

- Recall: Adam Smith's “invisible hand” of the marketplace leads self-interested buyers and sellers in a market to maximize the total benefit that society can derive from a market.

But market failures can still happen.

EXTERNALITIES AND MARKET INEFFICIENCY

- An externality refers to the uncompensated impact of one person's actions on the well-being of a bystander.
- Externalities cause markets to be inefficient, and thus fail to maximize total surplus.

EXTERNALITIES AND MARKET INEFFICIENCY

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

EXTERNALITIES AND MARKET INEFFICIENCY

- When the impact on the bystander is adverse, the externality is called a negative externality.
- When the impact on the bystander is beneficial, the externality is called a positive externality.

EXTERNALITIES AND MARKET INEFFICIENCY

- Negative Externalities
 - Automobile exhaust
 - Cigarette smoking
 - Barking dogs (loud pets)
 - Loud stereos in an apartment building



EXTERNALITIES AND MARKET INEFFICIENCY

- Positive Externalities
 - Immunizations
 - Restored historic buildings
 - Research into new technologies

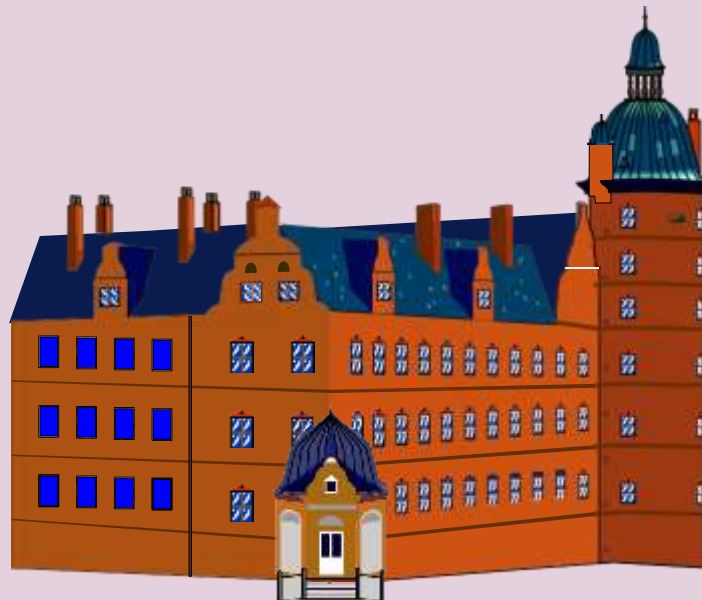
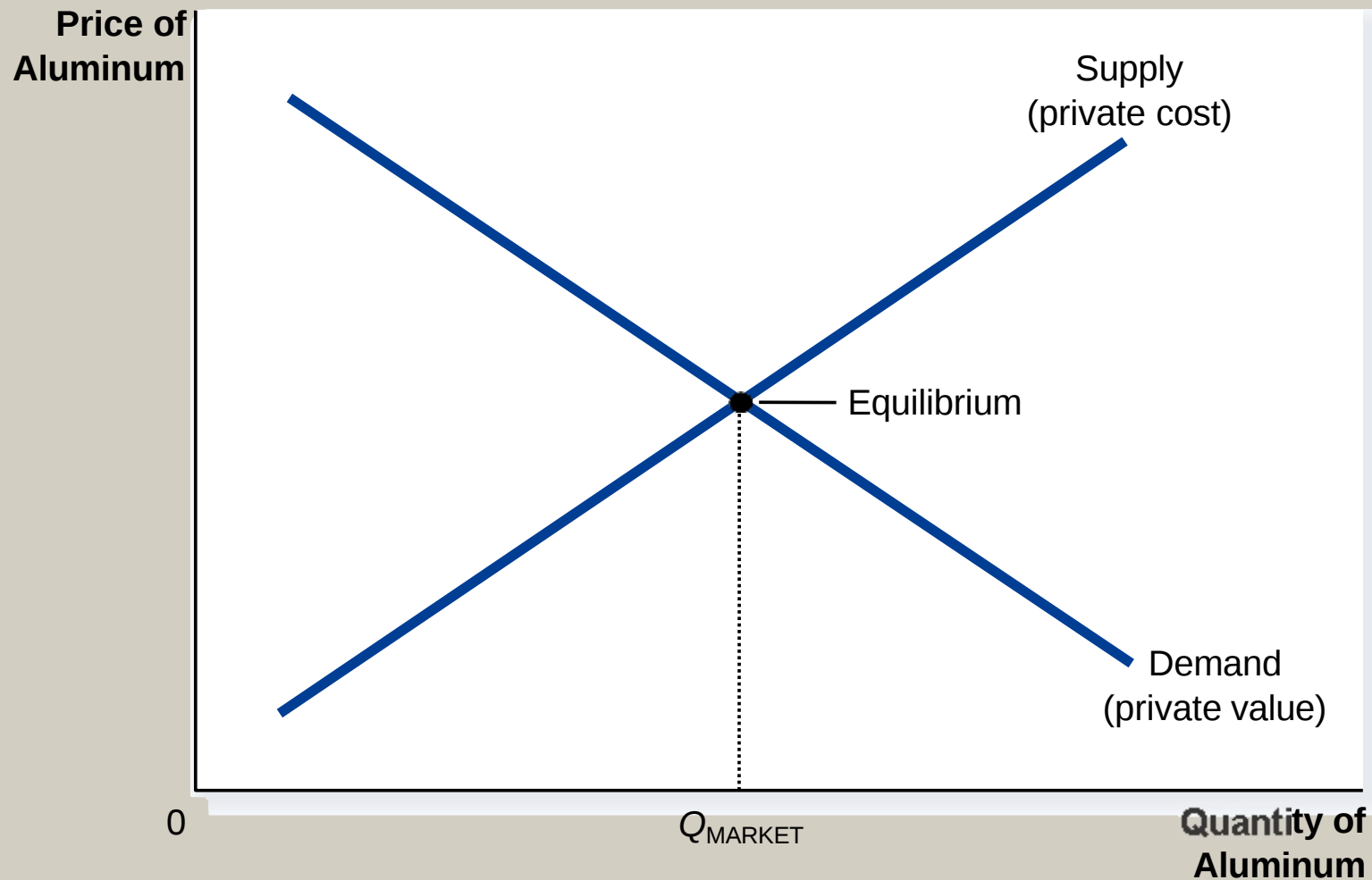


Figure 1 The Market for Aluminum



EXTERNALITIES AND MARKET INEFFICIENCY

- Negative externalities lead markets to produce a larger quantity than is socially desirable.
- Positive externalities lead markets to produce a smaller quantity than is socially desirable.

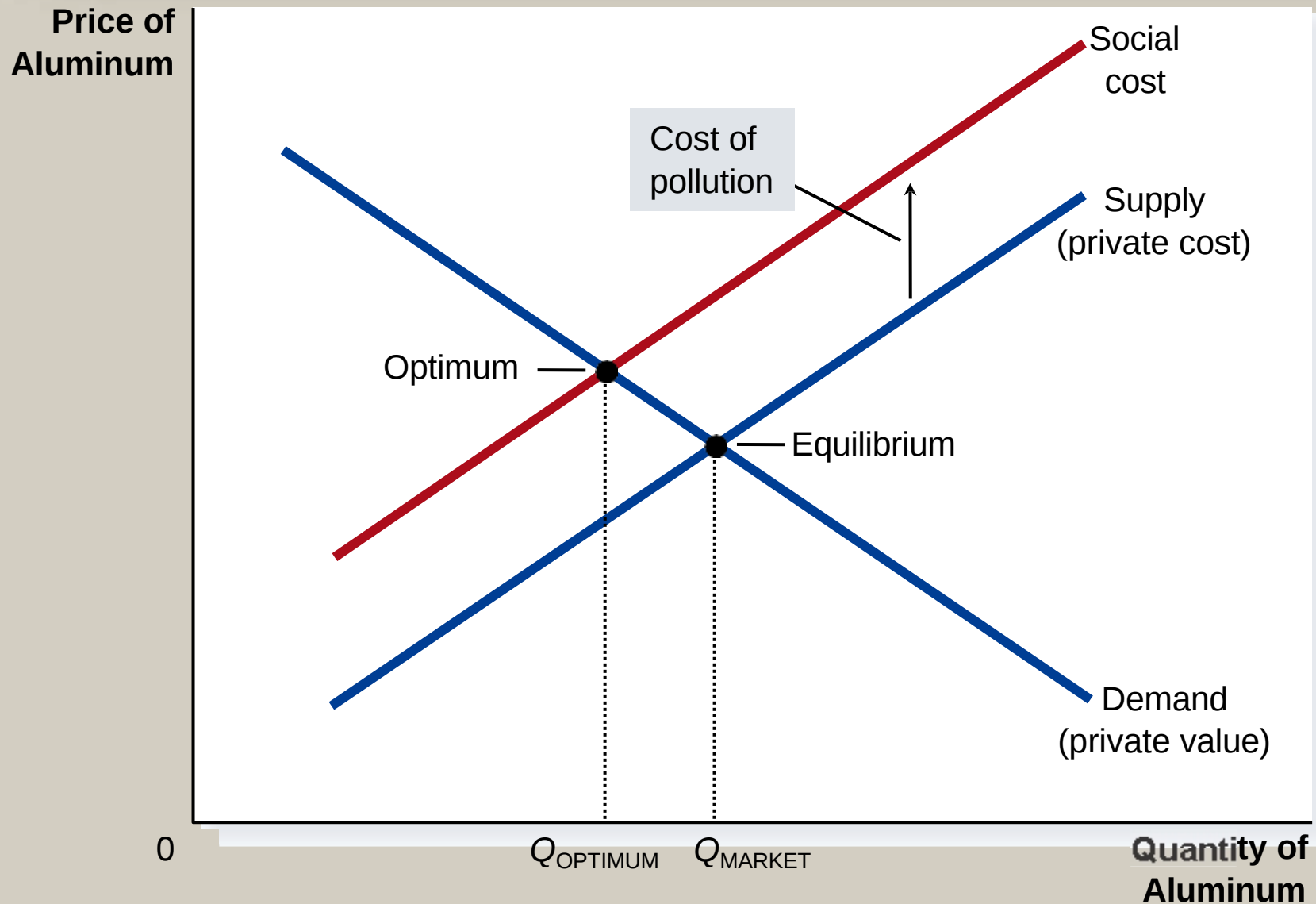
Welfare Economics: A Recap

- The Market for Aluminum
 - The quantity produced and consumed in the market equilibrium is efficient in the sense that it maximizes the sum of producer and consumer surplus.
 - If the aluminum factories emit pollution (a negative externality), then the cost to society of producing aluminum is larger than the cost to aluminum producers.

Welfare Economics: A Recap

- The Market for Aluminum
 - For each unit of aluminum produced, the *social cost* includes the private costs of the producers plus the cost to those bystanders adversely affected by the pollution.

Figure 2 Pollution and the Social Optimum



Negative Externalities

- The intersection of the demand curve and the social-cost curve determines the optimal output level.
 - The socially optimal output level *is less than* the market equilibrium quantity.

Negative Externalities

- *Internalizing an externality* involves altering incentives so that people take account of the external effects of their actions.

Negative Externalities

- Achieving the Socially Optimal Output
- The government can internalize an externality by imposing a tax on the producer to reduce the equilibrium quantity to the socially desirable quantity.

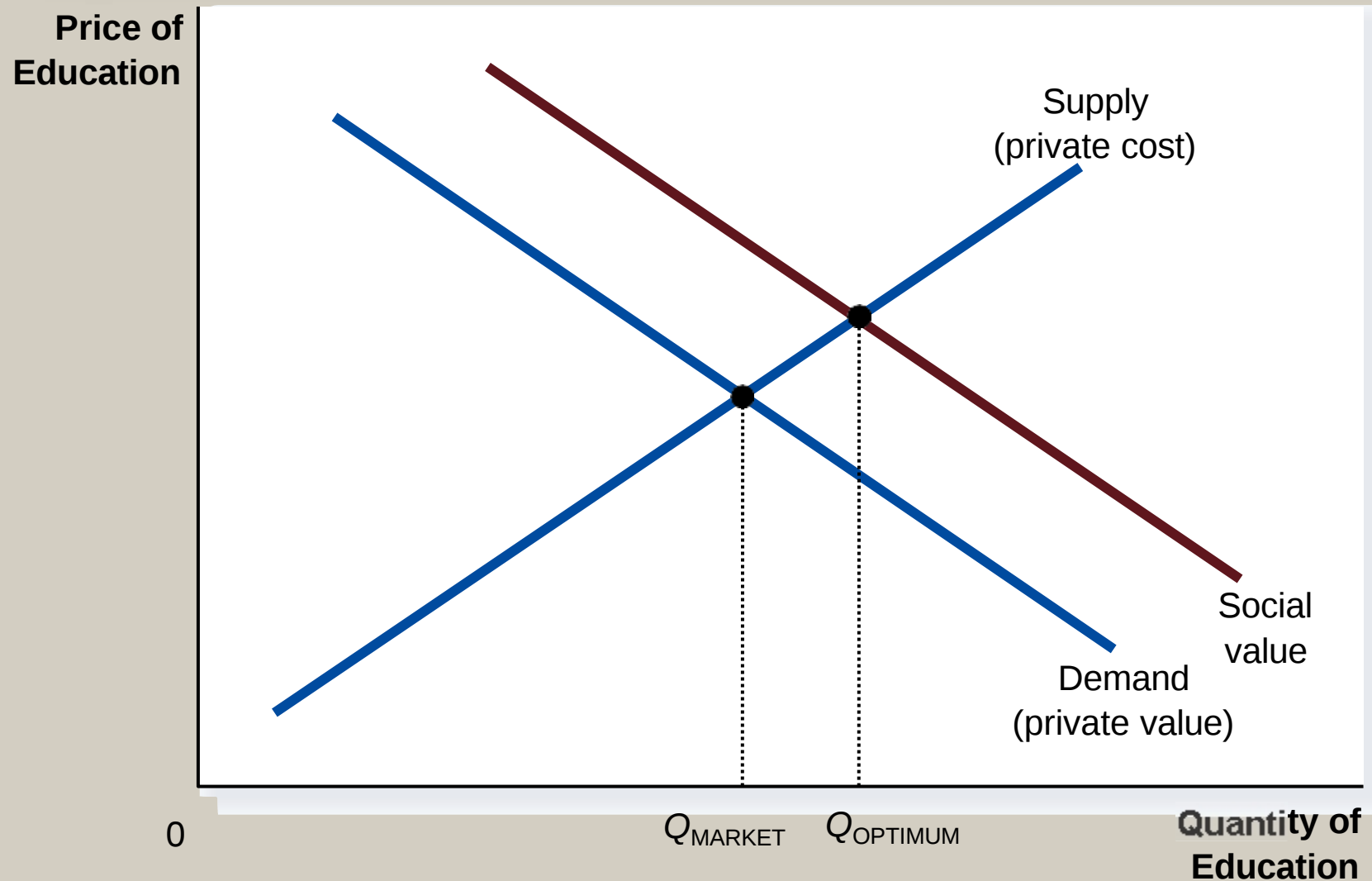
Positive Externalities

- When an externality *benefits* the bystanders, a positive externality exists.
 - The social value of the good exceeds the private value.

Positive Externalities

- A technology spillover is a type of positive externality that exists when a firm's innovation or design not only benefits the firm, but enters society's pool of technological knowledge and benefits society as a whole.

Figure 3 Education and the Social Optimum



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