

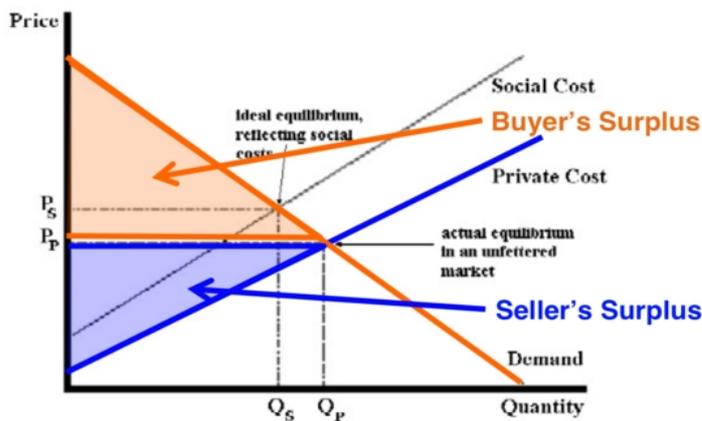
Answer on Question #46645, Economics, Macroeconomics

An externality (an action that has an uncompensated effect on someone else) causes the market equilibrium to fail to maximize the total benefit to a society. The government must then influence the behaviour of buyers and sellers through Pigovian taxes (a tax that equals the cost on the bystanders) and subsidies.

A negative externality has a negative effect on bystanders causing the cost to society (social cost) to be greater than the private cost to the suppliers. The social cost curve lies above the private cost curve and the difference between the two is the cost of the good on the bystanders. The government uses a Pigovian tax to influence sellers to produce the good at the social cost, causing the price of the good to increase and therefore the quantity demanded to decrease. The intersection between the social cost curve and the demand curve becomes the optimum quantity.

A positive externality has a positive effect on bystanders causing the value to society (social value) to be greater than the private demand of the buyers. The social value curve lies above the private value (demand) curve and the difference between the two is the value of the good on the bystanders. The government subsidizes sellers to influence sellers to produce more of the good at the quantity where the social value curve intersects the private cost (supply) curve. This becomes the optimum quantity.

Social Costs



Social Benefits

