

CHAPTER 18. ENVIRONMENTAL PROTECTION AND NEGATIVE EXTERNALITIES

INTRODUCTION TO ENVIRONMENTAL PROTECTION AND NEGATIVE EXTERNALITIES



Figure 1. Environmental Debate. Across the country, countless people have protested, even risking arrest, against the Keystone XL Pipeline. (Credit: modification of image by “NoKXL”/Flickr Creative Commons)

KEYSTONE XL

You might have heard about Keystone XL in the news. It is a pipeline system designed to bring oil from Canada to the refineries near the Gulf of Mexico, as well as to boost crude oil production in the United States. While a private company, TransCanada, will own the pipeline, U.S. government approval is required because of its size and location. The pipeline is being built in four phases, with the first two currently in operation, bringing oil from Alberta, Canada, east across Canada, south through the United States into Nebraska and Oklahoma, and northeast again to Illinois. The third and fourth phases of the project, known as Keystone XL, would create a pipeline southeast from Alberta straight to Nebraska, and then from Oklahoma to the Gulf of Mexico.

Sounds like a great idea, right? A pipeline that would move much needed crude oil to the Gulf refineries would increase oil production for manufacturing needs, reduce price pressure at the gas pump, and increase overall economic growth. Supporters argue that the pipeline is one of the safest pipelines built yet, and would reduce America’s dependence on politically vulnerable Middle Eastern oil imports.

Not so fast, say its critics. The Keystone XL would be constructed over an enormous aquifer (one of the largest in the world) in the Midwest, and through an environmentally fragile area in Nebraska, causing great concern among environmentalists about possible destruction to the natural surroundings. They argue that leaks could taint valuable water sources and construction of the pipeline could disrupt and even harm indigenous species. Environmentalist groups have fought government approval of the proposed construction of the pipeline, and as of press time the pipeline projects remain stalled.

Of course, environmental concerns matter when discussing issues related to economic growth. But how much should they factor in? In the case of the pipeline, how do we know how much damage it would cause when we do not know how to put a value on the environment? Would the benefits of the pipeline outweigh the opportunity cost? The issue of how to balance economic progress with unintended effects on our planet is the subject of this chapter.

CHAPTER OBJECTIVES

Introduction to Environmental Protection and Negative Externalities

In this chapter, you will learn about:

- The Economics of Pollution
- Command-and-Control Regulation
- Market-Oriented Environmental Tools
- The Benefits and Costs of U.S. Environmental Laws
- International Environmental Issues
- The Tradeoff between Economic Output and Environmental Protection

In 1969, the Cuyahoga River in Ohio was so polluted that it spontaneously burst into flame. Air pollution was so bad at that time that Chattanooga, Tennessee was a city where, as an article from Sports Illustrated put it: “the death rate from tuberculosis was double that of the rest of Tennessee and triple that of the rest of the United States, a city in which the filth in the air was so bad it melted nylon stockings off women’s legs, in which executives kept supplies of clean white shirts in their offices so they could change when a shirt became too gray to be presentable, in which headlights were turned on at high noon because the sun was eclipsed by the gunk in the sky.”

The problem of pollution arises for every economy in the world, whether high-income or low-income, and whether market-oriented or command-oriented. Every country needs to strike some balance between production and environmental quality. This chapter begins by discussing how firms may fail to take certain social costs, like pollution, into their planning if they do not need to pay these costs. Traditionally, policies for environmental protection have focused on governmental limits on how much of each pollutant could be emitted. While this approach has had some success, economists have suggested a range of more flexible, market-oriented policies that reduce pollution at a lower cost. We will consider both approaches, but first let’s see how economists frame and analyze these issues.

18.1 THE ECONOMICS OF POLLUTION

LEARNING OBJECTIVES

By the end of this section, you will be able to:

- Explain and give examples of positive and negative externalities
- Identify equilibrium price and quantity
- Evaluate how firms can contribute to market failure

From 1970 to 2012, the U.S. population increased by one-third and the size of the U.S. economy more than doubled. Since the 1970s, however, the United States, using a variety of anti-pollution policies, has made genuine progress against a number of pollutants. Table 1 lists the change in carbon dioxide emissions by users of energy (from residential to industrial) according to the U.S. Energy Information Administration (EIA). The table shows that emissions of certain key air pollutants declined substantially from 2007 to 2012; they dropped 730 million metric tons (MMT) a year—a 12% reduction. This seems to indicate that progress has been made in the United States in reducing overall carbon dioxide emissions, which cause greenhouse gases.

End-use Sector	Primary Fossil Fuels			Purchased Electric Power	Total Primary Fossil Fuels
	Coal	Petroleum	Natural Gas		
Residential	(0)	(14)	(31)	(134)	(179)
Commercial	(2)	(2)	(7)	(126)	(136)
Industrial	(40)	(62)	31	(118)	(191)
Transportation	0	(228)	5	(1)	(224)
Power	(464)	(36)	(122)	—	—
Change 2007–2012	(508)	(342)	121	(378)	(730)

Table 1. U.S. Carbon Dioxide (CO₂) Emissions from Fossil Fuels Consumed 2007–2012, Million Metric Tons (MMT) per Year. (Source: EIA Monthly Energy Review)

Despite the gradual reduction in emissions from fossil fuels, many important environmental issues remain. Along with the still high levels of air and water pollution, other issues include hazardous waste disposal, destruction of wetlands and other wildlife habitats, and the impact on human health from pollution.

EXTERNALITIES

Private markets, such as the cell phone industry, offer an efficient way to put buyers and sellers together and determine what goods are produced, how they are produced, and who gets them. The principle that voluntary exchange benefits both buyers and sellers is a fundamental building block of the economic way of thinking. But what happens when a voluntary exchange affects a third party who is neither the buyer nor the seller?

As an example, consider a concert producer who wants to build an outdoor arena that will host country music concerts a half-mile from your neighborhood. You will be able to hear these outdoor concerts while sitting on your back porch—or perhaps even in your dining room. In this case, the sellers and buyers of concert tickets may both be quite satisfied with their voluntary exchange, but you have no voice in their market transaction. The effect of a market exchange on a third party who is outside or “external” to the exchange is called an **externality**. Because externalities that occur in market transactions affect other parties beyond those involved, they are sometimes called **spillovers**.

Externalities can be negative or positive. If you hate country music, then having it waft into your house every night would be a **negative externality**. If you love country music, then what amounts to a series of free concerts would be a **positive externality**.

POLLUTION AS A NEGATIVE EXTERNALITY

Pollution is a negative externality. Economists illustrate the **social costs** of production with a demand and supply diagram. The social costs include the private costs of production incurred by the company and the external costs of pollution that are passed on to society. Figure 1 shows the demand and supply for manufacturing refrigerators. The demand curve (D) shows the quantity demanded at each price. The supply curve (S_{private}) shows the quantity of refrigerators supplied by all the firms at each price if they are taking only their private costs into account and they are allowed to emit pollution at zero cost. The market equilibrium (E_0), where quantity supplied and quantity demanded are equal, is at a price of \$650 and a quantity of 45,000. This information is also reflected in the first three columns of Table 2.

Price	Quantity Demanded	Quantity Supplied before Considering Pollution Cost	Quantity Supplied after Considering Pollution Cost
\$600	50,000	40,000	30,000
\$650	45,000	45,000	35,000
\$700	40,000	50,000	40,000
\$750	35,000	55,000	45,000
\$800	30,000	60,000	50,000
\$850	25,000	65,000	55,000
\$900	20,000	70,000	60,000

Table 2. A Supply Shift Caused by Pollution Costs

However, as a by-product of the metals, plastics, chemicals and energy that are used in manufacturing refrigerators, some pollution is created. Let’s say that, if these pollutants were emitted into the air and water, they would create costs of \$100 per refrigerator produced. These costs might occur because of injuries to human health, property values, wildlife habitat, reduction of recreation possibilities, or

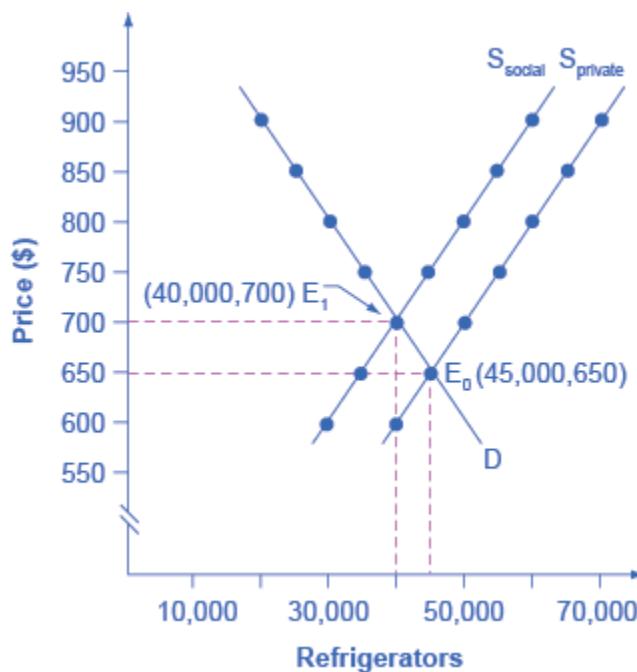


Figure 1. Taking Social Costs into Account: A Supply Shift. If the firm takes only its own costs of production into account, then its supply curve will be S_{private} , and the market equilibrium will occur at E_0 . Accounting for additional external costs of \$100 for every unit produced, the firm's supply curve will be S_{social} . The new equilibrium will occur at E_1 .

because of other negative impacts. In a market with no anti-pollution restrictions, firms can dispose of certain wastes absolutely free. Now imagine that firms which produce refrigerators must factor in these **external costs** of pollution—that is, the firms have to consider not only the costs of labor and materials needed to make a refrigerator, but also the broader costs to society of injuries to health and other values caused by pollution. If the firm is required to pay \$100 for the **additional external costs** of pollution each time it produces a refrigerator, production becomes more costly and the entire supply curve shifts up by \$100.

As illustrated in the fourth column of Table 2 and in Figure 1, the firm will need to receive a price of \$700 per refrigerator and produce a quantity of 40,000—and the firm's new supply curve will be S_{social} . The new equilibrium will occur at E_1 , taking the additional external costs of pollution into account results in a higher price, a lower quantity of production, and a lower quantity of pollution. The following Work It Out feature will walk you through an example, this time with musical accompaniment.

IDENTIFYING THE EQUILIBRIUM PRICE AND QUANTITY

Table 3 shows the supply and demand conditions for a firm that will play trumpets on the streets when requested. Output is measured as the number of songs played.

Price	Quantity Demanded	Quantity Supplied without paying the costs of the externality	Quantity Supplied after paying the costs of the externality
\$20	0	10	8
\$18	1	9	7
\$15	2.5	7.5	5.5
\$12	4	6	4
\$10	5	5	3
\$5	7.5	2.5	0.5

Table 3. Supply and Demand Conditions for a Trumpet-Playing Firm

Step 1. Determine the negative externality in this situation. To do this, you must think about the situation described and consider all parties that might be impacted. A negative externality might be the increase in noise pollution in the area where the firm is playing.

Step 2. Identify the equilibrium price and quantity when only private costs are taken into account, and then when social costs are taken into account. Remember that equilibrium is where the quantity demanded is equal to the quantity supplied.

Step 3. Look down the columns to where the quantity demanded (the second column) is equal to the “quantity supplied without paying the costs of the externality” (the third column). Then refer to the first column of that row to determine the equilibrium price. In this case, the equilibrium price and quantity when only private costs are taken into account would be at a price of \$10 and a quantity of five.

Step 4. Identify the equilibrium price and quantity when the additional external costs are taken into account. Look down the columns of quantity demanded (the second column) and the “quantity supplied after paying the costs of the externality” (the fourth column) then refer to the first column of that row to determine the equilibrium price. In this case, the equilibrium will be at a price of \$12 and a quantity of four.

Step 5. Consider how taking the externality into account affects the equilibrium price and quantity. Do this by comparing the two equilibrium situations. If the firm is forced to pay its additional external costs, then production of trumpet songs becomes more costly, and the supply curve will shift up.

Remember that the supply curve is based on choices about production that firms make while looking at their marginal costs, while the demand curve is based on the benefits that individuals perceive while maximizing utility. If no externalities existed, private costs would be the same as the costs to society as a whole, and private benefits would be the same as the benefits to society as a whole. Thus, if no externalities existed, the interaction of demand and supply will coordinate social costs and benefits.

However, when the externality of pollution exists, the supply curve no longer represents all social costs. Because externalities represent a case where markets no longer consider all social costs, but only some of them, economists commonly refer to externalities as an example of **market failure**. When there is market failure, the private market fails to achieve efficient output, because either firms do not account for all costs incurred in the production of output and/or consumers do not account for all benefits obtained (a positive externality). In the case of pollution, at the market output, social costs of production exceed social benefits to consumers, and the market produces too much of the product.

We can see a general lesson here. If firms were required to pay the social costs of pollution, they would create less pollution but produce less of the product and charge a higher price. In the next module, we will explore how governments require firms to take the social costs of pollution into account.

KEY CONCEPTS AND SUMMARY

Economic production can cause environmental damage. This tradeoff arises for all countries, whether high-income or low-income, and whether their economies are market-oriented or command-oriented.

An externality occurs when an exchange between a buyer and seller has an impact on a third party who is not part of the exchange. An externality, which is sometimes also called a spillover, can have a negative or a positive impact on the third party. If those parties imposing a negative externality on others had to take the broader social cost of their behavior into account, they would have an incentive to reduce the production of whatever is causing the negative externality. In the case of a positive externality, the third party is obtaining benefits from the exchange between a buyer and a seller, but they are not paying for these benefits. If this is the case, then markets would tend to under produce output because suppliers are not aware of the additional demand from others. If the parties that are generating benefits to others would be somehow compensated for these external benefits, they would have an incentive to increase production of whatever is causing the positive externality.

SELF-CHECK QUESTIONS

1. Identify the following situations as an example of a negative or a positive externality:
 - a. You are a birder (bird watcher), and your neighbor has put up several birdhouses in the yard as well as planting trees and flowers that attract birds.
 - b. Your neighbor paints his house a hideous color.
 - c. Investments in private education raise your country's standard of living.
 - d. Trash dumped upstream flows downstream right past your home.
 - e. Your roommate is a smoker, but you are a nonsmoker.
2. Identify whether the market supply curve will shift right or left or will stay the same for the following:
 - a. Firms in an industry are required to pay a fine for their emissions of carbon dioxide.
 - b. Companies are sued for polluting the water in a river.
 - c. Power plants in a specific city are not required to address the impact of their emissions on the quality of air.
 - d. Companies that use fracking to remove oil and gas from rock are required to clean up the damage.
3. For each of your answers to Self-Check Question 2, will equilibrium price rise or fall or stay the same?
4. The supply and demand conditions for a manufacturing firm are given in Table 4. The third column represents a supply curve without taking the social cost of pollution into account. The fourth column represents the supply curve when the firm is required to take the social cost of pollution into account. Identify the equilibrium before the social cost of production is included and after the social cost of production is included.

Price	Quantity Demanded	Quantity Supplied without paying the cost of the pollution	Quantity Supplied after paying the cost of the pollution
\$10	450	400	250
\$15	440	440	290
\$20	430	480	330
\$25	420	520	370
\$30	410	560	410

Table 4.

REVIEW QUESTIONS

1. What is an externality?
2. Give an example of a positive externality and an example of a negative externality.
3. What is the difference between private costs and social costs?
4. In a market without environmental regulations, will the supply curve for a firm take into account private costs, external costs, both, or neither? Explain.

CRITICAL THINKING QUESTIONS

Suppose you want to put a dollar value on the external costs of carbon emissions from a power plant. What information or data would you obtain to measure the external [not social] cost?

PROBLEMS

1. Show the market for cigarettes in equilibrium, assuming that there are no laws banning smoking in public. Label the equilibrium private market price and quantity as P_m and Q_m . Add whatever is needed to the model to show the impact of the negative externality from second-hand smoking. (Hint: In this case it is the consumers, not the sellers, who are creating the negative externality.) Label the social optimal output and price as P_e and Q_e . On the graph, shade in the deadweight loss at the market output.
2. Refer to Table 2. The externality created by the production of refrigerators was \$100. However, once both the private and additional external costs were taken into consideration, the market price increased by only \$50. If the external costs were \$100 why did the price only increase by \$50 when all costs were taken into account?
3. Table 5, shows the supply and demand conditions for a firm that will play trumpets on the streets when requested. Q_{s1} is the quantity supplied without social costs. Q_{s2} is the quantity supplied with social costs. What is the negative externality in this situation? Identify the equilibrium price and quantity when only private costs are taken into account, and then when social costs are taken into account. How does taking the externality into account affect the equilibrium price and quantity?

P	Qd	Qs1	Qs2
\$20	0	10	8
\$18	1	9	7
\$15	2.5	7.5	5.5
\$12	4	6	4
\$10	5	5	3
\$5	7.5	2.5	0.5

Table 5.

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GLOSSARY

additional external cost additional costs incurred by third parties outside the production process when a unit of output is produced

externality a market exchange that affects a third party who is outside or "external" to the exchange; sometimes called a "spillover"

market failure When the market on its own does not allocate resources efficiently in a way that balances social costs and benefits; externalities are one example of a market failure

negative externality a situation where a third party, outside the transaction, suffers from a market transaction by others

positive externality a situation where a third party, outside the transaction, benefits from a market transaction by others

social costs costs that include both the private costs incurred by firms and also additional costs incurred by third parties outside the production process, like costs of pollution

spillover see externality

SOLUTIONS

Answers to Self-Check Questions

1.
 - a. positive externality
 - b. negative externality
 - c. positive externality
 - d. negative externality

- e. negative externality
2. a. supply shifts left
b. supply shifts left
c. supply stays the same
d. supply shifts left
3. a. price will rise
b. price will rise
c. price stays the same
d. price will rise.
4. The original equilibrium (before the external social cost of pollution is taken into account) is where the private supply curve crosses the demand curve. This original equilibrium is at a price of \$15 and a quantity of 440. After taking into account the additional external cost of pollution, the production becomes more costly, and the supply curve shifts up. The new equilibrium will be at a price of \$30 and a quantity of 410.