CH10 NOTES

An externality arises when a person engages in an activity that influences the wellbeing of a bystander and yet neither pays nor receives any compensation for that effort.

1. If adverse – negative externality
2. If beneficial – positive externality

Why do we care?

Because the market equilibrium is not efficient when there are externalities, i.e. the equilibrium fails to maximize the total benefit to society as a whole.

Examples of Externalities and the Policy Responses to deal with market failure:

| NAME | TYPE | POLICY |
|---|---|---|
| Automobile Exhaust | Negative | Emission standards and gas tax |
| Barking Dogs | Negative | Illegal to disturb the peace |
| Research into new technologies | Positive | Subsidies/patent system |
| Restored historic buildings | Positive | Regulation of the destruction of historic buildings and tax breaks |

What are some other examples?

In order to examine how externalities affect economic wellbeing we use the tools of welfare economics learned in ch7.

Figure 1

Figure 2

Figure 3

PUBLIC POLICIES TOWARD EXTERNALITIES

COMMAND AND CONTROLL POLICIES: REGULATING BEHAVIOR DIRECTLY

Government can remedy an externality by making certain behaviors either required of forbidden (i.e. dumping trash into the Black Warrior River). But pollution is not as simple banning all polluting activity (transportation/ horse and buggy).

MARKET BASED POLICIES: INCENTIVES SO THAT PRIVATE DECISION MAKERS WILL CHOOSE TO SOLVE THE PROBLEM ON THEIR OWN (i.e. self-regulated)

POLICY1: CORRECTIVE TAXES AND SUBSIDIES

Regulation: The EPA could tell each factory to reduce its pollution to 300 tons of glop a year.

Corrective tax: The EPA could levy a tax on each factory of %50,000 for each ton of glop it emits.

POLICY2: TRADABLE POLLUTION PERMITS

FIGURE 4

PRIVATE SOLUTIONS TO EXTERNALITIES

MORAL CODE AND SOCIAL SANCTIONS

CHARITIES

ENTERING INTO A CONTRACT (prenuptial agreement)

<u>2 pt Bonus: Find an article related to the financial crisis/auto industry and give an example of a negative externality and how government policy is being created to remedy this market failure.</u>

<u>3 pt Bonus: The financial industry argued against regulation explain why regulation is necessary using the Coase theorem</u>