**Distinguishing between**

**consumption externalities and production externalities**

It is important to be able to distinguish between consumption and production externalities. Externalities can be positive or negative but you must also indicate from which perspective you are viewing them.

An externality is

It is a form of market failure because

MSC = +

MSB= +

Externalities are generated in consumption and production

MSC MPC = externalities in

MPC MSC = externalities in

MSB MPB= externalities in

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Externalities arising from consumption lead to a divergence between

Externalities arising from production lead to a divergence between

**Negative Externalities in production an example:**

A chemical manufacturer generates externalities for example waste dumped in the river or pollution of air. If left to the free market too much of the pollution would be generated and dumped on the third parties outside the market. This is because the functions of prices (in this case the incentive function breaks down). The diagram below shows a negative production externality.

To achieve the socially optimal level of production the government could intervene in the market and levy a pollution tax on the company that owns the chemical manufacturer which would lead to an inward shift of the supply curve and a reduction in the amount of pollution produced. However you would need to take into consideration the possibility of government failure resulting from such an intervention.

**A positive production externality**

A forestry company can generate positive externalities in production for example more trees would help to offset the problems of greenhouse gasses, avoid soil erosion etc. If left to the free market too few trees would be planted because the firms only take account of the private costs. How could this be solved? The government could provide a subsidy to encourage firms to plant more trees which would lead to an outward shift of the supply curve. Focusing only on production (i.e. costs) how would you illustrate the positive production externality?

**A positive consumption externality**

An inoculation programme brings not only benefits to the individual but benefits to third parties. However if left to the free market it would be underconsumed. The free market level of consumption would be less than the socially level of consumption. How would we show this taking into consideration consumption only.

**A negative consumption externality**

Consuming alcohol and cigarettes (demerit goods) while resulting in benefits to the individual lead to a negative benefit to the rest of society. If we focus on consumption only the free market level of consumption would be higher than the socially optimal level of consumption. How would we show this taking into consideration consumption only.