

6 Externalities – Part 1

Name: _____ Class: _____ Date: _____

Vocabulary

Write each word three times.

English

Write it 3 times (English)

externality

negative external-
ity

positive external-
ity

Pigovian tax

Recall

Markets usually work well, but not always:

- A factory's pollution harms people who had nothing to do with it.
- A vaccination protects not just you but everyone around you.
- Sometimes the government steps in to fix a problem.

This sheet lines up externalities. Each idea has a worked example.

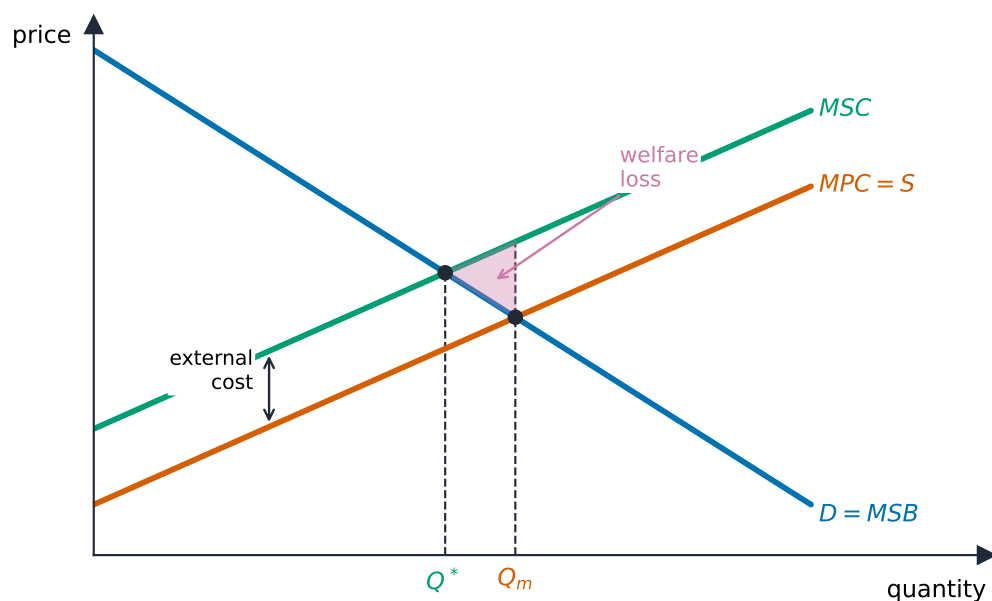
New ideas

■ 1 Externalities

An **externality** is a cost or benefit that falls on a **third party** not involved in a transaction – so buyers and sellers ignore it.

■ 2 Negative externalities

A **negative externality** (like pollution) means the true cost to society is **higher** than the private cost, so the market **over-produces**.



■ 3 Positive externalities

A **positive externality** (like vaccination or education) means society benefits **more** than the private buyer, so the market **under-produces**.

■ 4 Fixing them

- A **Pigovian tax** on a negative externality makes producers pay for the harm, cutting output to the right level.
- A **subsidy** on a positive externality encourages more of it.

Worked example. A factory's private cost is \$8 per unit, but each unit also causes \$3 of pollution. A tax of \$3 per unit raises the firm's cost to the true social cost of \$11, so it produces the efficient amount.

Watch out: with a negative externality the market makes **too much** (it ignores the harm); with a positive externality it makes **too little** (it ignores the extra benefit). The fixes go in opposite directions.

Practice

Try these in order. The methods are all above.

2.1 State what an externality is.

[2]

2.2 Give one example of a negative and one of a positive externality. [2]

2.3 State whether the market over- or under-produces a good with a negative externality. [1]

2.4 A factory's private cost is \$10 per unit and it causes \$4 of pollution per unit. State the Pigovian tax that would correct this. [2]

2.5 State the tool a government uses to encourage a good with a positive externality. [1]
