11.2 Lecture 24: Externalities

11.2.1 Externality theory

- An **externality** occurs whenever the actions of one party make another party worse or better off, yet the first party neither bears the costs nor receives the benefits of doing so.

- **Negative externality**: negative impacts on society which the individual does not pay for. Must abide by two conditions:
  - Costs on others, not self
  - Costs that the individual doesn't pay for
  - For example: smoking, drinking
  - Individuals tend to overconsume these as they do not bear all of the costs

- Society wants individuals to internalize the externality – price of the good includes the cost of the good to society.

11.2.2 Government solution

- Government has its regulation: if the government knows what the socially optimal outcome is, the government can just impose it.

- Government can impose a corrective tax of the magnitude of this externality. As a result, the tax effectively internalizes the externality and leads to the socially optimal outcome.

11.2.3 TO KNOW – Conceptual Understanding

- Describe what externality is, describe examples and impacts of negative externality

- Describe ways how government deals with externality