

Introduction to externalities

This exercise is designed to get students to think about the difference between external costs and benefits in consumption and production.

You may already have touched on this, but if not it is important that students understand at least partially what is meant by an external cost (a negative side effect that affects a third party or something like this – a precise definition is unimportant at this point) and an external benefit (a positive side effect affecting someone that isn't the consumer or producer).

It is also important that they understand that these side effects can occur either when the good or service is made (a production externality) or when it is used (a consumption externality) – although in reality the distinction may be a little blurred.

Instructions:

Divide the students into pairs or threes and give them:

- an A3 sheet with the grid and images to cut out from the Externalities Printable resource.

Then ask the students to decide in each case:

- where to place each good or service on the grid;
- what the external cost or benefit is;
- who is impacted by the external cost or benefit and why;
- why is each one a problem for a free market (over/under consumption is the basic idea).

Invite them to the whiteboard to use the interactive resource to give a clear idea of where agreements and disagreements are.

The students can now feed back their ideas to the group as a whole and a fairly clear idea should emerge of:

- what the difference is between a production and a consumption externality;
- what the difference is between an external cost and an external benefit;
- why they all create problems for a free market.

Possible answers

Health: External benefit in consumption (reduced contagion, impact on businesses from healthier workforce).

Education: External benefit in consumption (better skilled workforce, reduced training costs for firms).

Facebook: External benefit in consumption (network effects – one extra user makes it more valuable to existing users. However, there are also negatives, obviously).

Smoking: External cost in consumption (passive smoking, drain on NHS).



Power generation: External cost in production (CO₂ emissions causing flooding elsewhere in the world etc.).

GSK: External benefit in production (research and development makes profit for GSK but also benefits third parties as cures are found).

Starbucks: This is highly arguable. External benefit in production (free Wi-Fi – we can ‘free ride’). External cost in consumption (litter etc.).

Beer: External cost in consumption (Anti-social behaviour, drain on NHS).
External cost in production (industrial pollution into rivers).