CONCEPT: PUBLIC SOLUTIONS TO EXTERNALITIES

● *Internalize the externality* – forcing the full cost or benefit of a transaction to be included in the market transaction.
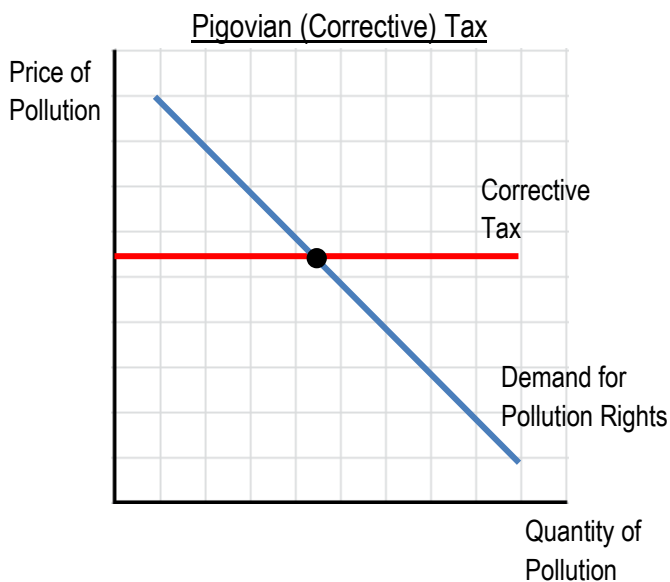
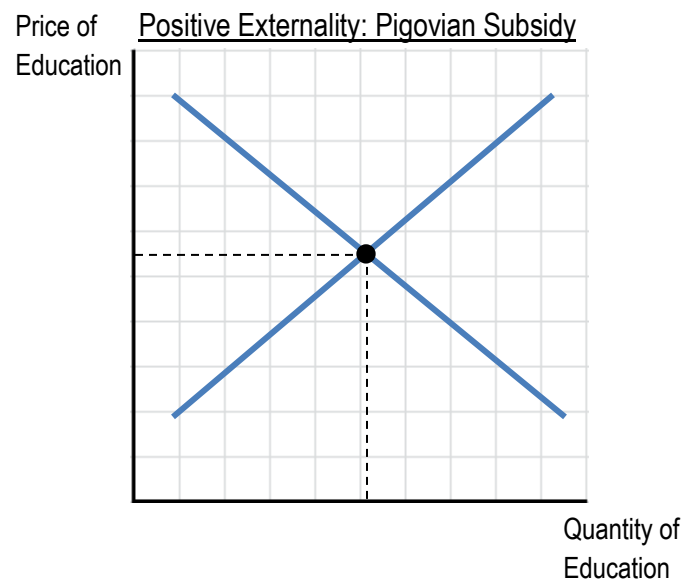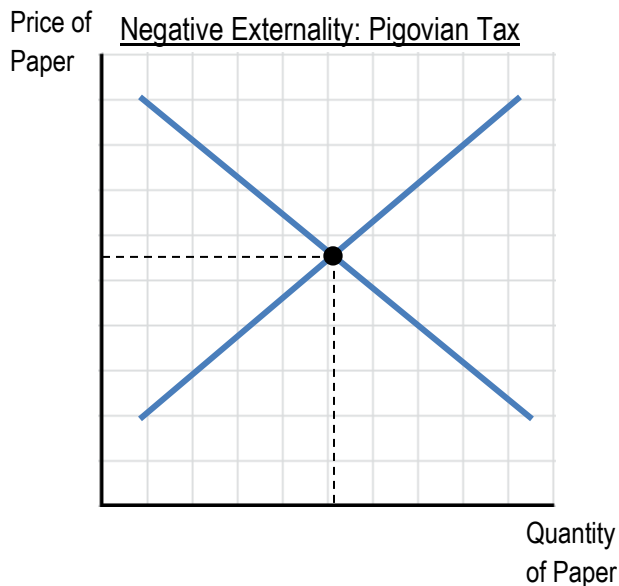 □ *Command-and-control policies* – The government requiring or forbidding certain behaviors

    - 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

Price of Paper

Negative Externality: Pigovian Tax

Quantity of Paper

Price of Education

Positive Externality: Pigovian Subsidy

Quantity of Education

Pigovian (Corrective) Tax

Price of Pollution

Corrective Tax

Demand for Pollution Rights

Quantity of Pollution

Tradeable Pollution Permits – Sell pollution permits up to the socially optimal quantity.

Supply of Pollution Permits

Demand for Pollution Rights
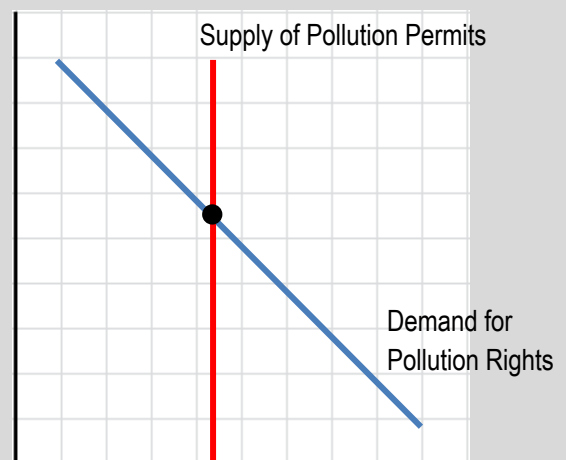
PRACTICE: Use this diagram to answer the following questions. PD is private demand. SD is social demand.
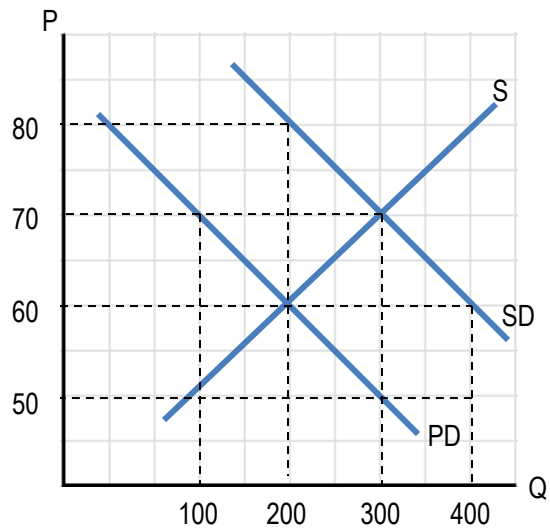
Based on the figure above, an unregulated market would produce:

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