

Externality



An externality can be defined as a substance that doesn't have monetary effect on the manufacturer of a product, but has an influence on the living standard of people entirely (Frank, 2008; Holcombe, 2006).

A positive externality is that which benefits humanity, except in a way that the manufacturer is not capable of entirely profiting from the achievements made (Caplan, 2008; Holcombe, 2006). On the other hand, a negative externality is the one that incurs nothing on the producer, but it is generally expensive to the people.

According to Holcombe (2006,) research and a clean up of the environment is an example of a positive externality, since it tends to benefit the society even if the companies responsible for the developments do not fully gain from it. A good example of this is the pollution that has a negative externality, since the companies polluting do not lose any money, but the people are the ones who pay heavily when looking for the solution that the pollution causes (Frank, 2008; Caplan, 2003).

The government forces firms to interiorize costs of externality. It does this by ensuring that those externalities that are harmful to the society, the effects are catered for by the firm itself, for example, if pollution leads to diseases, then the firm polluting meets the medical costs of those who get sick (Caplan, 2008). To do this, the government uses several ways of regulation like taxing firms for polluting, pollution restrictions or handing out of tradable contamination permits (Caplan, 2008).

The benefits of government policies is that they tend to reduce negative externality due to the strict laws against those firms contributing to them

and it also helps to control agreements, which as a result lead to fair allocation of resources (Caplan, 2008). On the other hand, the strict laws discourage researchers from setting up firms, thereby discouraging developments from taking place.

Externalities can be dealt with through negotiations. This may be between the society and the companies setting up or between the firm and the governments. Negotiations help in that it reduces the rate of harm that may do to the society and environment (Frank, 2008).