Ch 10. Externalities

- **<u>Externalities :</u>** One type of market failure
  - The uncompensated impact of one person's actions on the well-being of a bystander
- Negative externality and Positive externality
  - The market outcome is not efficient, because buyers and sellers in the market neglect the **<u>external costs</u>** or benefits of their action
  - Government policies can potentially improve the outcome.

- **Negative externalities**
  - ex. Air pollution from a factory, Noise from your neighbor..
- The market equilibrium maximizes consumer + producer surplus.
  - Supply curve shows private cost of sellers
  - Demand curve shows private value of buyers
  - With negative externality, the market equilibrium is greater than socially desirable amount.
- **Social cost = Private cost + External cost(=value of negative impact on bystanders)**
  - One solution: tax sellers $1/gallon, would shift S curve up $1.
- **Internalizing the externality**
  - Altering incentives
  - "market equilibrium = social optimal"

- **Positive externalities**
  - Ex. Being vaccinated against COVID 19, R&D, College education
  - With Positive externality, the market equilibrium is less than social optimal.
  - Social value = Private value + External benefit
  - To internalize, provide subsidy

- **Public policies toward externalities**
- Command and control policies

  - Direct regulation
- Market based policies

  - Providing incentives (taxes or subsidies)
  - Tradable pollution permits
- Pigouvian taxes

  - English economist A. Pigou
  - Corrective taxes

- **Private solutions to Externalities**

  <u>The Coase Theorem</u>

  - If private parties can bargain without cost over the allocation of resources, they can solve the problem of externalities on their own
- Why private solutions do not always work?

  - High transaction cost