

Externalities

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- Robbins points out another important limitation of the “free markets” of neoclassical economic ideology
 - people with no money cannot influence the market by buying certain goods and not others
 - that is, markets by definition do not serve the very poor
- Robbins also makes a good point about the reality of nation-states and markets
 - most societies decide that some goods and services are optional, and can be handled by free markets
 - luxury goods
 - housing, cars, food, etc.
 - but others are too important to leave to markets, so the state handles their distribution
 - odd, if markets are the best way to provide everything...
 - such as
 - water
 - education
 - old-age income
 - health care (to varying degrees!)
 - food and shelter for the very poor
- **Market externalities**
 - Robbins’ definition is a bit broad: “specific consequences of the working of the market”
 - a technical and more correct definition
 - **market externality**: costs or benefits of a market transaction that affect not the buyer or seller, but a third party
 - externalities may be positive (benefits) or negative (costs)
 - but negative externalities are more common
 - this is a standard economic concepts that all economists recognize
 - examples
 - negative externality:
 - A company manufactures and sells tires.
 - The company profits from selling the tires
 - The buyers gain the advantage of using the tires
 - The people living around the factory suffer the health effects of breathing the factory’s smoke
 - these people are neither buyers nor sellers in this scenario
 - they have no impact on the transaction
 - but they bear the cost of breathing the smoke
 - this cost is the negative externality
 - positive externality:
 - 90% of the population pays for flu shots
 - the vaccine company makes a profit

- the 90% of the population gains better health
- the remaining 10% also gain better health, because they rarely encounter anyone who is sick
- but they have not paid for the vaccine
 - these “freeloaders” are neither buyers nor sellers here
 - but they get the benefit of reduced risk of flu anyway
 - this benefit is the positive externality
- a classic positive externality: education
 - the student pays a school or university for education
 - the school or university profits (or meets its goals, etc.)
 - the student reaps the benefits
 - earnings
 - social class and prestige
 - personal satisfaction and intellectual enrichment
 - but the rest of society also benefits
 - from the student’s greater contributions to the economy
 - inventions, discoveries, entertainment, etc.
 - the student is less likely to commit crimes, require public aid, etc.
 - we think this positive externality is so large that we pay taxes to subsidize the price so plenty of students make the purchase
 - well, less so in recent years...
- both positive and negative externalities prevent the free market from optimally allocating resources among competing demands
 - the virtue of the free market (in theory and to some extent in practice) is that it balances costs and benefits, minimizing costs and maximizing production of what people most want
 - but it cannot do that if some of the costs or benefits are taken out of consideration
 - imagine you are literally balancing costs and benefits in a scale
 - where the total of the transactions by buyers and sellers will balance out the costs they are willing to pay for the benefits they receive
 - you only truly balance all the costs and benefits if they are all on the pans of the scale
 - if, say, some of the costs are borne by people not involved in the transactions
 - then the buyer is not paying all of the costs
 - and does not count those costs when deciding how much to pay for the benefits
 - the total costs, including those paid by people not involved in the transaction, will be greater than the benefits
 - this is a negative externality: additional costs, not counted by the buyer and seller, are paid by some third party
 - thus the total costs to society are greater than the benefits
 - example: neighbors who suffer from pollution put out by a factory
 - if, say, some of the benefits are gained by people not in the transaction
 - then fewer resources will be expended than should be for this good

- those other resources will be used for other things, and a less-than optimal amount of the benefits will be produced
- example: education
 - companies benefit from an educated workforce, but do not pay for it
 - so overall, less will be spent on education than the benefits would justify
- the problem with negative externalities is obvious
- the problem with positive externalities is that the free market does not take them into account, either
 - the producer does not get rewarded for them
 - so there is no market incentive to produce this good
 - so not enough will be produced to meet the demand
- in real life, externalities are much more complex
 - as in the many, many social, environmental, health, etc. costs borne by multiple third parties, in multiple countries, who are not directly involved in the sale of a cup of coffee
- the key point of externalities: the people who bear these costs have no direct influence on the players in the market
 - since they don't sell to, buy from, or work for the company
 - the free market has no way of taking these costs into account
 - so while the market IS good at producing the most and best goods at the lowest cost
 - that only includes the cost paid by the buyer
 - if there are other costs (and there usually are), the free market does NOT produce a socially optimal result
 - the people who bear these costs can influence the company's behavior only outside of the free market, using
 - politics to pass laws
 - courts to enforce laws
 - PR campaigns to influence those who *are* in the market for the good
 - demonstrations or riots
 - threats or violence
 - there is nothing illegitimate about these people's demands
 - they are simply responding to a cost for which they are getting no benefit in return
 - they are objecting to a company avoiding the pressures of the free market to truly minimize costs by imposing some of its costs on uninvolved third parties
- Examples of typical negative externalities
 - pollution, destruction of the landscape
 - social ills such as poverty, slavery, hunger, disease, war, terrorism
 - psychological ills such as alienation, depression, stress, desperation, etc.
 - corruption; reduction of social values and relations to monetary ones; loss of respect for the old, parents, etc. ; loss of traditions; etc.
 - distortion of the political system
 - corporations influence laws in their interest, rather than the public's
- Ways to look at externalities

- All other things being equal, the lower the price, the more of the cost is shifted from buyers to third parties as externalities
 - caused by the low wages required to keep the price low
 - caused by the cheaper factories that do less to control their pollution
 - caused by demanding cheaper inputs, and thus abuse of other producers, environment, etc.
 - Not all price reductions are due to increased externalities
 - but many are
- “We want clean air, clear water, good living conditions... yet we aren’t willing to pay for anything manufactured under those restrictions”
 - (Dobbins, in Fishman, cited by Robbins...)
 - when we (rationally) select the lowest price, we often select goods made in places with fewer environmental regulations
 - thus goods that impose more negative externalities on people we never meet