

Session 1.3

Economic Rationale of Projects

**Introductory Course on Economic Analysis
of Investment Projects
5-9 July 2010**

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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

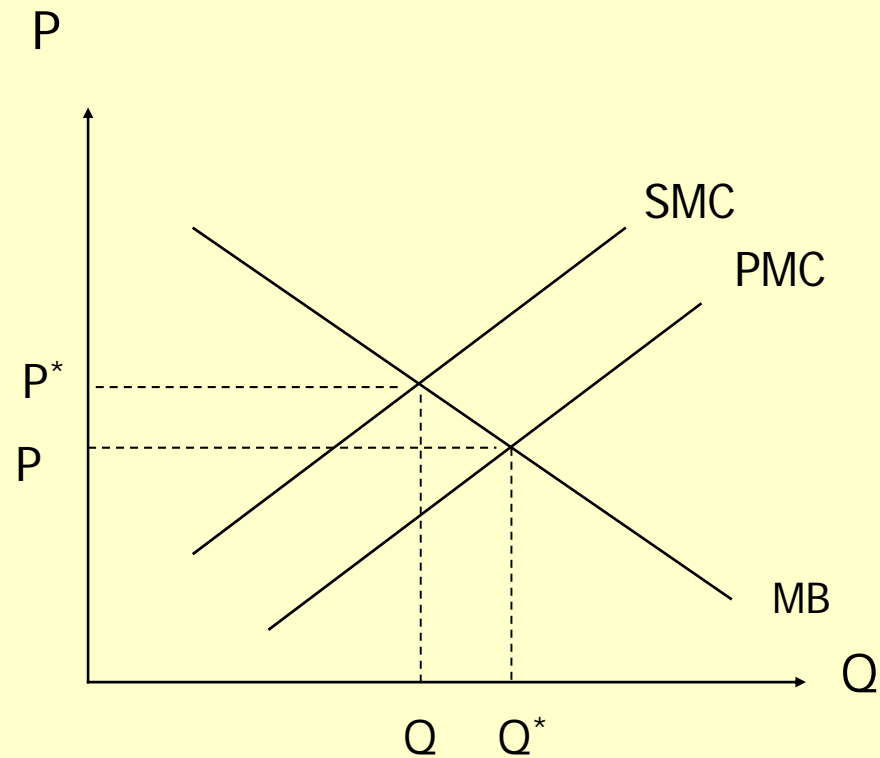
- Externalities
- Public goods
- Imperfect markets
- Information failures
- Coordination failures

Equity Issues: Market does not guarantee equitable distribution

Merit Goods: Intentional government failures



Externalities - Negative



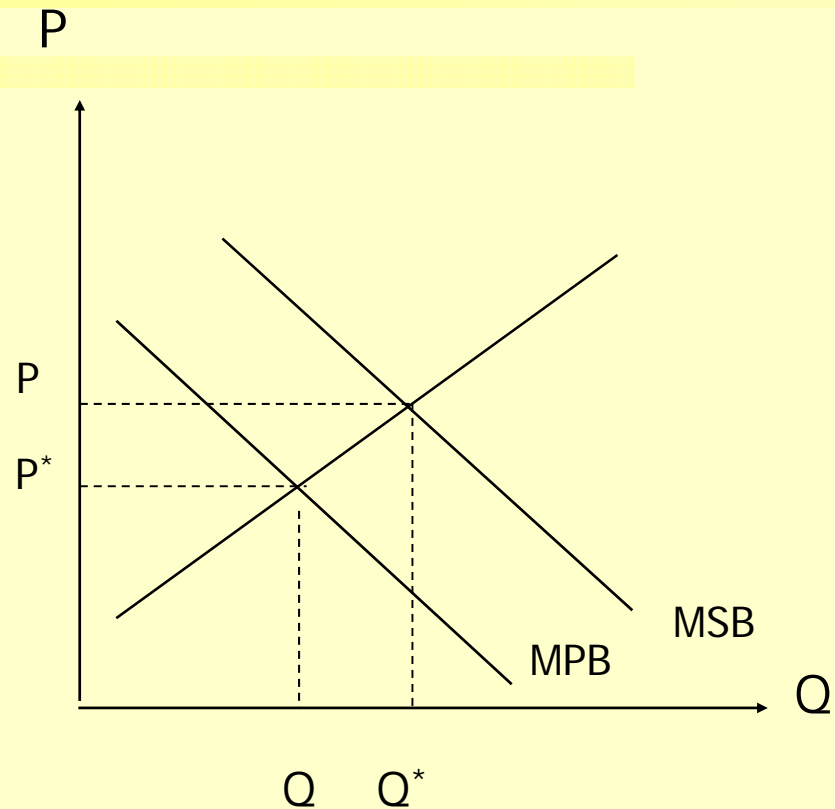
Markets produce more than optimal quantity




Interventions

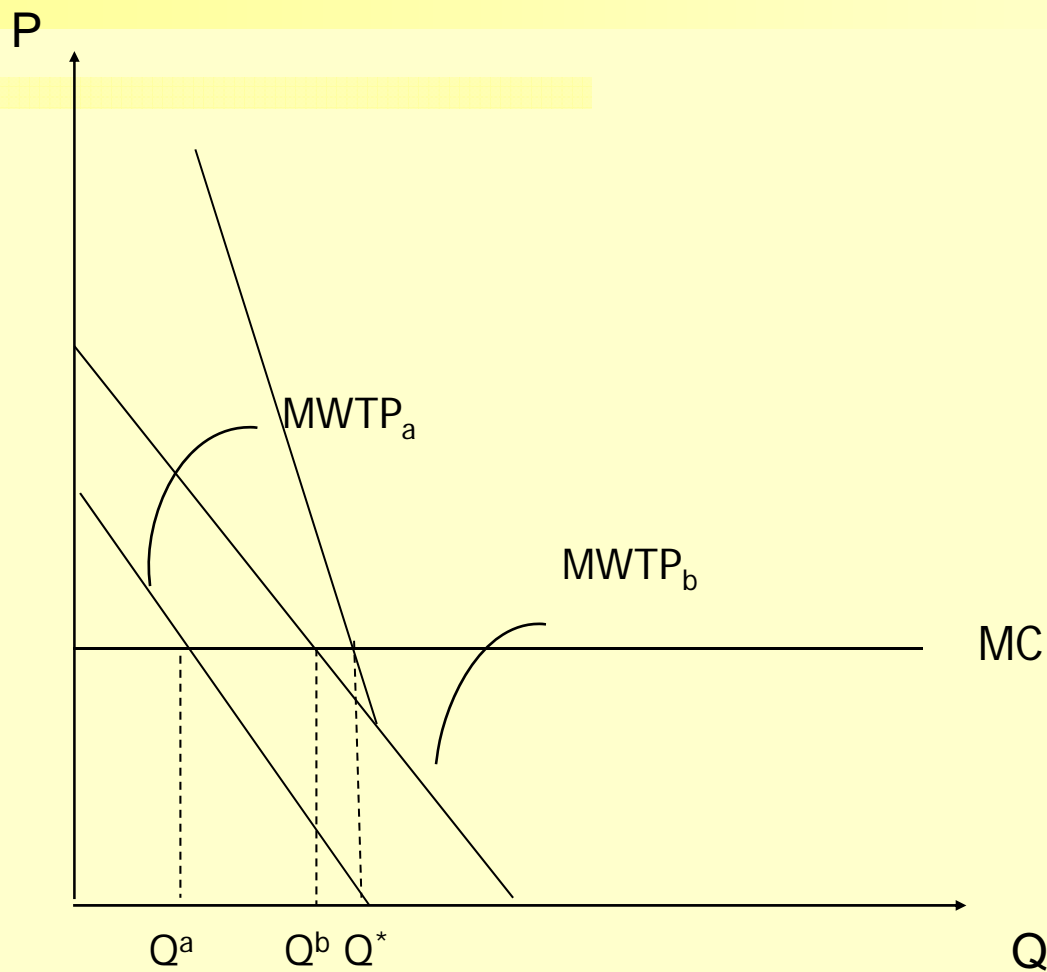


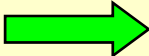
Externalities - Positive



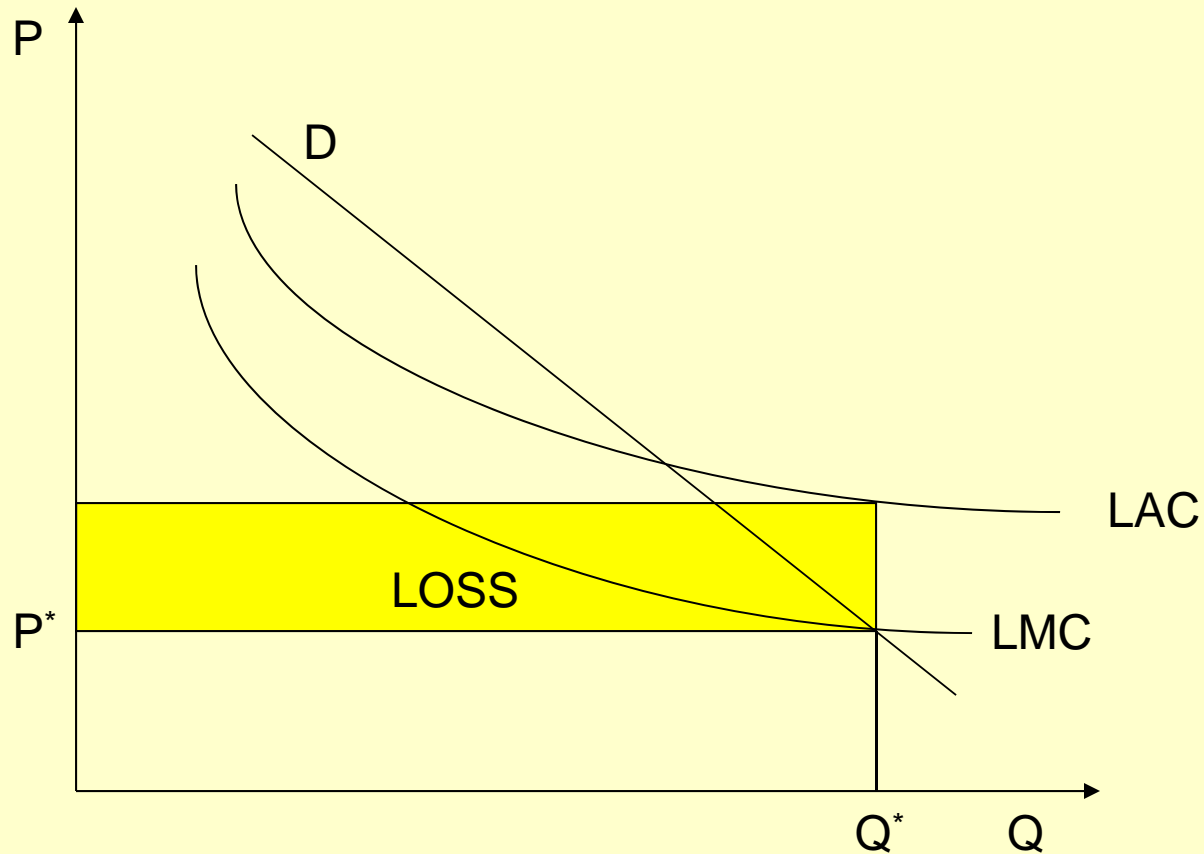
Markets produce less than optimal quantity  Interventions

Public Goods – Free Rider Problem

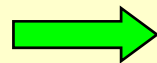


* Markets under-provide public goods  Public Provision

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

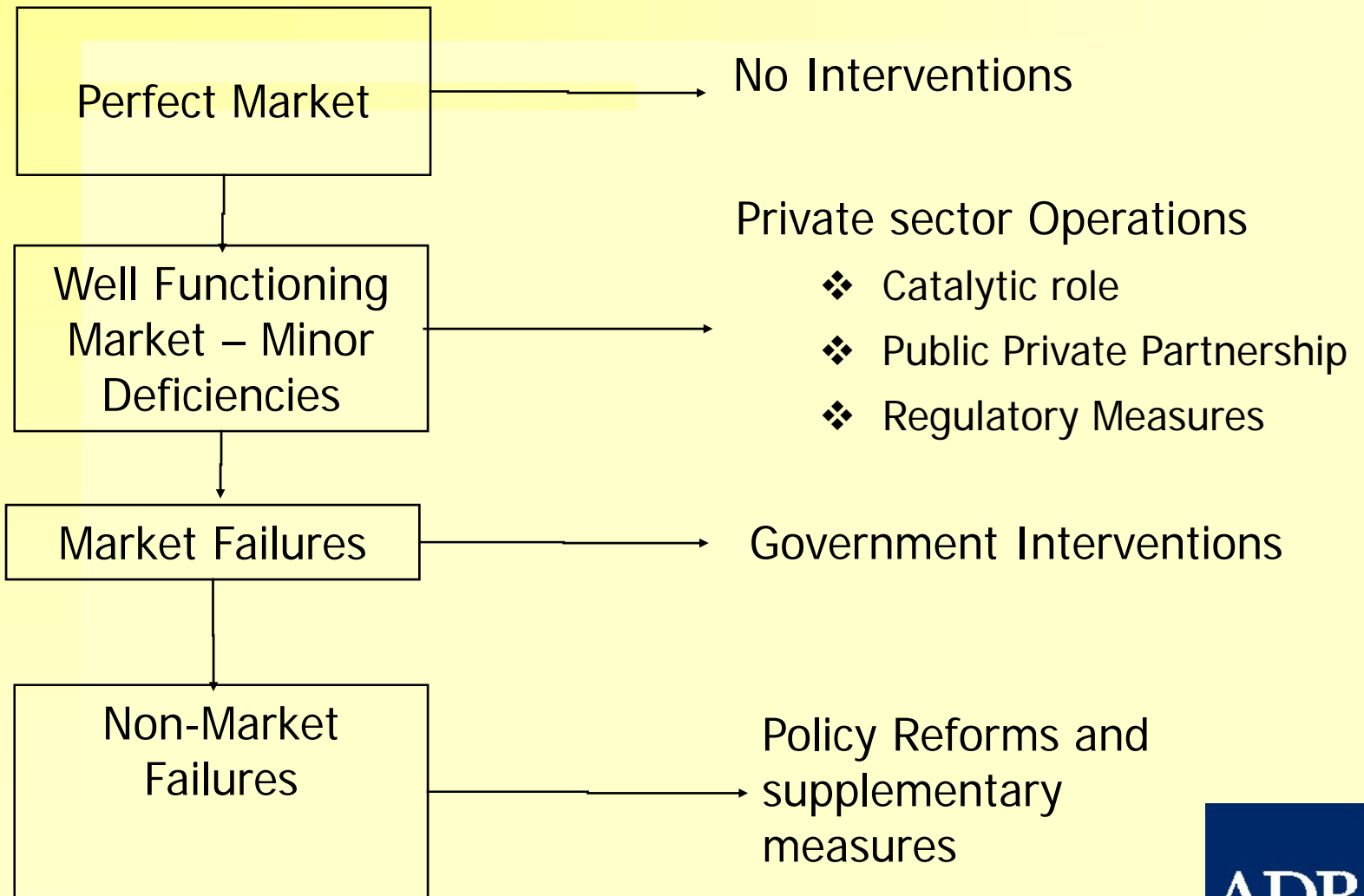
- Redundant and rising costs
- Internalities and organizational goals
 - Budget growth
 - Technological advances
 - Information acquisition
- Derived externalities
- Distributional inequity

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

