

Answer on Question #44495 – Economics - Finance

you know that the water park will increase the traffic flow in the streets around the water park. there both businesses and neighborhoods adjacent to the increased traffic flow. the cost to the community is estimated to be \$6 per person. what kind of externality is this? why?

Solution

It is a kind of negative externality, because people, who live near water park, have costs from the increased traffic.

A negative externality occurs when an individual or firm making a decision does not have to pay the full cost of the decision. If a good has a negative externality, then the cost to society is greater than the cost consumer is paying for it. Since consumers make a decision based on where their marginal cost equals their marginal benefit, and since they don't take into account the cost of the negative externality, negative externalities result in market inefficiencies unless proper action is taken.

When a negative externality exists in an unregulated market, producers don't take responsibility for external costs that exist--these are passed on to society. Thus producers have lower marginal costs than they would otherwise have and the supply curve is effectively shifted down (to the right) of the supply curve that society faces. Because the supply curve is increased, more of the product is bought than the efficient amount--that is, too much of the product is produced and sold. Since marginal benefit is not equal to marginal cost, a deadweight welfare loss results.