

Chapter 10: Externalities

- What is an externality?
- Why do externalities make market outcomes inefficient?
- What public policies aim to solve the problem of externalities?
- How can people sometimes solve the problem of externalities on their own? Why do such private solutions not always work?

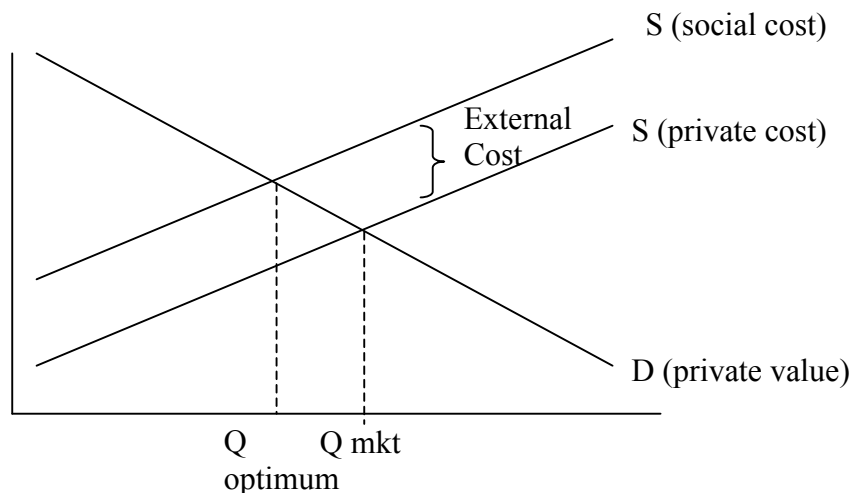
One type of market failure is externalities.

DEF: EXTERNALITY

- _____ externality – when the impact on the bystander is beneficial.
 - Examples: garden, restoring historic buildings
- _____ externality – when there is an adverse impact on the bystander.
 - Examples: cigarette smoking, groups of students talking during lecture

• **Negative Externalities**

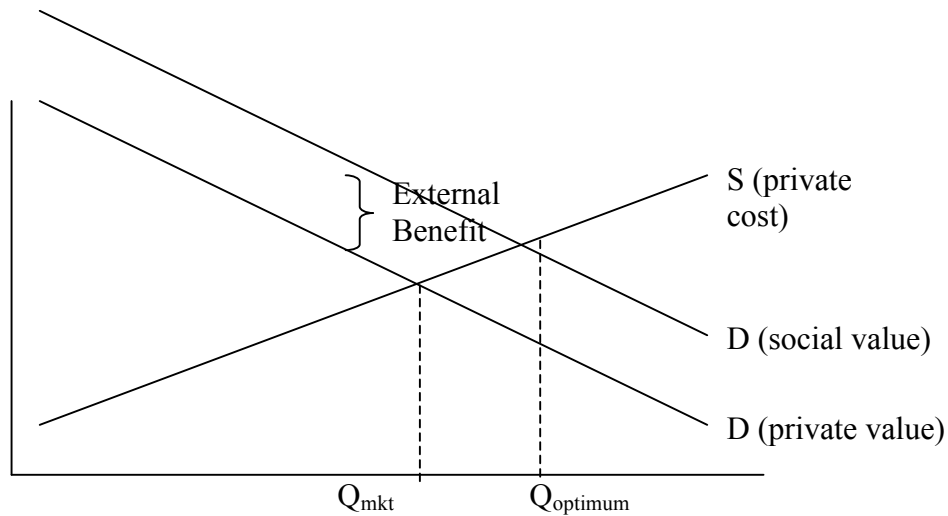
- Example: the Monfort feedlot in Greeley, CO
- Supply curve describes the private cost to the firm
- Demand curve shows private value to the individual
- Social Cost =
- The optimal amount of production is where D intersects the social cost curve.
- Optimal amount is smaller than the free market outcome.



- One solution: tax on producers for each unit of steel produced. This would shift S curve up.
- **DEF: INTERNALIZING THE EXTERNALITY**

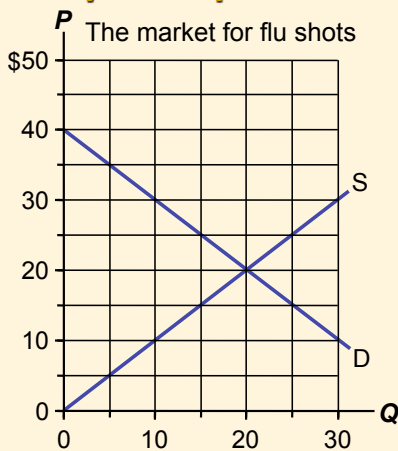
• **Positive Externalities**

- Demand curve describes the private value to the individual
- Social value =
- The optimal amount of production is where social value intersects S.
- Optimal amount is bigger than the free market outcome.



ACTIVE LEARNING 1

Analysis of a positive externality



External benefit = \$10/shot

- Draw the social value curve.
- Find the socially optimal Q .
- What policy would internalize this externality?

Public and Private Policies

I. Public Policies

- Government has two reactions
 - A. Command and Control: Regulation**
Example: laws, adoption of technology

B. Market-Based Policy: Corrective Taxes and Subsidies

Corrective tax

Tradable Pollution Permits

II. Private Solutions to Externalities

- Moral codes & social sanctions (e.g., don't litter, buy hybrid, use fabric bags in grocery store)
- Charities (e.g., Sierra Club – protect environment)
- Parties involved with externalities can reach an agreement

DEF: COASE THEOREM

- *Example*

Why private solutions do not always work?

Transaction costs: The costs parties incur in the process of agreeing to and following through on a bargain.

Stubbornness:

Coordination problems:

Suggested problems: Problems and Applications- 3, 6