Externalities (Partial Equilibrium) II

Public Good

- Non excludable
- Non rival

- Common Property: Resource anyone can access but rival

- Free Riding

Property Rights

- The exclusive control over the use of an asset or resource.

- Why are property rights important in dealing with externalities?

- Firm A – cattle
- Firm B – crop
- Cattle destroys crop

- Should cattle from A roam in B?
- Fence?
- Who pays?

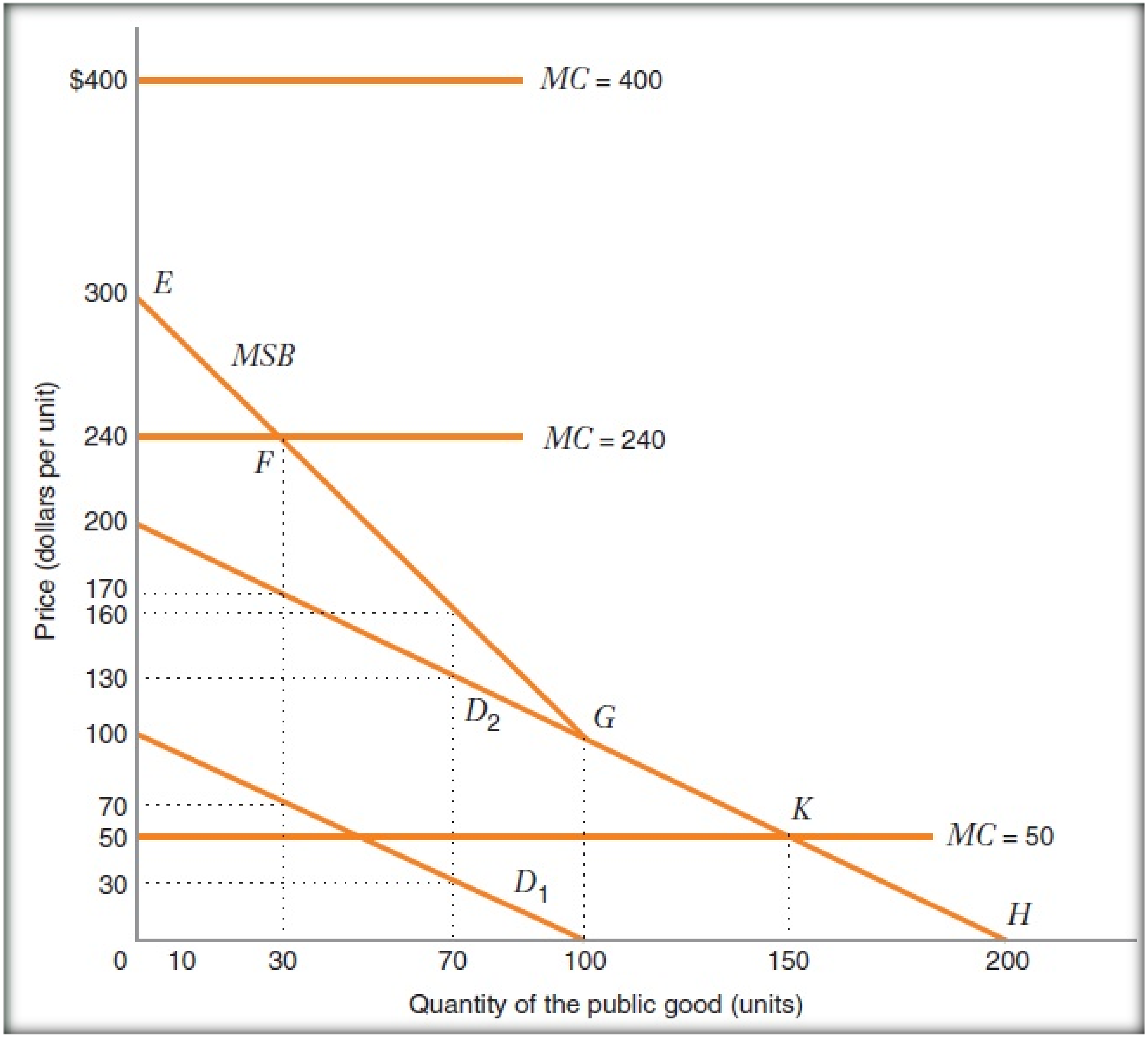
Coase Theorem

- Regardless of how property rights are assigned with an externality, the allocation of resources will be efficient when the parties can costlessly bargain with each other.

- If the owner of A has the right to let his cattle roam on B's land, B's owner will pay A's owner to build a fence when the damage to B's crops exceeds the cost of the fence. If the cost of the fence exceeds the damage to the crops, it will not be in the interest of owner B to pay for the fence, and the cattle will roam.

- In other words, when it is socially efficient to construct the fence, the fence will be built to eliminate the externality. (when benefit from fence exceeds cost of fence, fence will be erected)

Efficient Provision of a Public Good



Reference

1. David Besanko & Ronald Braeutigam; Microeconomics; 5th Edition; Wiley (Chapter 17)