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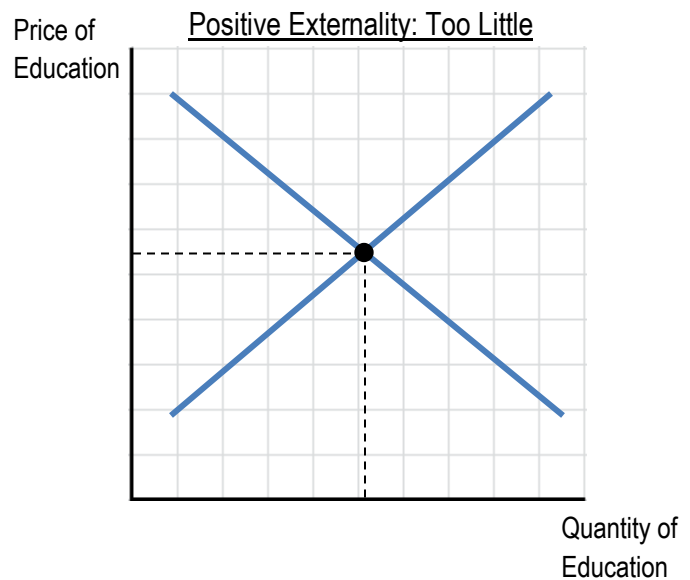
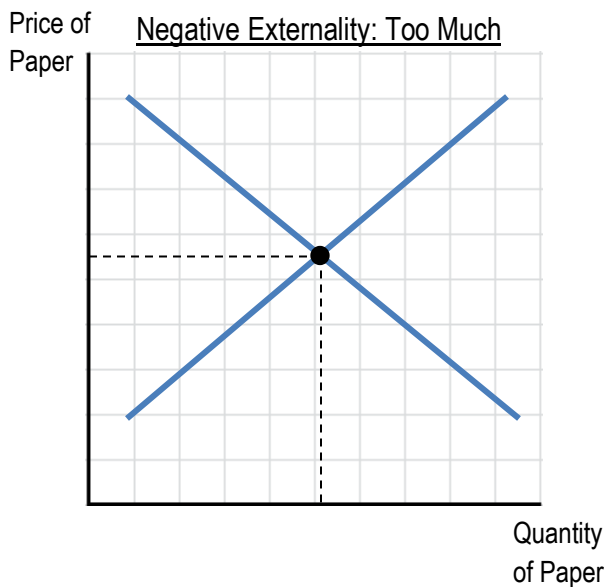
**CONCEPT: EXTERNALITIES – SOCIAL BENEFITS AND SOCIAL COSTS**

- Sometimes a market transaction can impose a cost or benefit on “innocent bystanders.”
  - A **negative externality** ( ) imposes an \_\_\_\_\_ on “innocent bystanders.”
    - The \_\_\_\_\_ cost is borne by the producer of the good.
    - The \_\_\_\_\_ cost is the full cost, including the private cost and the external cost.
    - The **marginal social cost curve** includes all private and external costs in a transaction.

Paper Production		Dog	
<u>Private Cost</u>	<u>External Cost</u>	<u>Private Cost</u>	<u>External Cost</u>

- A **positive externality** ( ) creates an \_\_\_\_\_ for “innocent bystanders.”
  - The \_\_\_\_\_ benefit is received by the consumer of the good.
  - The \_\_\_\_\_ benefit is the full benefit, including the private benefit and the external benefit.
  - The **marginal social benefit curve** includes all private and external benefits in a transaction.

Vaccinations		Education	
<u>Private Benefit</u>	<u>External Benefit</u>	<u>Private Benefit</u>	<u>External Benefit</u>



- Externalities cause **market failures** because the supply and demand curves do not fully reflect cost and benefit.
  - Overproduction ( ) / Underproduction ( )
  - Deadweight Loss
- Externalities exist when \_\_\_\_\_ are difficult to enforce or not clearly defined.

**CH. 7 - EXTERNALITIES**

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**PRACTICE:** Which of the following is an example of a positive externality?

- a) Jim hires Dwight to trim the hedges at his house. Jim pays Dwight \$100 for the service.
- b) While trimming the hedges, Dwight's tools emit smoke that Jim's neighbor, Pam, has to breathe.
- c) Jim's freshly cut hedges make the neighborhood more beautiful.
- d) Jim's community manager will pay him if he promises to keep his hedges trimmed on a regular basis.

**PRACTICE:** If the production of a good causes a negative externality, then the social-cost curve will lie \_\_\_\_\_ the supply curve, and the socially optimal quantity is \_\_\_\_\_ than the equilibrium quantity.

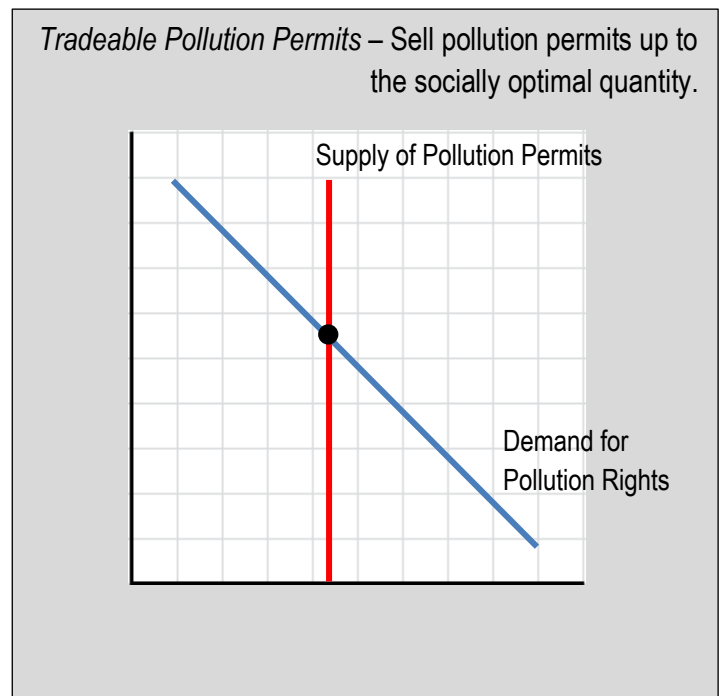
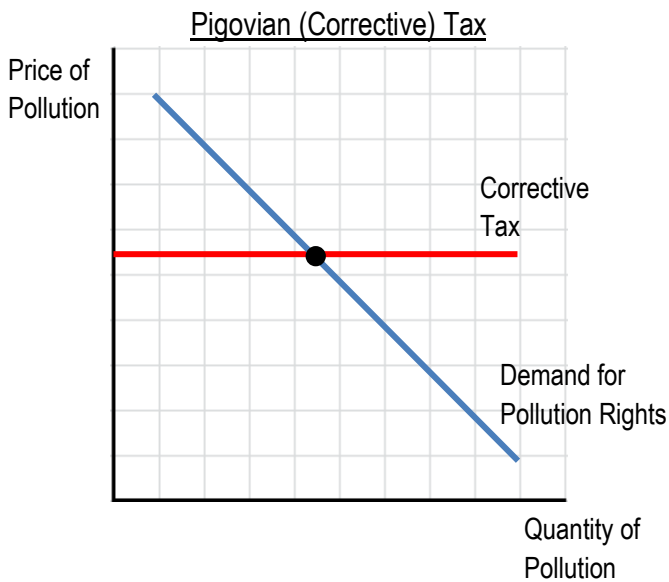
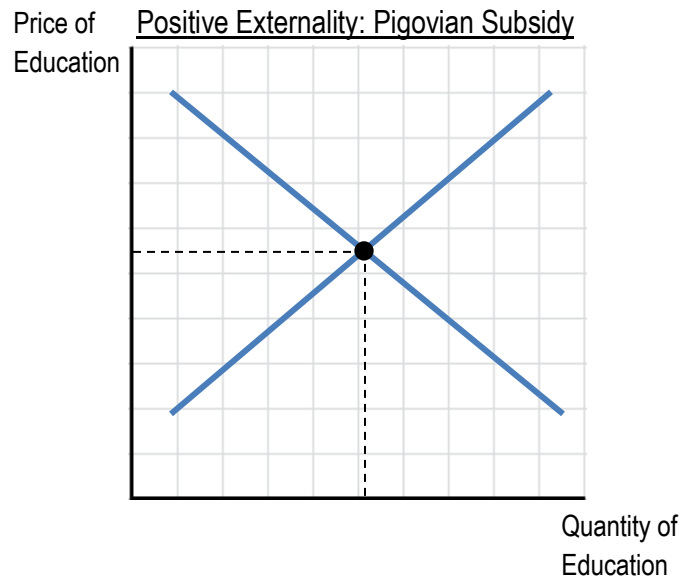
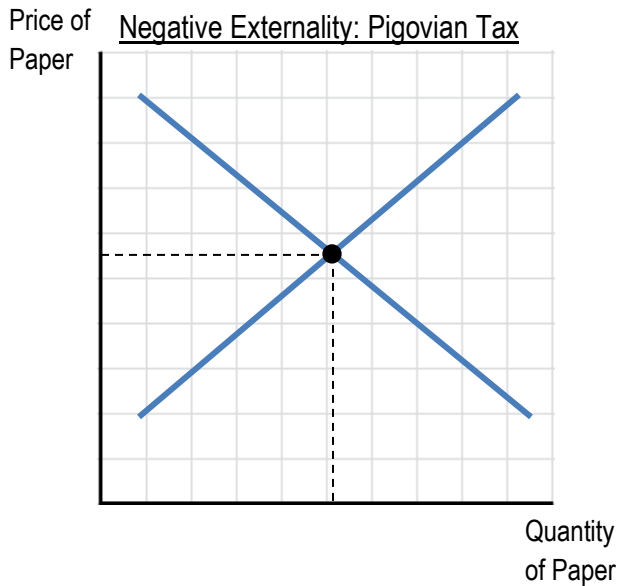
- a) Above; Greater
- b) Above; Less
- c) Below; Greater
- d) Below; Less

**PRACTICE:** Which of the following is true about externalities?

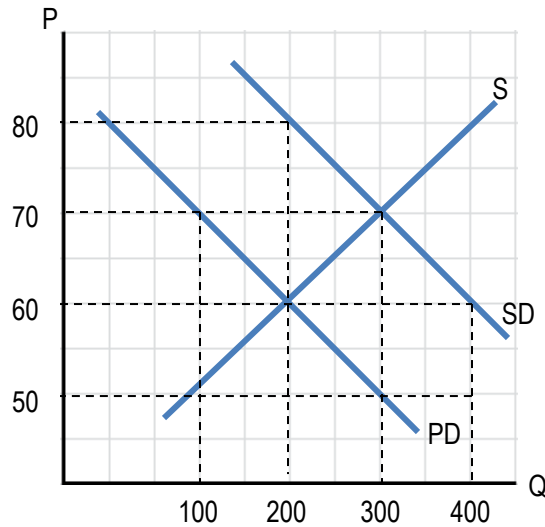
- a) Positive externalities are efficient, but negative externalities are not efficient
- b) Negative externalities are efficient, but positive externalities are not efficient
- c) Both positive and negative externalities are efficient
- d) Both positive and negative externalities are not efficient

**CONCEPT: PUBLIC SOLUTIONS TO EXTERNALITIES**

- **Internalize the externality** – forcing the full cost or benefit of a transaction to be included in the market transaction.
  - **Command-and-control policies** – The government requiring or forbidding certain behaviors
    - Grade School Education ( )                      - Dumping Chemicals ( )
  - **Market-based policies** – The government can implement **corrective taxes and subsidies** or **quantity limits**
    - **Pigovian Taxes and Subsidies** – Impose a tax or subsidy \_\_\_\_\_ to the amount of the externality



**PRACTICE:** Use this diagram to answer the following questions. PD is private demand. SD is social demand.



Based on the figure above, an unregulated market would produce:

- a) 100 units
- b) 200 units
- c) 300 units
- d) 400 units

The figure above contains:

- a) A positive externality
- b) A negative externality
- c) Both positive and negative externalities
- d) No externalities

A per-unit \_\_\_\_\_ would result in the production of the socially optimal quantity.

- a) Tax of \$10
- b) Tax of \$20
- c) Subsidy of \$10
- d) Subsidy of \$20

**CONCEPT: PRIVATE SOLUTIONS TO EXTERNALITIES**

- According to the **Coase theorem**, parties can privately reach an efficient solution to externalities if:
  - Property rights are clearly defined AND
  - Transaction costs are low
    - Time
    - Money
    - Coordination
    - Other Resources

**EXAMPLE:** The barking dog

Owner's benefit of owning a dog:	Owner's benefit of owning a dog:	Owner's benefit of owning a dog:
Neighbor's cost because of loud dog:	Neighbor's cost because of loud dog:	Neighbor's cost because of loud dog:
Property Rights Regarding Noise:	Property Rights Regarding Noise:	Property Rights Regarding Noise:
Possible Coase Theorem Solution:	Possible Coase Theorem Solution:	Possible Coase Theorem Solution:

Note: It doesn't matter which party has the property rights, an efficient outcome is still reached.

**PRACTICE:** A key element of the Coase theorem is:

- a) The ability to negotiate at a minimal cost
- b) That externalities occur in the production and consumption of all products
- c) That there are no efficient solutions to the problems caused by externalities
- d) None of the above

**PRACTICE:** Which of the following is not a way of dealing with externalities?

- a) Internalization
- b) Raising taxes
- c) Increasing competition
- d) Creating an additional market

**PRACTICE:** If the assumptions of the Coase theorem are satisfied, then

- a) The externality problem is resolved.
- b) The assignment of property rights does not matter for efficiency.
- c) There are no coordination and motivation problems.
- d) There is no role for the government.

**PRACTICE:** It is possible to remedy a positive externality by:

- a) Introducing a tax
- b) Introducing a subsidy
- c) Doing nothing because it is good to have positive externalities
- d) None of the above

**PRACTICE:** The socially optimal level of pollution:

- a) Is zero.
- b) Is constant.
- c) Is above zero.
- d) None of the above