

ECON 203: Principles of Microeconomics

Class 11: Externalities

Knowledge Recap

- In general, free market equilibrium is efficient.
 - Maximizes total surplus (CS+PS).
 - Goods are allocated to buyers who value them most and produced by sellers with the lowest possible costs.
- Market efficiency relies upon two main assumptions:
 - Markets are perfectly competitive.
 - Market outcomes matter only to buyers and sellers in the given market.
- Market failure may occur if either or both of these assumptions are violated.
 - Markets that are not competitive may lead to *market power*.
 - People outside a market may be affected by *externalities*.

Externalities

- Externalities occur when an action results in a cost or benefit for a bystander that is not reflected in a cost or benefit for the person taking the action.
 - Negative externalities occur when the impact on the bystander is adverse, for example pollution.
 - Positive externalities occur when the impact on the bystander is beneficial, for example vaccination.
- Externalities may result in market failure.
 - The buyers and sellers neglect the external effects of their actions on bystanders.
 - Maximal social welfare has to consider the well-being of bystanders together with that of the buyers and sellers.