

Seventh Edition

Principles of  
**Economics**

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Wojciech Gerson (1831-1901)

CHAPTER  
**10**

**Externalities**

# In this chapter, look for the answers to these questions

- What is an externality?
- Why do externalities make market outcomes inefficient?
- What public policies aim to solve the problem of externalities?
- How can people sometimes solve the problem of externalities on their own? Why do such private solutions not always work?

# Introduction

- One of the Ten Principles from Chapter 1:

***Markets are usually a good way to organize economy activity.***

In absence of market failures, the competitive market outcome is efficient, maximizes total surplus.

- One type of market failure:

**externality**, the uncompensated impact of one person's actions on the well-being of a bystander.

- Externalities can be **negative** or **positive**, depending on whether impact on bystander is adverse or beneficial.

# Introduction

- Self-interested buyers and sellers neglect the external costs or benefits of their actions, so the market outcome is not efficient.
- Another principle from Chapter 1:  
***Governments can sometimes improve market outcomes.***

In presence of externalities, public policy can improve efficiency.

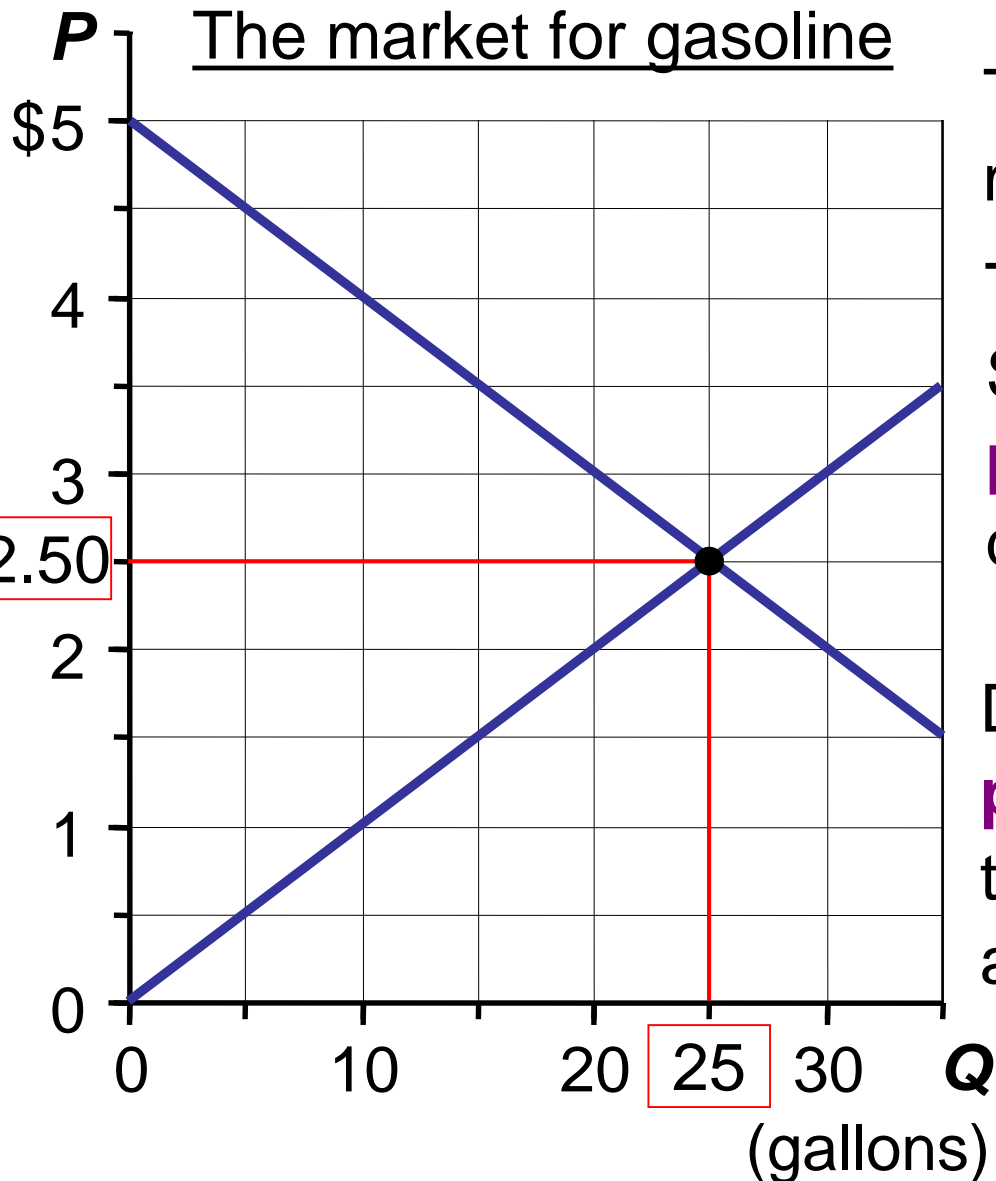
# Examples of Negative Externalities

- Air pollution from a factory
- The neighbor's barking dog
- Late-night stereo blasting from the dorm room next to yours
- Noise pollution from construction projects
- Health risk to others from second-hand smoke
- Talking on cell phone while driving makes the roads less safe for others



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# Recap of Welfare Economics

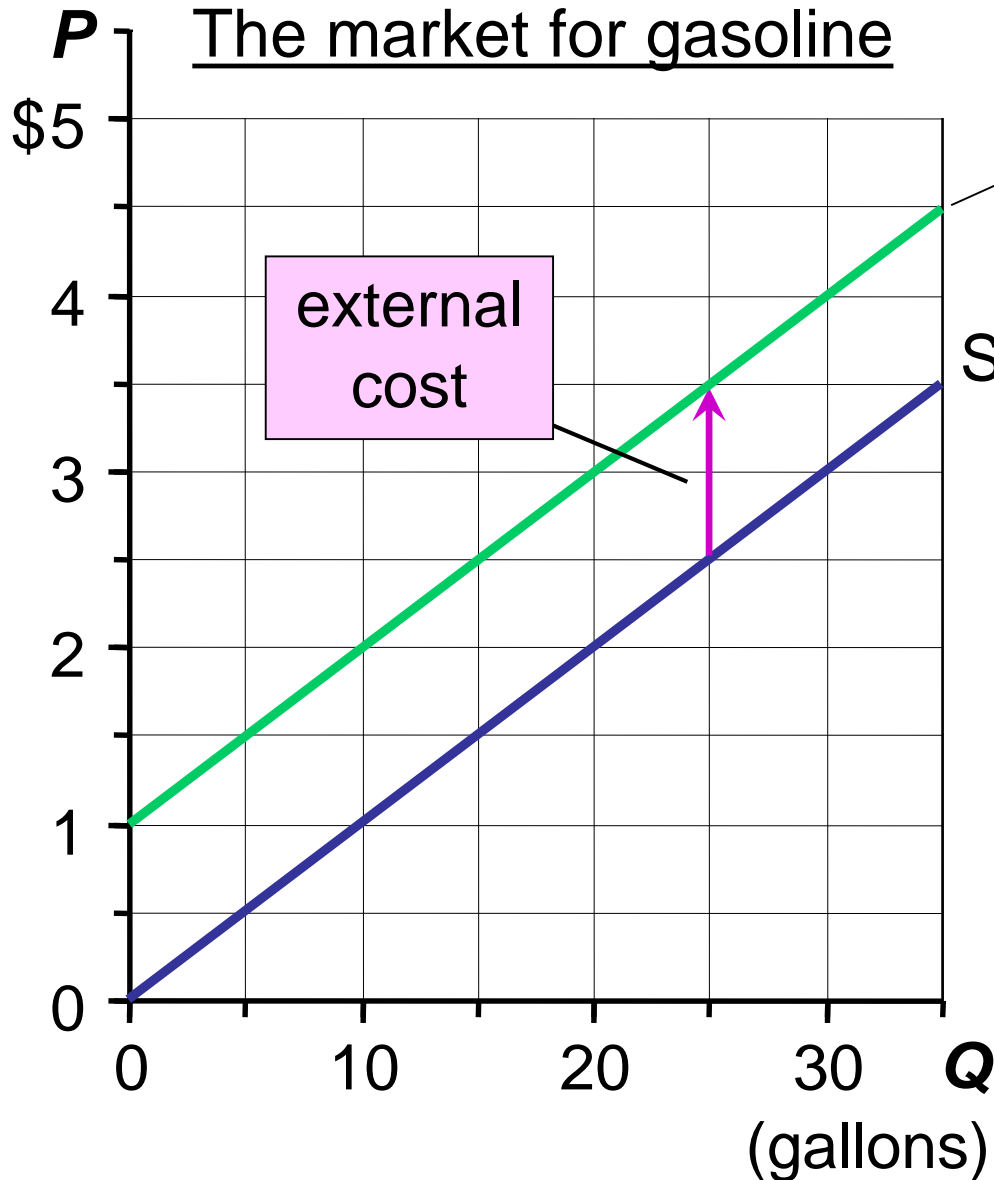


The market eq'm maximizes consumer + producer surplus.

Supply curve shows **private cost**, the costs directly incurred by sellers.

Demand curve shows **private value**, the value to buyers (the prices they are willing to pay).

# Analysis of a Negative Externality



**Social cost**

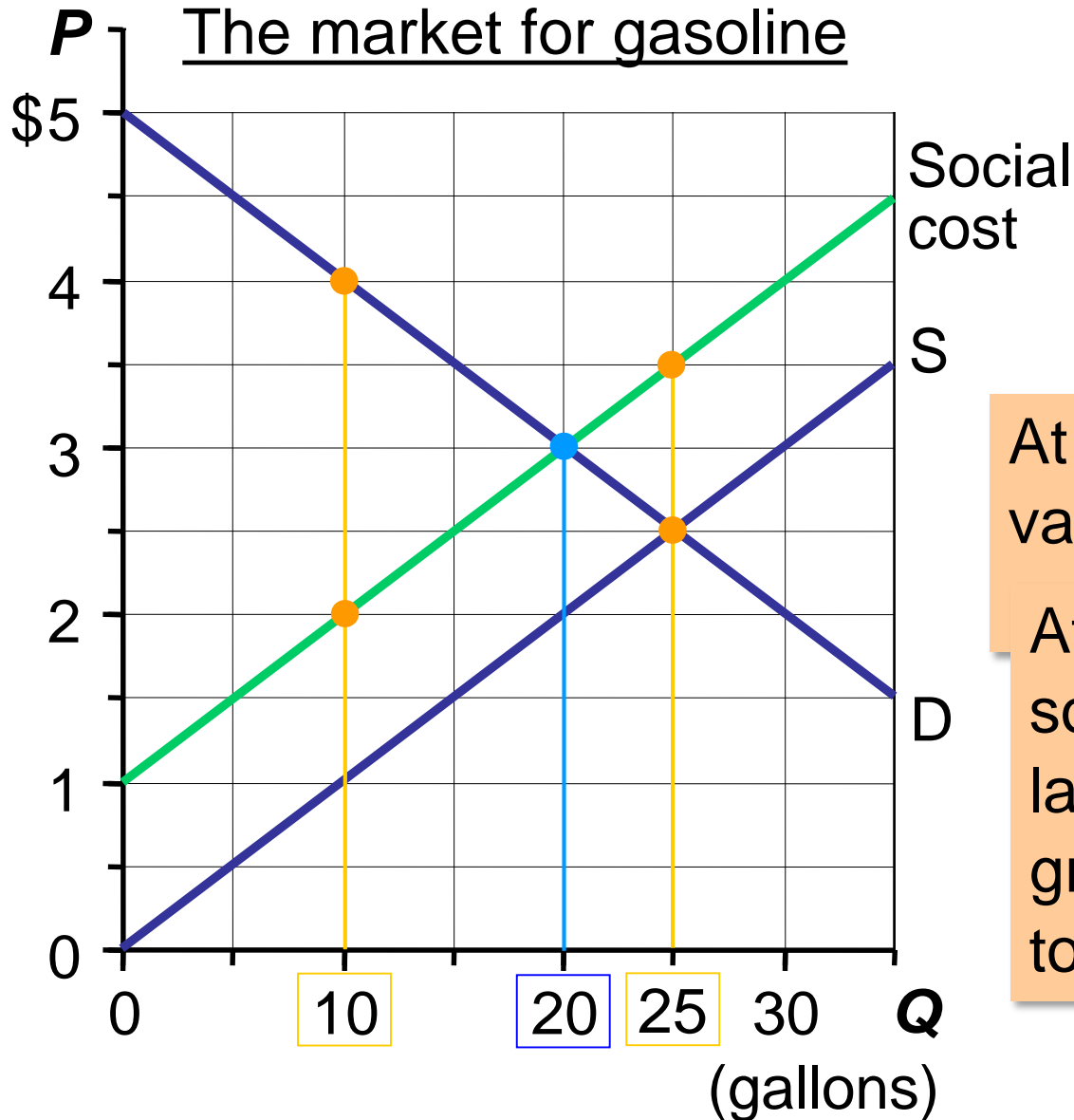
= private + external cost

**External cost**

= value of the negative impact on bystanders

= \$1 per gallon (value of harm from smog, greenhouse gases)

# Analysis of a Negative Externality



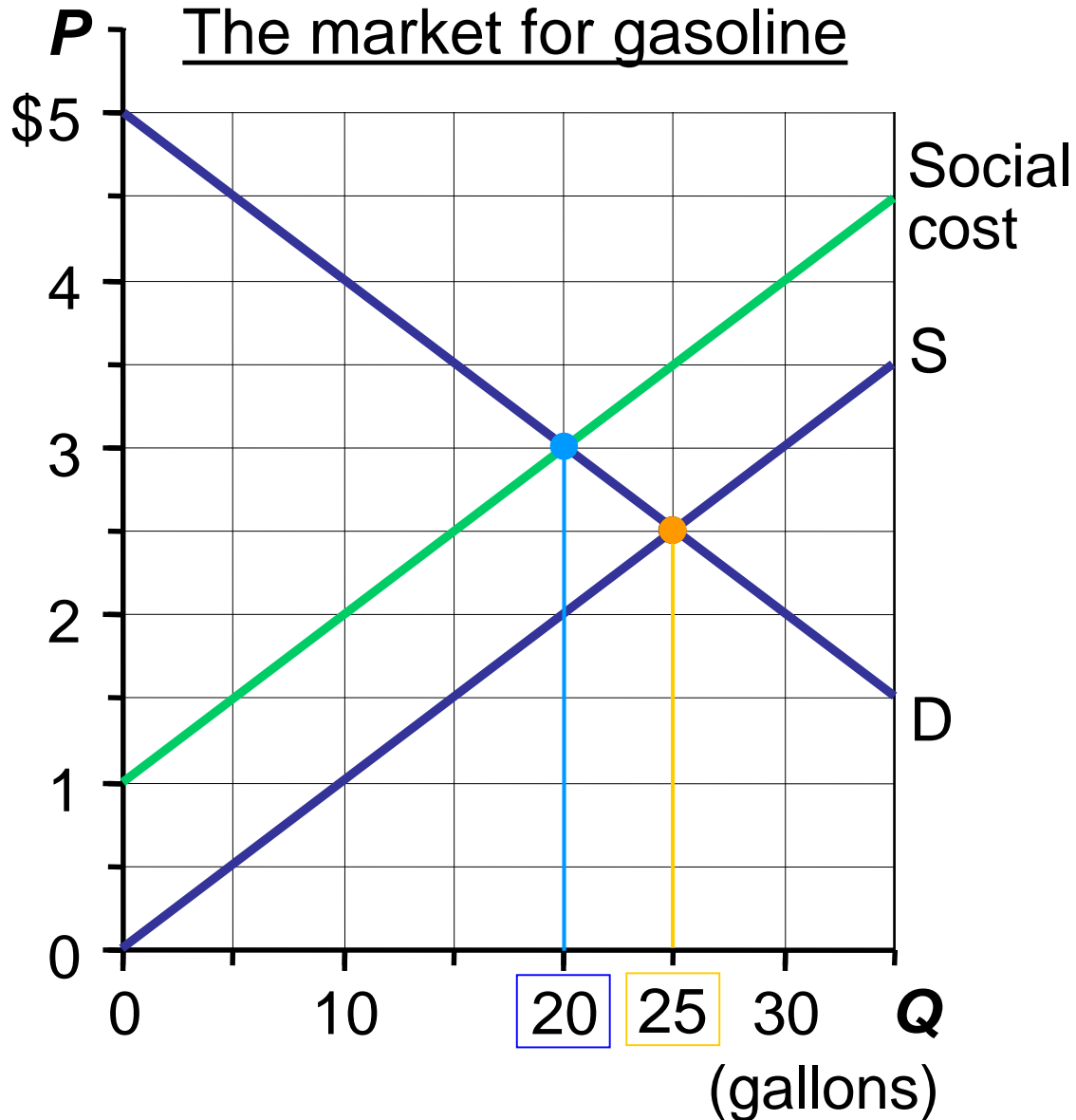
The socially optimal quantity is 20 gallons.

At any  $Q < 20$ , value of additional gas

At any  $Q > 20$ , social cost of the last gallon is greater than its value to society.



# Analysis of a Negative Externality



Market eq'm  
( $Q = 25$ )  
is greater than  
social optimum  
( $Q = 20$ ).

One solution:  
tax sellers  
\$1/gallon,  
would shift  
**S** curve up \$1.

# “Internalizing the Externality”

- **Internalizing the externality:** altering incentives so that people take account of the external effects of their actions
- In our example, the \$1/gallon tax on sellers makes sellers' costs = social costs.
- When market participants must pay social costs, market eq'm = social optimum.

(Imposing the tax on buyers would achieve the same outcome; market  $Q$  would equal optimal  $Q$ .)

# Examples of Positive Externalities

- Being vaccinated against contagious diseases protects not only you, but people who visit the salad bar or produce section after you.
- R&D creates knowledge others can use.
- People going to college raise the population's education level, which reduces crime and improves government.



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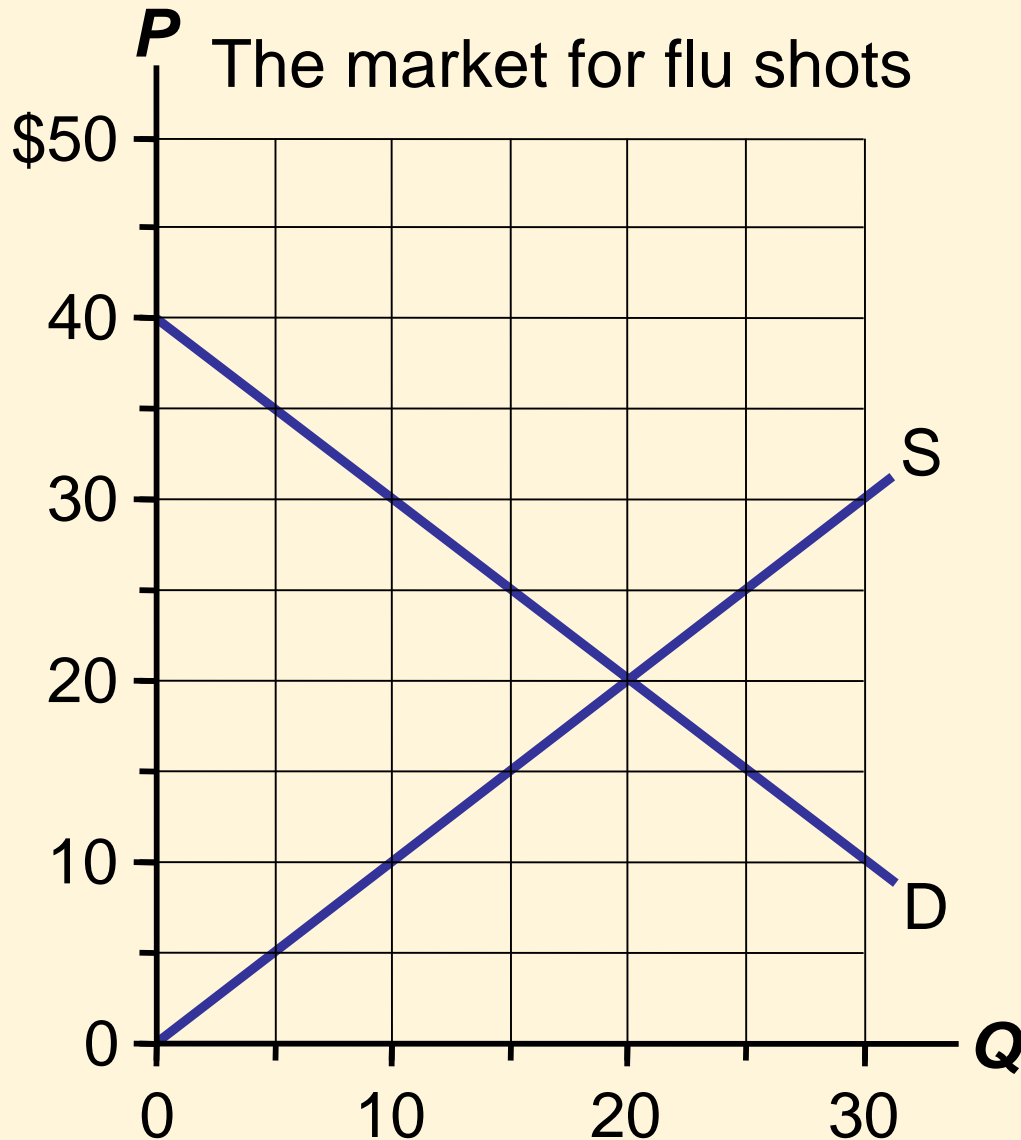
*Thank you for  
not contaminating  
the fruit supply!*

# Positive Externalities

- In the presence of a positive externality, the **social value** of a good includes
  - **private value** – the direct value to buyers
  - **external benefit** – the value of the positive impact on bystanders
- The socially optimal **Q** maximizes welfare:
  - At any lower **Q**, the social value of additional units exceeds their cost.
  - At any higher **Q**, the cost of the last unit exceeds its social value.

# ACTIVE LEARNING 1

## Analysis of a positive externality

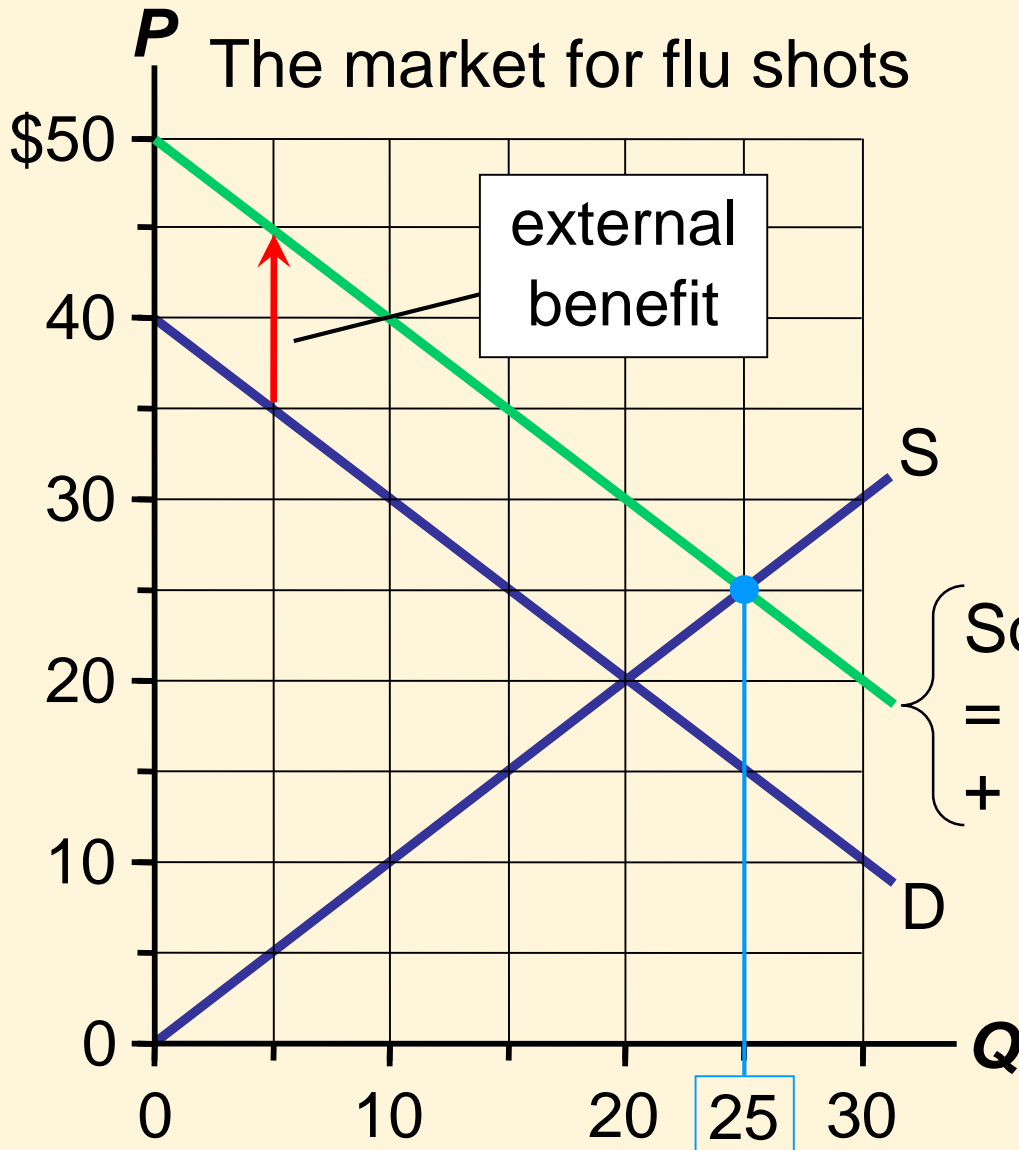


External benefit  
= \$10/shot

- Draw the social value curve.
- Find the socially optimal **Q**.
- What policy would internalize this externality?

# ACTIVE LEARNING 1

## Answers



Socially optimal  $Q$   
= 25 shots.

To internalize the  
externality, use  
subsidy = \$10/shot.

Social value  
= private value  
+ \$10 external benefit

# Effects of Externalities: Summary

If negative externality

- market quantity larger than socially desirable

If positive externality

- market quantity smaller than socially desirable

To remedy the problem,

“internalize the externality”

- tax goods with negative externalities
- subsidize goods with positive externalities

# Public Policies Toward Externalities

Two approaches:

- **Command-and-control policies** regulate behavior directly. Examples:
  - limits on quantity of pollution emitted
  - requirements that firms adopt a particular technology to reduce emissions
- **Market-based policies** provide incentives so that private decision-makers will choose to solve the problem on their own. Examples:
  - corrective taxes and subsidies
  - tradable pollution permits



# Corrective Taxes & Subsidies

- **Corrective tax:** a tax designed to induce private decision-makers to take account of the social costs that arise from a negative externality
- Also called **Pigouvian taxes** after Arthur Pigou (1877-1959).
- The ideal corrective tax = external cost.
- For activities with positive externalities, ideal corrective subsidy = external benefit.

# Corrective Taxes & Subsidies

- Other taxes and subsidies distort incentives and move economy away from the social optimum.
- Corrective taxes & subsidies
  - align private incentives with society's interests
  - make private decision-makers take into account the external costs and benefits of their actions
  - move economy toward a more efficient allocation of resources

# Corrective Taxes vs. Regulations

- Different firms have different costs of pollution abatement.
- Efficient outcome: Firms with the lowest abatement costs reduce pollution the most.
- A pollution tax is efficient:
  - Firms with low abatement costs will reduce pollution to reduce their tax burden.
  - Firms with high abatement costs have greater willingness to pay tax.
- In contrast, a regulation requiring all firms to reduce pollution by a specific amount not efficient.

# Corrective Taxes vs. Regulations

Corrective taxes are better for the environment:

- The corrective tax gives firms incentive to continue reducing pollution as long as the cost of doing so is less than the tax.
- If a cleaner technology becomes available, the tax gives firms an incentive to adopt it.
- In contrast, firms have no incentive for further reduction beyond the level specified in a regulation.

# Example of a Corrective Tax: The Gas Tax

The gas tax targets three negative externalities:

- Congestion  
The more you drive, the more you contribute to congestion.
- Accidents  
Larger vehicles cause more damage in an accident.
- Pollution  
Burning fossil fuels produces greenhouse gases.

## ACTIVE LEARNING 2

### A. Regulating lower SO<sub>2</sub> emissions

- Acme and US Electric run coal-burning power plants. Each emits 40 tons of sulfur dioxide per month, total emissions = 80 tons/month.
- Goal: Reduce SO<sub>2</sub> emissions 25%, to 60 tons/month
- Cost of reducing emissions:  
\$100/ton for Acme, \$200/ton for USE

#### Policy option 1: Regulation

Every firm must cut its emissions 25% (10 tons).

**Your task:** Compute the cost to each firm and total cost of achieving goal using this policy.

## ACTIVE LEARNING 2

### A. Answers

- Each firm must reduce emissions by 10 tons.
- Cost of reducing emissions:  
\$100/ton for Acme, \$200/ton for USE.
- Compute cost of achieving goal with this policy:  
Cost to Acme:  $(10 \text{ tons}) \times (\$100/\text{ton}) = \$1000$   
Cost to USE:  $(10 \text{ tons}) \times (\$200/\text{ton}) = \$2000$   
Total cost of achieving goal = **\$3000**

## ACTIVE LEARNING 2

### B. Tradable pollution permits

- Initially, Acme and USE each emit 40 tons SO<sub>2</sub>/month.
- Goal: reduce SO<sub>2</sub> emissions to 60 tons/month total.

#### Policy option 2: Tradable pollution permits

- Issue 60 permits, each allows one ton SO<sub>2</sub> emissions. Give 30 permits to each firm. Establish market for trading permits.
- Each firm may use all its permits to emit 30 tons, may emit < 30 tons and sell leftover permits, or may purchase extra permits to emit > 30 tons.

**Your task:** Compute cost of achieving goal if Acme uses 20 permits and sells 10 to USE for \$150 each.



## ACTIVE LEARNING 2

### B. Answers

- Goal: reduce emissions from 80 to 60 tons
- Cost of reducing emissions:  
\$100/ton for Acme, \$200/ton for USE.

Compute cost of achieving goal:

#### Acme

- sells 10 permits to USE for \$150 each, gets \$1500
- uses 20 permits, emits 20 tons SO<sub>2</sub>
- spends \$2000 to reduce emissions by 20 tons
- net cost to Acme:  $\$2000 - \$1500 = \mathbf{\$500}$

*continued...*

## ACTIVE LEARNING 2

### B. Answers, *continued*

- Goal: reduce emissions from 80 to 60 tons
- Cost of reducing emissions:  
\$100/ton for Acme, \$200/ton for USE.

#### USE

- buys 10 permits from Acme, spends \$1500
- uses these 10 plus original 30 permits, emits 40 tons
- spends nothing on abatement
- net cost to USE = **\$1500**

Total cost of achieving goal = \$500 + \$1500 = **\$2000**

*Using tradable permits, goal is achieved at lower total cost and lower cost to each firm than using regulation.*

# Tradable Pollution Permits

- A tradable pollution permits system reduces pollution at lower cost than regulation.
  - Firms with low cost of reducing pollution do so and sell their unused permits.
  - Firms with high cost of reducing pollution buy permits.
- Result: Pollution reduction is concentrated among those firms with lowest costs.

# Tradable Pollution Permits in the Real World

- SO<sub>2</sub> permits traded in the U.S. since 1995.
- Nitrogen oxide permits traded in the northeastern U.S. since 1999.
- Carbon emissions permits traded in Europe since January 1, 2005.

# Corrective Taxes vs. Tradable Pollution Permits

- Like most demand curves, firms' demand for the ability to pollute is a downward-sloping function of the "price" of polluting.
  - A corrective tax raises this price and thus reduces the quantity of pollution firms demand.
  - A tradable permits system restricts the supply of pollution rights, has the same effect as the tax.
- When policymakers do not know the position of this demand curve, the permits system achieves pollution reduction targets more precisely.

# Objections to the Economic Analysis of Pollution

- Some politicians, many environmentalists argue that no one should be able to “buy” the right to pollute, cannot put a price on the environment.
- However, people face tradeoffs. The value of clean air and water must be compared to their cost.
- The market-based approach reduces the cost of environmental protection, so it should increase the public’s demand for a clean environment.

# Private Solutions to Externalities

Types of private solutions:

- Moral codes and social sanctions, e.g., the “Golden Rule”
- Charities, e.g., the Sierra Club
- Contracts between market participants and the affected bystanders

# Private Solutions to Externalities

- **The Coase theorem:**

If private parties can costlessly bargain over the allocation of resources, they can solve the externalities problem on their own.



# The Coase Theorem: An Example

Dick owns a dog named Spot.

Negative externality:

Spot's barking disturbs Jane,  
Dick's neighbor.

The socially efficient outcome  
maximizes Dick's + Jane's well-being.

- If Dick values having Spot more than Jane values peace and quiet, the dog should stay.



*See Spot bark.*

*Coase theorem: The private market will reach the efficient outcome on its own...*

# The Coase Theorem: An Example

- CASE 1:  
Dick has the right to keep Spot.  
Benefit to Dick of having Spot = \$500  
Cost to Jane of Spot's barking = \$800
- Socially efficient outcome:  
Spot goes bye-bye.
- Private outcome:  
Jane pays Dick \$600 to get rid of Spot,  
both Jane and Dick are better off.
- Private outcome = efficient outcome.

# The Coase Theorem: An Example

- CASE 2:  
Dick has the right to keep Spot.  
Benefit to Dick of having Spot = \$1000  
Cost to Jane of Spot's barking = \$800
- Socially efficient outcome:  
See Spot stay.
- Private outcome:  
Jane not willing to pay more than \$800,  
Dick not willing to accept less than \$1000,  
so Spot stays.
- Private outcome = efficient outcome.

# The Coase Theorem: An Example

- CASE 3:  
Jane has the legal right to peace and quiet.  
Benefit to Dick of having Spot = \$800  
Cost to Jane of Spot's barking = \$500
- Socially efficient outcome: Dick keeps Spot.
- Private outcome: Dick pays Jane \$600 to put up with Spot's barking.
- Private outcome = efficient outcome.

*The private market achieves the efficient outcome regardless of the initial distribution of rights.*

## ACTIVE LEARNING 3

### Applying Coase

Collectively, the 1000 residents of Green Valley value swimming in Blue Lake at \$100,000.

A nearby factory pollutes the lake water, and would have to pay \$50,000 for non-polluting equipment.

- A.** Describe a Coase-like private solution.
- B.** Can you think of any reasons why this solution might not work in the real world?

# Why Private Solutions Do Not Always Work

## 1. **Transaction costs:**

The costs parties incur in the process of agreeing to and following through on a bargain. These costs may make it impossible to reach a mutually beneficial agreement.

## 2. **Stubbornness:**

Even if a beneficial agreement is possible, each party may hold out for a better deal.

## 3. **Coordination problems:**

If # of parties is very large, coordinating them may be costly, difficult, or impossible.

# Summary

- An externality occurs when a market transaction affects a third party. If the transaction yields negative externalities (e.g., pollution), the market quantity exceeds the socially optimal quantity. If the externality is positive (e.g., technology spillovers), the market quantity falls short of the social optimum.

# Summary

- Sometimes, people can solve externalities on their own. The Coase theorem states that the private market can reach the socially optimal allocation of resources as long as people can bargain without cost. In practice, bargaining is often costly or difficult, and the Coase theorem does not apply.



# Summary

- The government can attempt to remedy the problem. It can internalize the externality using corrective taxes. It can issue permits to polluters and establish a market where permits can be traded. Such policies often protect the environment at a lower cost to society than direct regulation.