**Qn1. Differentiate between public and private sector economy.**

**Definition of Public Sector**

The sector, which is engaged in the activities of providing government goods and services to the general public is Public Sector. The enterprises, agencies, and bodies are fully owned, controlled and run by the Government whether it is central government, statement government or a local government.

**Public Sector Organizations**

There are two types of public sector organizations, i.e. either the Government fully finances them through the revenues they raise by collecting taxes, duties, fees, etc. or the government holds more than 51% of the total share capital of the company which comes under various ministries. The enterprises are established with service motive. It is the largest sector, which works for the upliftment of the people by providing the following services to the people:

* Generation of employment opportunities
* Postal services
* Providing education and health facilities at low cost
* Providing security
* Railway service

**Definition of Private Sector**

The segment of a national economy that is owned, controlled and managed by private individuals or enterprises is known as Private Sector. The private sector companies are divided on the basis of sizes like small & medium enterprises and large enterprises which are either privately or publicly traded organizations. They can be created in two ways, i.e. either by the formation of a new enterprise or by the privatization of any Public Sector Enterprise.

**Private Sector Organizations**

Business entities of the private sector are generally established with the sole objective of making profit and building brand reputation. They provide quality services to the community to win the trust and goodwill from people to survive in the long run and compete with the enemies. These enterprises also have to follow the government law and order. It is the largest sector in terms of employees.

Although in private sector performance is the basic criterion for job stability, i.e. if you perform well you will get promoted and if you won’t, you will be terminated. The major services provided by the Private sector are as under:

* Quality education
* Telecommunication services
* IT services
* Courier Services
* Infrastructure development

**Key Differences between Public Sector and Private Sector**

**The following are the major differences between public sector and private sector:**

1. Public Sector is a part of the country’s economy where the control and maintenance are in the hands of Government. If we talk about Private Sector, it is owned and managed by the private individuals and corporations.
2. The aim of the public sector is to serve people, but private sector enterprises are established with the profit motive.
3. In the public sector, the government has full control over the organizations. Conversely, Private Sector companies enjoy less government interference.
4. The employees of the public sector have the security of the job along with that they are given the benefits of allowances, perquisites, and retirement like gratuity, pension, superannuation fund, etc. which are absent in the case of the private sector.
5. In the private sector working environment is quite competitive which is missing in the public sector because they are not established to meet commercial objectives.
6. In general Public Sector uses Seniority for promoting employees, however, merit cum seniority is also taken as a base for promoting employees. Unlike Private Sector, where performance is everything, and so merit is considered as a parameter to promote them

Conclusion

Nowadays, Private Sector is progressing faster because promotes quality, not quantity; it encourages talent. Public Sector is full of reservations like reservations for minority section, females, a person with a disability and much more, here nobody sees talent, it is completely ignored and because of this, competent youths remain unemployed.

Public sector enterprises give so many facilities to their employees, which makes them satisfied that their job is secured, due to which, all the people are running after it like it is a marathon. However in the Private Sector, your job is never secured, even if you give years to it, you can be fired anytime just because of a single mistake.

Again in the private sector, where performance is king, the workload is much, but it keeps you active, this is missing in the public sector due to which the work sometimes becomes monotonous which creates boredom. One thing is really good in Private Sector i.e. it is corruption free. In Public Sector, you have to pay lots of money to the government officers even for a simple work, for no reason. It is an unending debate, both are good at their places, if the drawbacks are removed, they will surely prove good for the economy.

**(b). discuss the role of public sector in modern economies**.

forces of demand and supply control prices in modern capitalist economies, government intervention has been limited to provision of social services. Prices of goods and services as well as cost of production are determined with minimal government intervention. A perfect capitalist economy can only exist in an ideal situation and since there is no ideal situation, there are always some government controls, rules and regulations in an economy (Pigou, 2006). In general, government controls the performance of an economy through fiscal and monetary policies. These policies are aimed at changing or controlling certain factors in the economy to enhance or limit production. Government participation varies among countries were developing countries need a higher involvement than developed countries (Ceccacci, Marchesiani and Pecchi, 2007) This paper discusses the role of the public sector in modern economies and factors public sector consider when making financial decision.

**Political stability**

The government is made up of political class, who control the economies of a country, they play the role of politicians and economic drivers, and however, political situation in the world is not stable. There have been changes and uncertainty in different countries. A country like Kenya in East Africa underwent tribal crashes in 2007 after a disputed election. The crisis affected the economy of the country. In November 2010, Ivory Coast in Central Africa had disputed election a move that have affected the country's economic performance. In civilized countries like the United States of America, which is the world's largest economy, the performance of the ruling class affects the economy positively and negatively. A country as China, which has the highest economic growth in the world, has a stable government (Dalton, 2003) from the above discussion, it is clear that one major functions of government is to ensure there is political stability in the country. If the political class maintains political harmony in an economy then growth and stability in the country is possible. One of the most surprising thing is that to destroy an economy that had been built for many years can take a matter of weeks in case of political unrests. For example, Zimbabwe was among Africans best performing countries, when there were disputed presidential economies in 2009; the country is now ranked as the poorest in the world. Other than local politics, international politics affects country economic, social and political performances. International policies and relations affect how economies conduct their business. There are times that goods from a certain countries have been limited to enter in the international market through tariff and non-tariff barriers (Buchanan, 1987).

**Maintaining good International relations**

Foreign ministry in different countries is given the responsibility of maintaining good international relations with different countries. Globalisation and international trade has opened the international market, assisted by transport and communication networks (Quigley, 2000). To ensure that a country participates in international trade effectively and reduce chances of international rivalry, it should ensure that there are good international relations. Switzerland has managed to be the world largest tourism country because of its political neutrality and maintaining of good relations with other countries. Sometime to be competitive, countries engage in economical alliances to be able to negotiate for better teams in the world markets. Such integration includes European Union, East African Community, and Pan African among others (Dietmar, 2000). Other than having a good international relations, it is the role of the government to ensure that its country have a good reputation. It should not be known for negative things like poverty, corruption and inequality. Such reputations are not built by word of mouth by through actions undertaken by the government.

**Protection of citizens**

The government has the mandate of ensuring that the constitutional rights of every human being are respected. These rights include rights to protection, where the government provides security to its citizens. Security is from foreign and internal attackers. There are times that the government sets minimum or maximum prices of goods to ensure that consumers are not exploited. On the other hand, the government also sets standards required in a country; this is in the move to ensure that it has protected its consumers against substandard goods and services provided by businesspersons. There was another move made by Chinese government, which has been seen as a new government move where the government aims at reducing the rate of economic growth in the country (Edward, McCaffery and Joel, 2006).

**Infrastructures**

The government has the mandate of providing infrastructures like roads and communication networks, which cannot be left in the hands of individuals. These infrastructures ensure that an economy has social resources that can be used by society members without paying for them directly. In time of disaster, the public sector is called upon to assist. This is in case of terror attacks, drought and floods. The government should have adequate machinery and mechanisms to ensure that in case of a disaster, it has assisted its own citizens and sometimes extend the help to other nations. Other social economic factors affect an economy. They include inflation and deflation. The government has the mandate of ensuring that its economy has neither excess funds (inflation) or has limited funds (deflation) (Gabriele, 2009).

**Leadership and strategic decision-making**

The government is expected to make strategic decisions, which define the pathway that the country aims to follow over a certain period. This can be yearly or take a couple of years. Every year, governments make financial budgets to be followed when financing various projects in the country. These budgets contain yearly, monthly or projects that take more than one year. Such policies are the ones, which attract international investments in a country. In the 1990's, many countries had Vision 2000, which they wanted to have attained certain economic, social and political goals. In the current 20th century, there are calls to Vision 2020, Vision 2015 and visi0n 2030 among others depending with a country and the goals it has for the economy (Wildasin, 2008)

**Issues a government need to take into account when financing the activities adopted to fulfil the role set out in (a) above**

The government control an economy using fiscal or monetary policies. They can be either direct or indirect. The kind of financing adopted, depends with the goal and objective the government want to attain in a particular time. To control the economy effectively, consideration must be made to ensure that the most appropriate measure is taken (Reed and Swain, 1997). Generally, there are factors that government need to consider when financing different projects in the economy they are:

**The level of economic development in the country or locations**

The government has the role of setting up infrastructures to be used by the public and private sectors in their efforts to grow the economy. Before certain infrastructures are made, the government need to analyse the project and ensure that it is economically viable. Priority should be given to those places that have potential yet the exploitation of such potential is hindered by lack of infrastructures like roads and communication networks. Investments in infrastructures is an expensive exercise where the government spend public resources to make such infrastructures, they should thus benefit the greatest majority in the country. In developing economies, the government has a more active role where it is expected to make a platform that international and national inventors can built on. Such infrastructures include electricity production plants, transport networks, taxation incentive and communication networks. Some countries like China have had the government cut down its public finance expenditure to ensure that the economic growth rate in the country slows down. It has opted to have higher taxation to companies and individuals to ensure that they have low income to spend in economic development (Schulte, 2000).

**Countries competitive advantage sectors**

Different countries have different economic potentials; the kind of products that can be produced effectively by a nation varies among different nations. There is need to understand the potential that a country has and investments should be skewed to that direction. For example is a country has a potential in natural resources like oil reserves or good climate, then the government should direct most of its finances to these sectors. This will ensure that high levels of efficiency have been attained for economic development. Absolute and competitive advantages are important when deciding the countries to make economic integrations. There are times that countries produce the same commodities, in such cases such countries can make good economic blocs to negotiate for better prices for their products. They though cannot make good trading partners since they make more the same products (Schumpeter , 1994).

**The rate of inflation/deflation**

The rate of inflation in country affects expenditure decision by the government. When an economy is facing high rate of inflation, then the government has the mandate of controlling the economy. Controlling inflation and deflation are monetary issues where the government devises measures to reduce money in circulation (in the case of inflation) or increase money in circulation (in the case of deflation). In inflation, the government can decide to sell government securities like bond and bills at an attractive interest rate where investors will be attracted to buy them and the money in circulation is reduced. On the other hand, it might decide to increase the lending rate to banks through central bank, which will be transmitted, to consumers making the cost of lending money expensive. This reduces the rate of money attractiveness thus, the growth of money in the economy reduces (Sheila, 2004).

In the case of deflation, the government devises measures to increase the flow of cash in the economy. If the government decides to reduce central bank's lending rate, then banks will be more willing to lend money. This increases the money in circulation curing the deflation (Tresch, 2002).

**Living standards**

Different countries have different living standards. It is the dream of leaders to have citizens who have high living standards. To attain this need, the government takes deliberate measures to increase the living standards of its people. Such measures include wide investment in social facilities like public hospitals, building of roads, communication networks and education facilities. There are countries, which have opted to offer free medical and educational facilities to their citizens in the move to have increased living standards. Countries with high living standards do not require much invention of the government in their affairs but those that are underdeveloped and have reduced living standards the government intervention is highly required (Shinnick, 2008).

Some government have national libraries, some even mobile ones to ensure that its population has access to information for personal empowerment. Adoption of technology in different sectors has enabled a countries population have higher living standards as people are more informed of their rights that they can fight for (Shoup, 2006)

**Resources distribution**

Resources in a country are not equally distributed; there are some parts, which have higher allocation of natural and manmade resources in a country. The in-equally bring about difference in social, economic and sometimes political. The government should ensure that its country have well distributed resources for a harmonious growth in all regions of the country. The differences make the government direct most of its resources to areas that are disadvantaged (Musgrave, 2008). They are given priorities in the efforts to see whether they can catch up with other areas. A country that has high levels of inequality is most likely to be in political disputes from time to time. This is when some people feel oppressed by the system. In the past, social rivalry in countries for example in French revolution, were brought about by inequality and oppression in the economy. To avoid a repeat of such things in an economy, the government should ensure there is equality in the economy. Equality can be brought through indirect measures like education, social amenities, and employment (Moore, 2009).

**Unemployment level**

Government has a role in creating employment in its country. If the economy is facing high levels of inflation, then the government must put on measures to ensure that the economy produces job opportunities. For an increased employment creation in country, the government should create an atmosphere where local and international investors feel attracted (Minea and Villieu, 2009). Such measures include reduce taxation, offer incentives to investors like tax holidays , investments deductions and offering land for factory settlements. Other than focusing on international and local major investors, the government can undertake different measures to facilitate small-scale investments through small traders and artisan. Finances can be directed to the areas where the government offer loans to deserving population to starts up their own business . Other than business, there are other individual talents that can be tapped and still create employment. This includes sporting activities and entertainment industry where the government can support youth to engage in such activities (McGee, 2004).

**Security situation**

It is the role of the government to ensure that its citizens are protected from internal and external security threats. The state of security in a country will determine the amount of investment that will be directed to this task. There are times that a country may be threatened of an attack, or the security system in the country is not good. In such cases, the budget for security should be increased appropriately. Different times require different security levels, for example, in times of political unrests, high security is required than in times of harmony in a country, so the amount of investment that a country makes in investment is determined by security level in the country (Martin, 2005).

**Global environment**

The international community affects the trend of spending in a government. There are times that international relation and trade may require a government to spend higher than in normal circumstances. Currently with globalisation, the world is facing an increased trade among countries. The trade calls for improved infrastructures, communication systems and security along borders. Although these factors benefit an economy, they require the government to make investments in the economy. To facilitate international trade, the government need to invest in good roads to transport goods produced within the country to the departure ports and those coming from abroad to their destinations (Kabelo, Khalo and Mafunisa, 2007). Communication is crucial in making trading negotiations and contracts where the government should lay good communication systems. International trade does not just happen without government intervention, there is need to control the flow of goods. Through customs department, the government imposes custom duties and tariffs to some imports and exports in its move to collect revenue and protect internal industries. Through borders, some goods that are harmful to a population can get their way; it is the role of the government to ensure that borders are free from such goods. For border security, revenue collection and national companies protection to be effective, the government has to make massive investment in detecting tools like scanners, personnel's to patrol the borders and revenue collection officers. Making of ports is capital intensive and thus before such an investment is made the government should ensure that it has analysed the economic benefit of such a move. For example, the decision to make Suez Canal was for trading purposes, it has assisted North African countries like Egypt, however, maintaining high standards in such an entry is an expensive practice (J&uuml;rgen and Wagner, 2004)

**Technology**

Scientific innovation and inventions have resulted to an increase in technology in the world. Efficient technology assists a county to produce goods and services effectively with maximum utilisation of resources. The government has a role to play in technological development and adoption in the economy. This can be through its own adoption of technology in its systems or it can be creating an environment that enables companies to adopt technology. There are times that the government controls the rate of technological adoption in its economy. For example in Kenya, the government is opposing the use of tea plucking machines by tea growing factories since it believes that the number of jobs that will be lost as a result are going to harm the economy. To enhance adoption of technology, the government have sometimes offered incentives to those companies with high technology like tax incentives to facilitate further technology use (Hyman, 2007)

**Environmental concerns**

The world is having increased concerns about environmental damage. International bodies have enacted rules and regulations to be followed in its efforts to reduce environmental damage. Such international regulations include Kyoto protocol on green gas emission where signatories were expected to reduce their production of green house gasses (Howard, 1992). To facilitate moves that protect the environment, the government is involved in different activities that aim at corporate and to individuals. It has put on measure that reduces the amount of emission from industry. Such measures include taxation on carbon emission, having national environmental control policies and programs, offering tax incentive and facilitating technology adoption (Bradford, Auerbach and Shaviro, 2000).

**The rate of investments in a country**

The investment environment in countries determines the rate of investment in a country. When the environments are not attracting investments, then the government has to undertake strategic measures to ensure that it has facilitated investments. This can be through targeting certain industries, which are crucial for investment decisions in a country, and enhancing their capabilities in attracting investments (Gstoettner and Jensen, 2010). For example, the energy sector is important for economic development and attracting investment. The government can control prices in such an industry and cover the deficit. This will make investors attracted by the low rate of production cost offered by such moves. In countries like China, the government have used this consideration to devise measure that reduces the rate of investment. There are times that the government becomes the investor in come strategic industries, which are considered low income generating. This is in the move to ensure that all essential products and services are available in a country (Blanca and Wodon, 2006)

**Economic deficits and Balances of payments**

There are times that a country may be facing economic and balance of payments deficits. The deficits harm an economy, the government requires to take strategic decisions to ensure these deficits are cured. In cases of economic deficits, it means that a government will not be able to finance all budget activities in a particular year or periods. It may be forces to offer some government bonds and bills, which are offered at a cost to the public. It may also decide to sell its products to raise money to finance its deficit. The right move to make in such case is determines the decision made by the government (Bastable, 2003)

International trade brings about balances of payments (B.O.P.). For a healthy economy without a deficit in balance of payment, then imports should be of a lower cost than exports. To facilitate an increase export, or reduce importation, the government have a role to play. In facilitation of exports, the government offers incentives to exporters to increase their exportation. These incentives may be subsidies in production. To discourage importation, the government can increase taxes charged to imports and empower local companies to produce goods that were otherwise imported. When a country has a healthy balance of payment, its currency is strong making its goods and services competitive in the international markets (Arye, 2003)

**Conclusion**

Modern economies are mostly capitalists, where forces of demand and supply determine prices. Government intervention in these economies is minimal but important. Government intervenes in economies to facilitate an appropriate economic growth rate and protect citizens from violation of their constitutional rights. It uses monetary and fiscal policies to control the economy. Before making an investment decision, government consider economic, political, social, global and environmental implication of such decision. Maintain political stability in a county is an important role of the government. The right decision to make is one that results to increased welfare of majority in the country.

**Qn2. (a) discuss the type of budgets in public administration.**

The public budgets are different from other forms of budgets in many ways; here the voters delegate the power of spending their money to the politicians or the elected representatives. Now having understood the concept of budget in the last article, let us understand the different kinds of budget that are there in the public financial management:

**Balanced Budget:** As suggested by the name a balanced budget is that which has no deficit or surplus. The revenues coming are equal to the expenditures.

**Revenue Budget:** It is just the details of the revenue received by the government through taxes and other sources and the expenditure that is met through it.

**Performance Budget:** This type of budget is mostly used by the organizations and ministries involved in the developmental activities. This process of budgeting, takes into account the end result or the performance of the developmental program thus insuring cost effective and efficient planning. With the increasing developmental challenges and awareness regarding the usage of tax payer’s money, new methods of budgeting are required of which the performance based budgeting has emerged as a transparent and accountable method.

It relies on three aspects of understanding of the final outcome, the strategies formulated to reach those final outcomes and the specific activities that were carried out to achieve those outcomes. With a very detailed and objective analysis, this budgeting process is very result oriented in its approach.

**Zero based budget:** Zero based budgeting has its clear advantage when the limited resources are to be allotted carefully and objectively. It is quite flexible in nature and relies on rational methods, systematic evaluation to reallocate resources and justify the usage of funds. It starts from a zero base unlike traditional budgets where incremental approach is used. Here, the needs and costs of every function of the organization are taken into consideration for the next year’s budget. So the budget is futuristic and may or may not be equal or more from the last year’s budget as traditionally calculated.

The budgets in the parliamentary kind of system similar to what exists in a country like India become a tool of political negotiations where the budgeting powers are delegated to the Finance Minister of the country.

In a single party government, the entire party shares the same views regarding the spending of the resources however; the disagreement arises when individual members may differ on the cost of the distributive policies and would want the government funds to be diverted to their respective electoral constituencies.

In a coalition government, the differing opinions are tackled through compromise and contracts approach where the coalition parties keeps the check on the budget process ensuring that it lies within the boundaries of the agreed contract. The infamous fallout between the ruling UPA and the Trinamool Congress over the Railway Budget last year is worth citing in reference to the current discussion.

In the presidential kind of system too, the executive plays a somewhat similar process. A significant change that happened in US regarding the budget process was the Budget Enforcement Act passed in 1990s under the Bush administration, which protected the budgetary parameters against later modifications once cleared in the budget summit between the president and the legislature.

The budget process in different systems of government may vary but they are all aligned to achieve the relevant economic and social goals of that country. With increasing globalization and interdependent economies, several external considerations also come into play when the budgets are designed. We shall learn about the budget process in the next section.

**(b). give examples and characteristics of pure public goods.**

**Definition of Public Good**

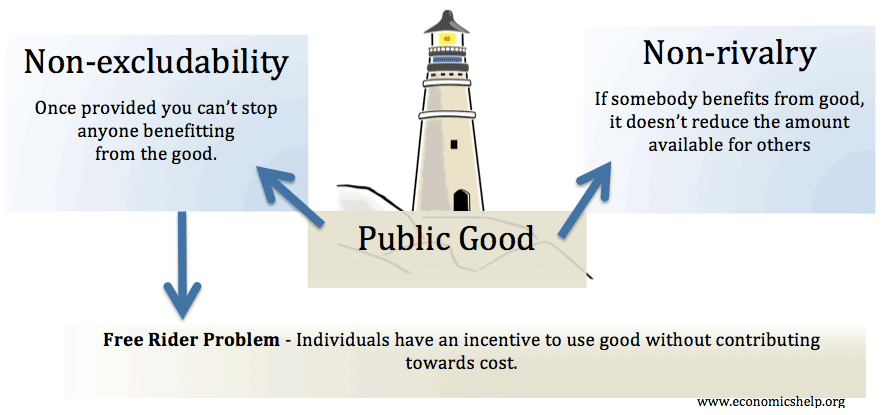
**A public good has two characteristics:**

1. Non-rivalry: This means that when a good is consumed, it doesn’t reduce the amount available for others.

– E.g. benefiting from a street light doesn’t reduce the light available for others but eating an apple would.

1. Non-excludability: This occurs when it is not possible to provide a good without it being possible for others to enjoy. For example, if you erect a dam to stop flooding – you protect everyone in the area (whether they contributed to flooding defences or not.

A public good is often (though not always) under-provided in a free market because its characteristics of non-rivalry and non-excludability mean there is an incentive not to pay. In a free market, firms may not provide the good as they have difficulty charging people for their use.



**Free rider problem**

The problem with public goods is that they have a free rider problem. This means that it is not possible to prevent anyone from enjoying a good, once it has been provided. Therefore there is no incentive for people to pay for the good because they can consume it without paying for it.

However, this will lead to there being no good being provided.

Therefore there will be social inefficiency.

Therefore there will be a need for the govt to provide it directly out of general taxation.

**Examples of Public Goods**

Both a public bridge and street lighting exhibit characteristics of a public good.

**National defence.** If you protect the country from invasion, it benefits everyone in the country.

**Street lighting.** If you provide light at night, you can’t stop anyone consuming the good. Walking under a street light doesn’t reduce the amount of light for others.

**Police service.** If you provide law and order, everyone in the community will benefit from improved security and reduced crime.

**Flood defences** – Protecting the coastline against flooding provides benefits for the whole community.

**Quasi-Public Goods**

These are goods which have an element of non-excludability and non-rivalry. Roads are a good example. Once provided most people can use them, for example, those who have a driving licence. However, when you use a road, the amount others can benefit is reduced to some extent, because there will be increased congestion.

**Market provision of public goods**

Although classical economic theory suggests public goods will not be provided by a free market, there are cases when groups of individuals can come together to voluntarily provide public goods.

Behavioral economics suggests that individuals can have motivations other than just money.

People may volunteer to contribute to local flood defences out of a sense of civic pride, peer pressure or genuine altruism. Therefore, in the real world, enough people may contribute to paying for a public good, even if – from a narrow self-interest point of view – it may be rational to avoid paying.

**Examples of market provision of public goods include:**

Local communities providing private policing

Local communities raising money to pay for a local school, new garden or new statue.

**Difference between public spending and public goods**

One possible area of confusion. We talk about public spending. This is spending done by the government. E.g. UK public spending

However, not all government (public) spending is on ‘public goods’, e.g. government will also spend on other goods and services, .e.g. – merit goods, like education and healthcare.

**Qn.3 (a) define the term market failure and its causes.**

**Definition of Market Failure** This occurs when there is an inefficient allocation of resources in a free market. Market failure can occur due to a variety of reasons, such as monopoly (higher prices and less output), negative externalities (over-consumed) and public goods (usually not provided in a free market)

Types of market failure:

1. [Positive externalities](https://www.economicshelp.org/micro-economic-essays/marketfailure/positive-externality/) – Goods/services which give benefit to a third party, e.g. less congestion from cycling
2. [Negative externalities](https://www.economicshelp.org/micro-economic-essays/marketfailure/negative-externality/) – Goods/services which impose cost on a third party, e.g. cancer from passive smoking
3. [Merit goods](https://www.economicshelp.org/micro-economic-essays/marketfailure/merit-demerit-goods/) – People underestimate the benefit of good, e.g. education
4. [Demerit goods](https://www.economicshelp.org/blog/glossary/demerit-goods/) – People underestimate the costs of good, e.g. smoking
5. [Public Goods](https://www.economicshelp.org/micro-economic-essays/marketfailure/public-goods/) – Goods which are non-rival and non-excludable – e.g. police, national defence.
6. [Monopoly Power](https://www.economicshelp.org/microessays/markets/monopoly/) – when a firm controls the market and can set higher prices.
7. [Inequality](https://www.economicshelp.org/blog/310/economics/rising-inequality-in-the-uk/) [– unfair distribution of resources in free market](https://www.economicshelp.org/blog/glossary/factor-immobility/)
8. [Factor Immobility](https://www.economicshelp.org/blog/glossary/factor-immobility/) – E.g. geographical / occupational immobility
9. [Agriculture](https://www.economicshelp.org/blog/4977/economics/problems-of-agriculture-market-failure/) – Agriculture is often subject to market failure – due to volatile prices and externalities.
10. [Information failure](https://www.economicshelp.org/blog/glossary/information-failure/) – where there is a lack of information to make an informed choice.
11. [Principal-agent problem](https://www.economicshelp.org/blog/26604/economics/principal-agent-problem/) – Two agents with different objectives and information asymmetries

Key Terms in Market Failure

* Externalities:  These occur when a third party is affected by the decisions and actions of others.
* Social benefit:  the total benefit to society =  
  Private Marginal Benefit (PMB) + External Marginal  Benefit (XMB)
* Social Cost: is the total cost to society =  
  Private Marginal Cost (PMC) + External Marginal Cost (XMC
* Social Efficiency: This occurs when resources are utilised in the most efficient way. This will occur at an output where social marginal cost (SMC) = Social Marginal Benefit. (SMB)

Overcoming Market Failure

* [Tax on Negative Externalities](https://www.economicshelp.org/micro-economic-essays/marketfailure/tax-negative-externality/) – e.g. Petrol tax
* [Carbon Tax](https://www.economicshelp.org/blog/2207/economics/carbon-tax-pros-and-cons/) e.g. tax on CO2 emissions
* [Subsidy on positive externalities](https://www.economicshelp.org/micro-economic-essays/marketfailure/subsidy-positive-ext/) – why government may subsidies public transport
* [Laws and Regulations](https://www.economicshelp.org/micro-economic-essays/marketfailure/laws-regulations/) – Simple and effective ways to regulate demerit goods, like a ban on smoking advertising.
* [Buffer stocks](https://www.economicshelp.org/blog/glossary/buffer-stocks/) – aim to stabilize prices
* [Government failure](https://www.economicshelp.org/microessays/market-failure/government-failure/) – why government intervention may not always improve the situation

Market failure and behavioral economics

Behavioral economics examines how individuals often act in a non-rational manner – contrary to the expectation of conventional economic models. These types of ‘irrational behaviour’ can lead to a type of market failure where people make poor choices. For example.

* [Irrational exuberance](https://www.economicshelp.org/blog/404/economics/economics-of-irrational-exuberance/) – people getting carried away by good news leading to boom and bust.

**How can the government avoid public sector failure?**

Firstly, it makes a change to consider a question like this. Usually, the question is – Why is the government inefficient? Why do we get government failure? Should we privatise public services? But, here we can examine whether the tendency to government failure can be overcome.

**Public sector failure/government failure**

Occurs when government intervention in the economy leads to an inefficient allocation of resources and leads to an overall decline in economic welfare. Government failure can occur for various reasons, such as.

* Lack of profit incentive in the public sector. People working for the government may not have the same profit motive to cut costs / work hard/ increase efficiency. Therefore, this causes the government sector to be inefficient compared to the private sector.
* Greater bureaucracy in public sector.
* The conflict between political and economic objectives.

**How can the government avoid public sector failure?**

1**. Introduce profit incentives/performance targets into the government sector.**

There is no reason why those working in the public sector can’t be given performance targets. For example, schools can be given targets to achieve minimum exam standards and climb up the league tables of exam performance. People working in the public sector can be paid piecemeal – rather than per hour. For example, rather than pay refuse collectors £8.00 an hour. They could be paid £64 a day to do a job estimated to take 8 hours. This gives them an incentive to work faster and not dawdle on the job.

* Evaluation. It can be difficult to introduce the profit motive into many areas of the public sector. For example, education and healthcare do not lend themselves so well to performance targets and profit motives. Schools which target better exam results may do so at the cost of excluding less intelligent pupils. They may sacrifice other aspects of an all-rounded education to get better exam results. Managers in a hospital may be able to cut costs, but the consequence may be to put greater pressure on nurses and doctors – it may compromise the standards of health care.

The problem is that the government tends to get involved in public services which are either not provided by the free market or are under-provided (e.g. merit goods and public goods). The problem of these public services is that they are not natural profit oriented industries.

2. **Competition**

One thing the Conservative government did in the 1980s was to introduce competitive tendering for many public services. This meant local councils lost their monopoly provision of public services, such as school meals and refuse collection. Council services could still bid to run refuse collection. But, if a private company offered a better service, then they would lose out to the private sector. The argument is that the threat of competition creates incentives for the public sector to act like a private company and cut costs.

* Evaluation**.** The problem with competitive tendering is that the cheapest service may not be the best. A private company may offer to provide school meals for a cheap cost but at the expense of reducing the quality of food. Therefore, you reduce costs, but you have a decline in standards. A government body then needs to be responsible for checking standards of service.

Many public services are natural monopolies, therefore, competition is hard to introduce. If you get the right to run a refuse collection for five years, a private company effectively has a private monopoly for five years.

In the 1980s, public bus companies lost their legal monopoly and competition was introduced, with private companies such as Stagecoach entering the market. However, this means that there is often an overlap and duplication of bus services, leading to increased congestion. Also, with private companies, fare increases lead to higher profit for private companies, rather than benefiting the local council.

3**. Public-private partnerships**

Another policy is to try and encourage public-private partnerships. This means that for a project, the government try to involve the private sector. The private sector pays part of the cost and brings expertise and the incentives of the private sector into the project.

The downside is that private companies tend to cherry-pick projects. They benefit from government investment, but they get the profit rather than the government.

4. **Rely on good-will**

Some public services are sectors of the economy where the usual profit motivate is not all dominant. For example, most doctors, nurses and healthcare workers choose their profession – not to maximize earnings but to gain satisfaction from serving patients. What healthcare professionals need is not performance related pay, but working conditions conducive to good morale. If staff are overworked or have too much paperwork – this can lead to poor morale. Reducing bureaucracy and creating a well-funded health care system is a powerful way to get the most from government funds. It is a similar situation in education, with many teachers over-worked from filling in forms.

**What are the main causes of market failure?**

Markets may fail to create the best possible results for several reasons:

1**. Imperfect competition**

If there is only one seller of a good, prices will be higher than in a well functioning marked with many buyers and sellers.

2. **External effects**

External effects imply that not all consequences are accounted for in the price. For instance, if a firm does not have to pay the true cost of production, the good will be too cheap compared to its true cost. Example: Producing things which cause pollution which you do not have to pay for. In this case too much of the good will be produced in the market.

3**. Imperfect information**

Some markets may fail because the buyer or the seller have more information than the other, which may cause markets to fail or function inefficiently. For instance, dentists know more than you and may tell you than you need more than you truly need in order to drive up demand.

4. **Public goods**

Markets will tend to fail for goods which are difficult or impossible to prevent other people from consuming once it is produced. People who do not pay for defence and lighthouses can still enjoy those goods if they are made available. In this case it may not be profitable for private companies to provide it, since nobody will pay for it.

These were four reasons, but it is important to note three things. First, some of these problems can partly be solved by the market itself. For instance, we can have agents which provide information about dentists.

Second, even if there is a market failure, this does not automatically imply that government intervention will be better since there are also problems with government intervention. The cure may be worse than the disease. It may, of course, also help so one should be careful and discuss each issue on its own merits and not just generalize.

Finally, these conditions are only the technical conditions necessary for the market to work in the sense that they are required to produce an outcome in which nobody can be better off without somebody else being made worse off. It does not imply that markets will produce results which are good in a moral sense (fair, just, or equal) or that the market works well over time (by creating new innovations). One may argue that markets are fair and innovative, but this is different from the technical definition of the factors that make markets work or fail is a standard classical sense.

Market equilibrium requires rational actors to realize substantially all of the costs and benefits of trade. Market failure is possible any time these conditions are not satisfied.  
  
Some specific situations contributing to market failure:

* **Regulations**: Restrictions such as price floors or price ceilings prevent the price mechanism from efficiently allocating resources. *Example:* minimum wage laws
* **Market power**:Some industries may feature economies of scale or significant start-up costs, so is possible for an inefficient market outcome to be reached if one firm (or a few large firms) is able to exclude others to the detriment of potential market participants. *Example:* telecommunications
* **Transaction costs**: If the cost of engaging in any trade are high in the first place, a market cannot function.
* **Imperfect information**: One party has material information that the other does not, or both parties lack material information that would affect whether or not the trade occurs, or for what price it occurs. *Examples:* used cars, financial instruments
* **Externalities**: A trade (or the goods being traded) may impose substantial costs on individuals not participating in the trade. Alternately, individuals not participating in the trade would realize significant benefits from it but the parties directly involved in the trade would not. *Example:* national defense
* **Irrational actors**: One party is not of sound mind when making the trade, factors are weighted inappropriately, long-term costs are ignored in favor of short-term benefits, etc.
* It is important to understand that it's often a subjective call as to whether or not market failure exists in a given market.

**8 Major Causes of Market Failure (Explained With Diagram)**

Some of the major causes of market failure are: 1. Incomplete markets, 2. Indivisibilities, 3. Common Property Resources, 4. Imperfect Markets, 5. Asymmetric Information, 6. Externalities, 7. Public Goods and 8. Public Bads.

Meaning:

In the real world, there is non-attainment of Pareto optimality due to a number of constraints in the working of perfect competition. An important cause of environmental degradation is market failure. It means poor functioning of markets for environmental goods and services. It reflects failure of government policy in removing market distortions created by price controls and subsidies.

Incomplete markets:

Markets for certain things are incomplete or missing under perfect competition. The absence of markets for such things as public goods and common property resources is a cause of market failure. There is no way to equate their social and private benefits and costs either in the present or in the future because their markets are incomplete or missing.

2. Indivisibilities:

The Paretian optimality is based on the assumption of complete divisibility of products and factors used in consumption and production. In reality, goods and factors are not infinitely divisible. Rather, they are indivisible. The problem of divisibility arises in the production of those goods and services that are used jointly by more than one person.

An important example is of road in a locality. It is used by a number of persons in the locality. But the problem is how to share the costs of repairs and maintenance of the road. In fact, very few persons will be interested in its maintenance. Thus marginal social costs and marginal social benefits will diverge from each other and Pareto optimality will not be achieved.

3. Common Property Resources:

Another cause of market failure is a common property resource. Common ownership when coupled with open access, would also lead to wasteful exploitation in which a user ignores the effects of his action on others. Open access to the commonly owned resources is a crucial ingredient of waste and inefficiency.

Its most common example is fish in a lake. Anyone can catch and eat it but no one has an exclusive property right over it. It means that a common property resource is non-excludable (anyone can use it) and non-rivalrous (no one has an exclusive right over it). The lake is a common property for all fishermen.

When a fisherman catches more fish, he reduces the catch of other fishermen. But he does count this as a cost, yet it is a cost to society. Because the lake is a common property resource where there is no mechanism to restrict entry and to catch fish. The fisherman who catches more fish imposes a negative externality on other fishermen so that the lake is overexploited.

This is called the tragedy of the commons which leads to the elimination of social gains due to the overuse of common property. Thus when property rights are common, indefinite or non-existent, social costs will be more than private costs and there will not be Pareto Optimality.

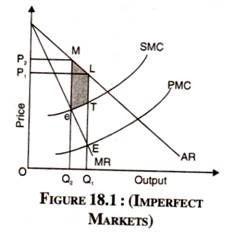
4. Imperfect Markets:

Pareto efficiency increases under perfect competition. But it declines under market distortions or imperfections. Let us consider a case of monopoly. Initially, monopoly equilibrium is at point E where the private marginal cost curve, PMC, cuts the marginal revenue curve, MR, from below.

The monopolist produces OQ1 output at OP1 price. But the production process generates smoke in the air. Therefore, the pollution board levies a tax equal to ТЕ on the monopoly firm. The imposition of a pollution tax is, in fact, a fixed cost to the monopoly firm. Now the social marginal cost curve cuts the marginal revenue curve at point e.

The monopolist increases the price of his product from OP1 to OP2 and restricts output to OQ2 and thereby reduces consumers’ surplus to Q2 MLQ1 (= OQ1 LP1 – OQ2 MP2). In fact, Q2 MLQ1 is the social cost of OQ2 output. But the net loss to society is Q2 MLQ1 – TE= eMLT, the shaded area in the figure.

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5. Asymmetric Information:

Pareto optimality assumes that producers and consumers have perfect information regarding market behaviour. But according to Joseph Stiglitz, “In the real world, there is asymmetric (incomplete) information due to ignorance and uncertainty on the part of buyers and sellers. Thus they are unable to equate social and private benefits and costs.”

Suppose a producer introduces a new antipollution device in the market. But it is very difficult for him to predict the current demand of his product. On the other hand, consumers may be ignorant about quality and utility of this anti-pollution device. In some cases, information about market behaviour in the future may be available but that may be insufficient or incomplete. Thus market asymmetries, fail to allocate efficiently.

6. Externalities:

The presence of externalities in consumption and production also lead to market failure. Externalities are market imperfections where the market offers no price for service or disservice. These externalities lead to misallocation of resources and cause consumption or production to fall short of Pareto optimality.

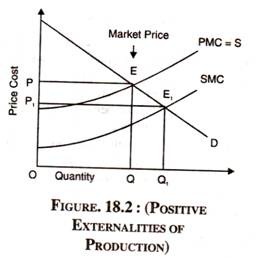
Because under perfect competition private marginal cost (PMC) is equated to private marginal benefit (i.e. the price of the product). We discuss below how external economies and diseconomies of consumption and production affect adversely the allocation of resources and prevent the attainment of Pareto optimality.

**Positive Externalities of Production:**

According to Pigou, when some firm renders a benefit or cost of a service to other firms without appropriating to itself all the benefits or costs of his service, it is an external economy of production. External economies of production accrue to one or more firms in the form of reduced average costs as a result of the activities of another firm.

In other words, these economies accrue to other firms in the industry with the expansion of a firm. They may be the result of reduced input costs which lead to pecuniary external economies. Whenever external economies exist, social marginal benefit will exceed private marginal benefit and private marginal cost will exceed social marginal cost.

This is illustrated in Figure 18.2 where PMC is the private marginal cost curve or supply curve of firms. The demand curve D intersects the PMC curve at point E and determines the competitive market price OP and output OQ.

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**Positive Externalities in Consumption:**

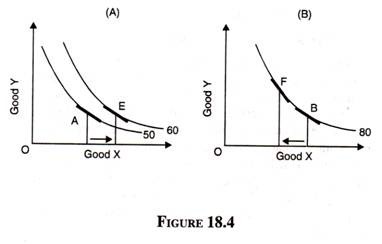
Externalities in Consumption lead to non-attainment of Pareto optimality. External economies of consumption arise from non-market interdependences of the satisfactions enjoyed by different consumers. An increase in the consumption of a good or service which affects favorably the consumption patterns and desires of other consumers is an external economy of consumption.

When an individual installs a TV set, the satisfaction of his neighbors increases because they can watch TV programmes free at his place. Here social benefit is larger and social cost is lower than the private benefit and cost. But the TV owner is likely to use his TV set to a smaller extent than the interests of society require because of the inconvenience and nuisance caused by his neighbors to him.

**Negative Externalities in Consumption:**

Negative externalities in consumption arise when the consumption of a good or service by one consumer leads to reduced utility (dissatisfaction or loss of welfare) of other consumers. Negative externalities in consumption arise in the case of fashions and articles of conspicuous consumption which reduce their utility to some consumers. For example, smokers cause disutility to non-smokers, and noise nuisance from stereo systems to neighbours etc. Such diseconomies of consumption prevent the attainment of Pareto optimality.

Suppose there are two room-mates A and B. Individual A likes to smoke while individual В likes clean air. Further, B’s utility of consuming clean air is affected by individual A’s smoking. This is explained in terms of Figure 18.4 (A) & (B). Initially, individual A’s utility from smoking gives him 50 utilis at point A while individual B’s consumption of clean air gives him 80 utilis at point B. When there are no externalities in consumption, the tangent at point A and point В are parallel to each other.

**[](http://cdn.yourarticlelibrary.com/wp-content/uploads/2014/05/clip_image0072.jpg)**

If individual A smokes at his leisure then his utility increases to 60 utilis and he moves to point E. The effect of individual A’s smoking reduces the utility of clean air to individual В who moves from point В to point F on the same utility curve.

Individual A has moved on a higher utility curve from 50 to utility curve 60, but the non-smoker is on the same utility curve 80. Thus Pareto optimality is not attained because the utility of one consumer (smoker) A has increased whereas the utility level of the other consumer (non-smoker) В has been reduced.

**7. Public Goods:**

Another cause of market failure is the existence of public goods. A public good is one whose consumption or use by one individual does not reduce the amount available for others. An example of a public good is water which is available to one person and is also available to others without any additional cost. Its consumption is always joint and equal.

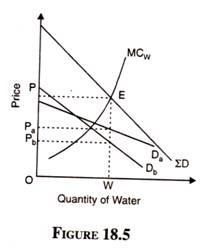
It is non-excludable if it can be consumed by anyone. It is non-rivalrous if no one has an exclusive rights over its consumption. Its benefits can be provided to an additional consumer at zero marginal cost. Thus public goods are both non-excludable and non- rivalrous. Moreover, environmental quality is generally considered as a public good and when it is valued at market price, it leads to market failure.

The Paretian condition for a public good is that its marginal social benefit (MSB) should equal its marginal social cost (MSC). But the characteristics of a public good are such that the economy will not reach a point of Pareto optimality in a perfectly competitive market. Public goods create externalities.

The externality starts when the marginal cost of consuming or producing an additional unit of a public good is zero but a price above zero is being charged. This violates the Paretian welfare maximization criterion of equating marginal social cost and marginal social benefit. This is because the benefits of a public good must be provided at a zero marginal social cost.

Suppose potable water is supplied by the municipal corporation. There are two individuals A and В who use it. Both consume the same quantity of water. But they differ in how much they are willing to pay for any given quantity.

This is illustrated in Figure 18.5. where Da and Db are the demand curves of two individuals A and В respectively. Therefore, demand prices are OPa and OPb corresponding to a given quantity OW of water. The curve ΣD is the vertical summation of Da and Db curves.

**[](http://cdn.yourarticlelibrary.com/wp-content/uploads/2014/05/clip_image009.jpg)**

The Lindhal equilibrium for a public good exists where the sum of the individual prices equal marginal cost. Therefore,

OP = OPa + OPb = MCW

But each consumer is being charged a different price. This is a case of price discrimination because price OPa is greater than price OPb for the same quantity of water OW. Hence there is market failure.

**8. Public Bads:**

There are also public bads in which one person experiencing some disutility does not diminish the disutility of another, such as air and water pollution. Public goods and public bads cannot be handled by the institution of private property. K.E. Boulding has explained public bads with the following example: “If someone drives his car into my living room and pollutes it, I can sue him for damages. This is a private bad. But if someone congests the roads or pollutes the air, however, there is not much I can do about it as an individual. This is public bad.”

Market failure is a necessary but not a sufficient condition for intervention. To be truly worthwhile, a government intervention must outperform the market or improve its functions. Second, the benefits from such intervention must exceed the costs of planning, implementation, and enforcement, as well as any indirect and unintended costs of distortions introduced to other sectors of the economy by such intervention.

**(b).Describe the structure of Uganda taxes and current reform proposals.**