

PUBLIC FINANCE

UNIT – I EXTERNALITIES

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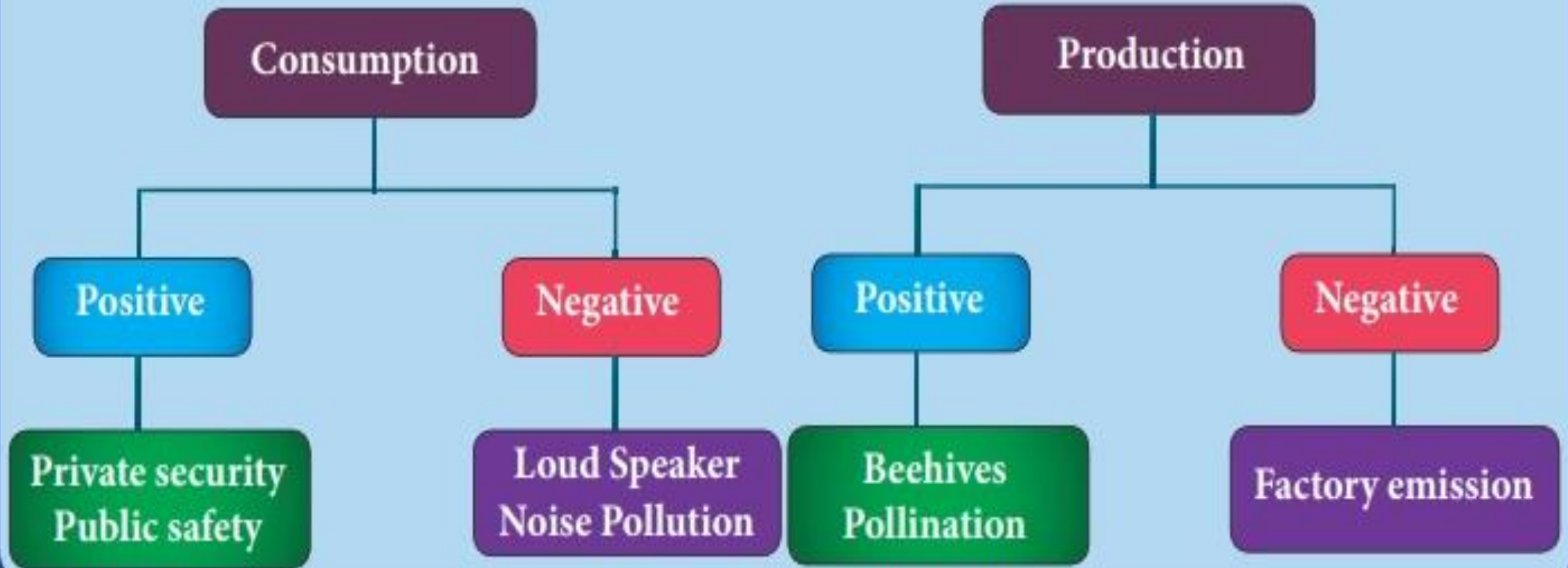
DEFINITION

Externality may be defined as “the cost or benefit imposed by the consumption and production activities of the individuals on the rest of the society not directly involved in these activity and towards which no payment is made”.

CLASSIFICATION

The externalities arise from both production and consumption activities and their impact could be beneficial or adverse. Beneficial externalities are called "positive externalities" and adverse ones are called "negative externalities".

Classification of Externalities



POSITIVE CONSUMPTION EXTERNALITY

When some residents of a locality install CCTV cameras to monitor their area, the other residents of the area also benefit from better security without bearing cost.



NEGATIVE CONSUMPTION EXTERNALITY

A person smoking cigarette may give satisfaction to that person, but this act causes hardship (dissatisfaction) to the non-smokers who are driven to passive smoking.



POSITIVE PRODUCTION EXTERNALITY

Suppose training is given for the workers in a company. If those trained workers leave the company to join some other company, the later company gets the benefit of skilled workers without incurring the cost of training.



The ideal location for beehives is orchards (first growing fields). While bees make honey, they also help in the pollination of apple blossoms. The benefits accrue to both producers (honey as well as apple). This is called 'reciprocal untraded interdependency'.



NEGATIVE PRODUCTION EXTERNALITY

The emissions and effluents of a factory cause air and water pollution. Water becomes contaminated and unfit for drinking e.g. Tanneries. The innocent community bears the external cost for which it is not compensated.



Air pollution
from factories



Pollution from
fertilizers



Noise pollution



Industrial waste



Collapsing fish
stocks



Methane
emissions


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graph TD; A([Fiscal Measures in controlling externalities]) --> B([Subsidies for Positive Externalities]); A --> C([Taxes for Negative Externalities]);
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Fiscal Measures in controlling externalities

Subsidies for
Positive
Externalities

Taxes for
Negative
Externalities

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graph TD; A[Other Policy Instruments] --> B[Command and Control Method]; A --> C[Capping and Trading of pollution rights]
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Other Policy Instruments

Command
and Control
Method

Capping
and Trading
of pollution
rights