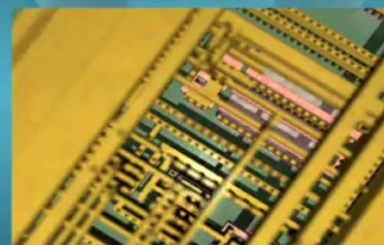

LECTURE TWELVE - PART FIVE

Negative and Positive Externalities

- The production or consumption of a good may generate “spillover effects.
- Key Point: External benefits or costs are not accurately reflected in the supply and demand curves of producers and consumers.
- As a result of externalities, the free market may be inefficient and under-supply or over-supply the good.

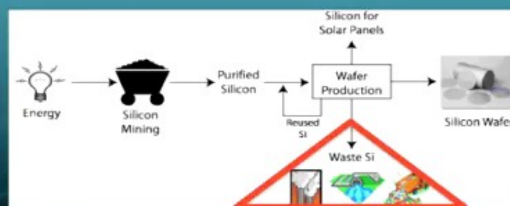
A Silicon Valley Chip Example

- To make chips, your company must pay workers, invest in new plant and equipment, and buy raw materials.
- Each of these costs will be reflected in your private marginal cost curve which, you may recall, is also your firm's supply curve.



Toxic Wastes R Us

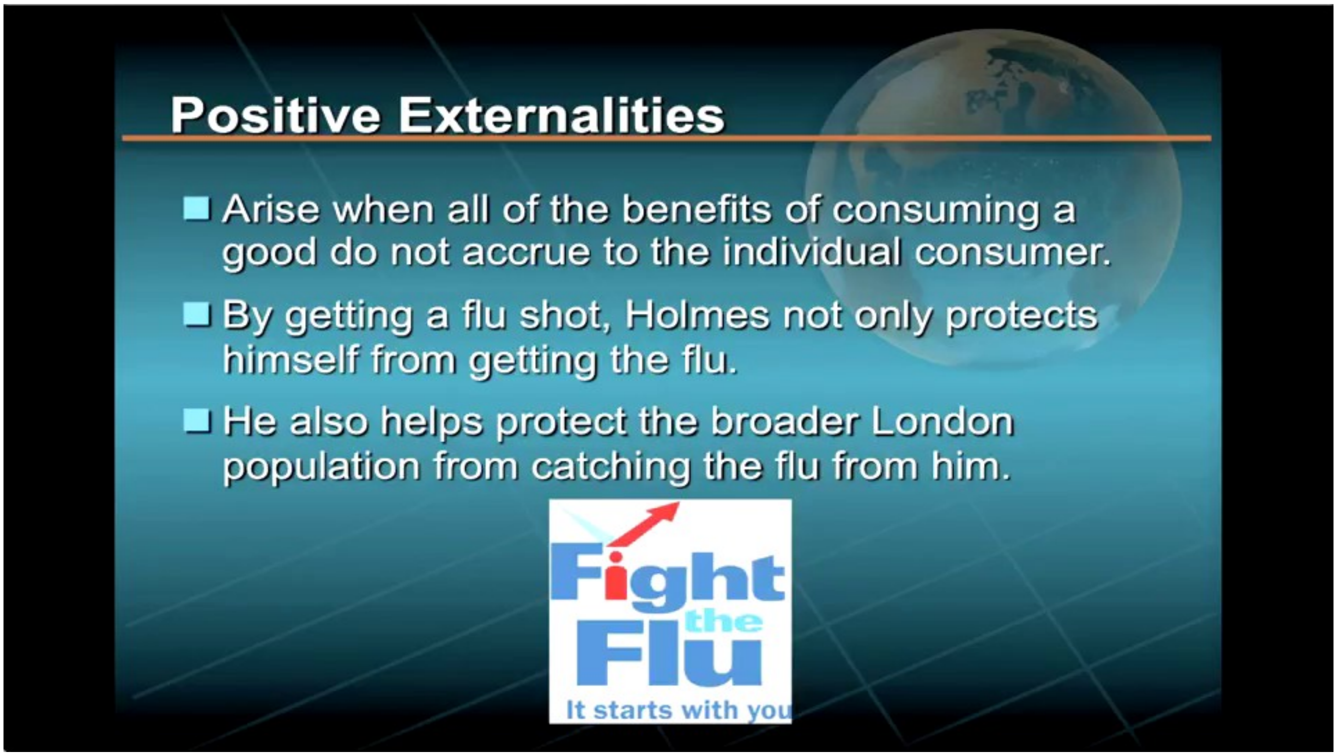
- In a free market and in the absence of any laws to the contrary, your company may simply dump these toxic wastes into a nearby river to minimize its costs.
- Nonetheless, the resulting pollution will not be without cost to the broader society.




Why It Is A Negative Externality
Children may get leukemia
Fishermen catch less fish
Homeowners get sick

Why It Is A Negative Externality

- These types of external or spillover effects are called negative externalities.
- Because they will not be borne by your firm in a free market, they are not reflected in your supply curve.
- The likely result: Your firm will produce both too many computer chips and too much pollution from society's point of view!


Positive Externalities
Arise when all of the benefits of consuming a good do not accrue to the individual consumer.
By getting a flu shot, Holmes not only protects himself from getting the flu.
He also helps protect the broader London population from catching the flu from him.
Fight the Flu
It starts with you

The Problem of Underconsumption

- When we magnify Holmes' behavior to the entire population, vaccinations mean a healthier and more productive workforce, a larger national output, and higher incomes for society.
- The Problem: The free market tends to lead to the underconsumption of goods that yield positive externalities – from vaccinations to education.

The Broader Point

- Externalities: A strong economic rationale for federal, state, and local intervention into the free market.
- Examples: Environmental protection, traffic congestion, education and public health.
- Accordingly, it is appropriate that we take a more systematic theoretical look now at this very important market failure.