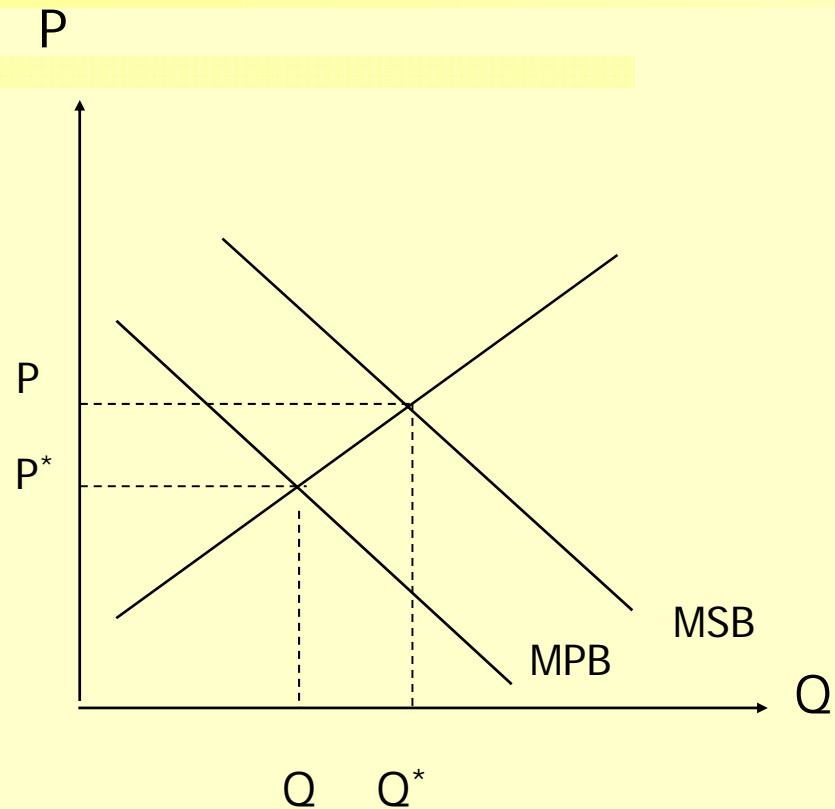
Markets produce more than optimal quantity



Interventions



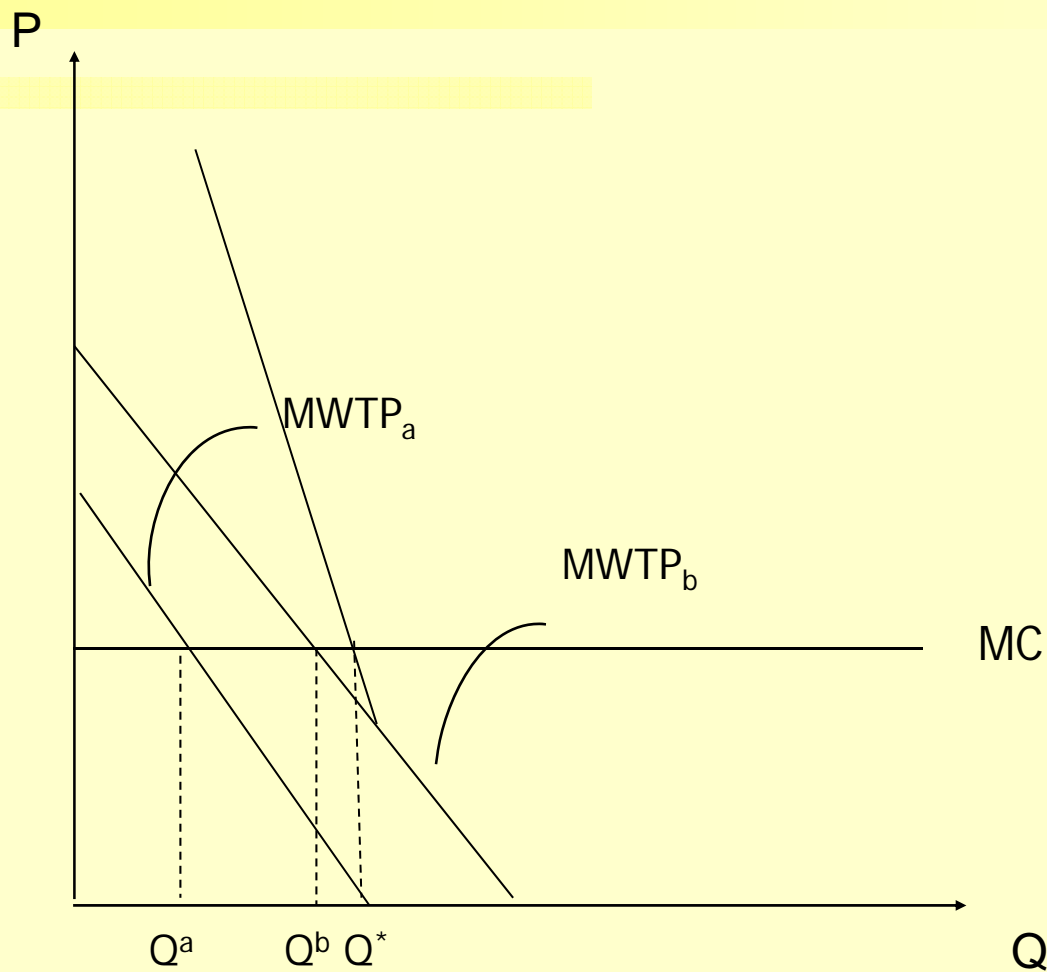
Externalities - Positive

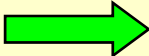


Markets produce less than optimal quantity → Interventions

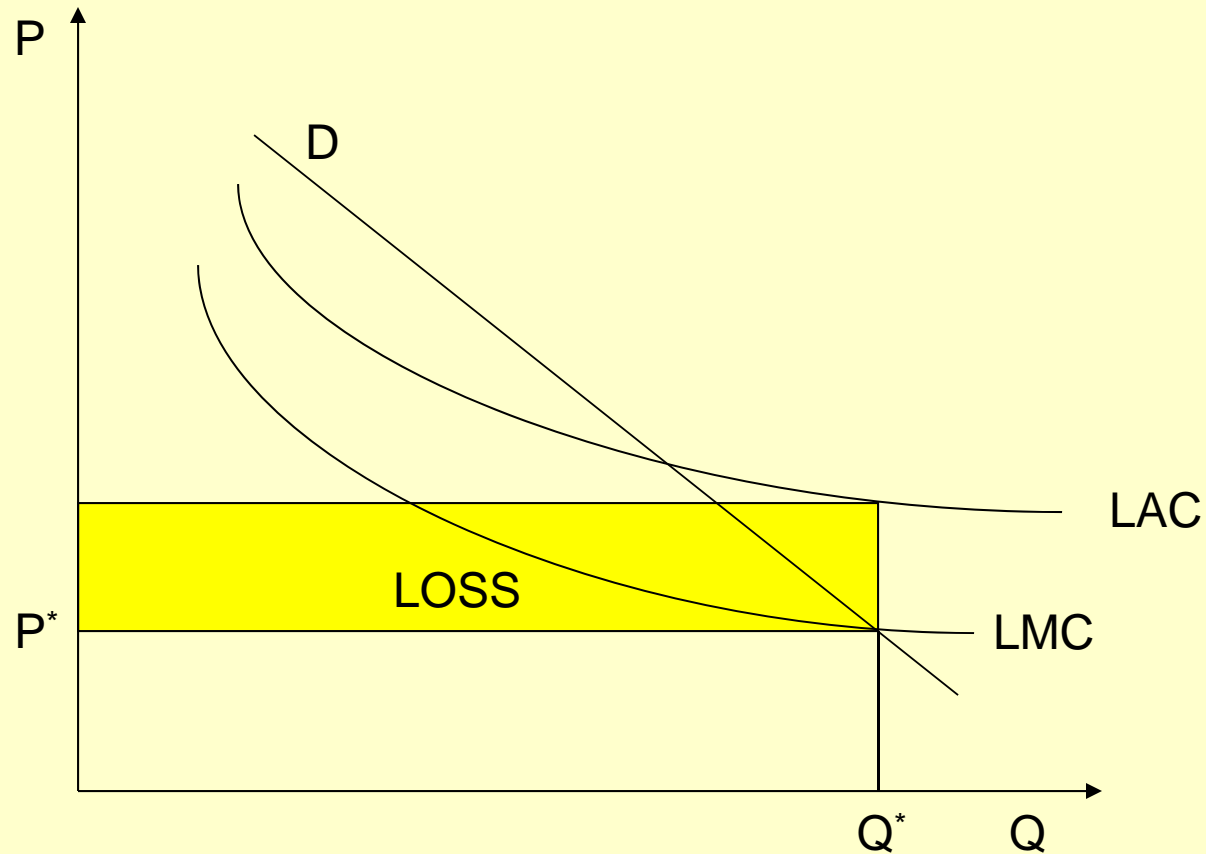


Public Goods – Free Rider Problem

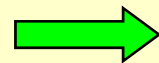


* Markets under-provide public goods  Public Provision

Natural Monopolies



Private sector will not invest



Public investments

Tariff and regulatory measures



Information and Coordination Failures

- Public goods character
- Information asymmetry
 - moral hazard
 - adverse selection
- Self discovery problems
- Coordination failures

Non-Market Failures

- Market failures justify government interventions but governments also fail to deliver optimal outcomes
 - ❖ Inaction
 - ❖ Wrong interventions
 - ❖ Non-optimal interventions

- Demand and supply for public actions
 - ❖ Decided through political process
 - ❖ Decoupling between burdens and benefits
 - ❖ Difficulty in measuring outputs
 - ❖ Single source production
 - ❖ Lack of exit mechanism

Sources of Non-Market Failures - 1

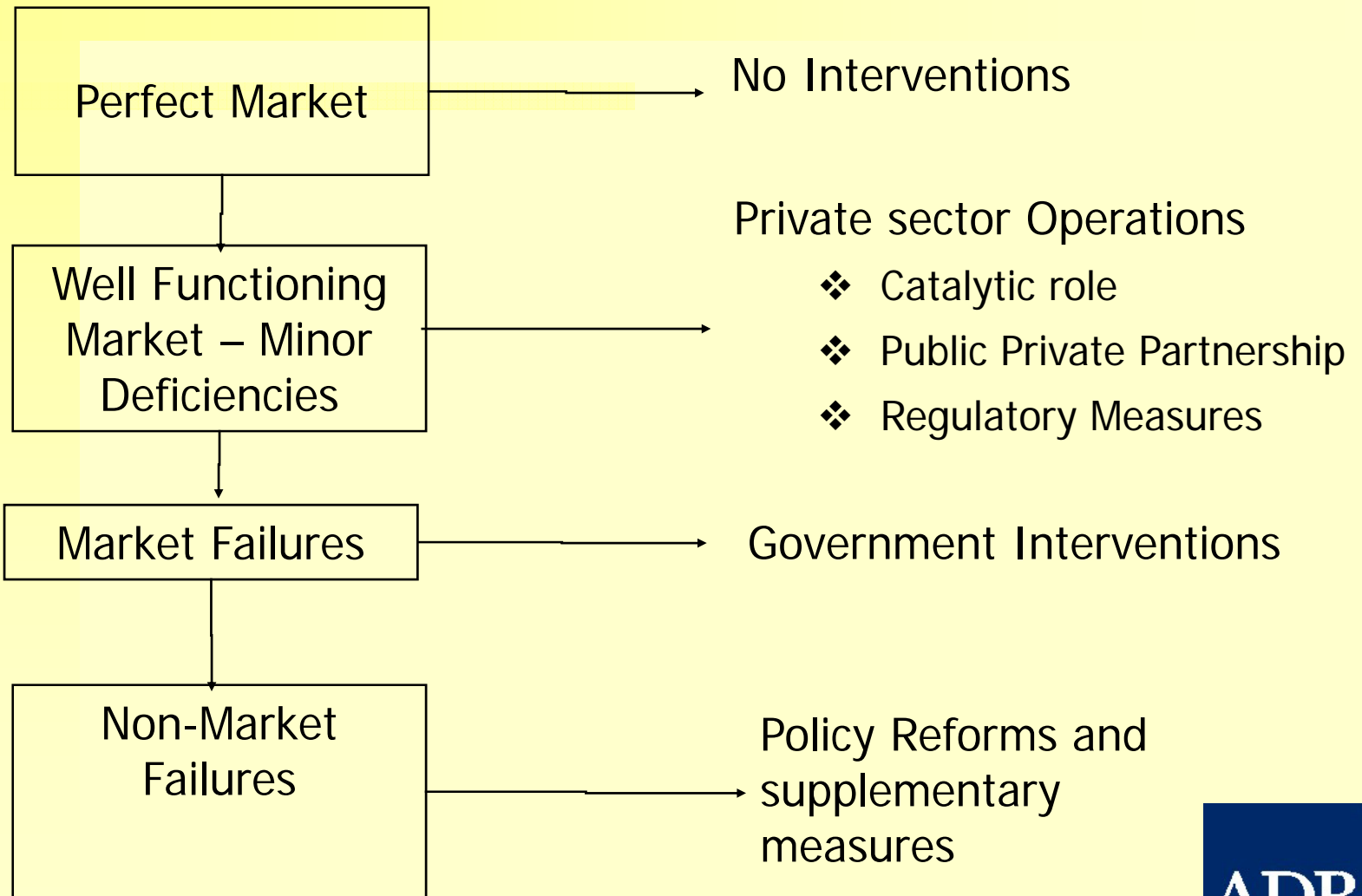
- Redundant and rising costs
- Internalities and organizational goals
 - Budget growth
 - Technological advances
 - Information acquisition
- Derived externalities
- Distributional inequity

Sources of Non-Market Failures – 2

- Failure by structure
- Failure by legitimacy
- Failure by Information
 - ❖ does not encourage foresight
 - ❖ inappropriate for organization's agenda
 - ❖ conflicting policy goals

Summary

Market and non-market failures help identify correct actions



Market Failures

- Externalities – Internalization (regulation, taxes, subsidies)
- Public goods – Public provision
- Property rights – Community management, privatization
- Information failures – Research, public provision, subsidies, competitive bidding
- Coordination failures – Industrial policy, incentives
- Natural Monopolies – Public provision



Non-Market Failures

- Policy reforms
- Regulatory reforms
- Institutional strengthening, capacity building
- Governance, accountability
- Privatization, service contracts, public private partnerships, out-sourcing

Thank you

