

**Key advantages:**

- there is an incentive for firms to take into account both the private costs and the external costs
- firms caught polluting could be fined and the money used to compensate those damaged
- the costs of administering these schemes are low relative to those associated with systems of regulation

**Key disadvantages:**

- there is the initial problem of assigning property rights
- if a breach of property rights has occurred, there may be an expensive legal procedure to determine how much compensation should be paid and to whom
- it may be difficult to agree on the monetary value of the external cost

**Legal restrictions**

Measures could include:

- a complete ban on the product
- regulations which place limits on the production process or on the amount of pollution allowed

In theory, this should restrict pollution to the required level, but without enforcement firms may not meet the legal requirements. To ensure that the law is upheld, considerable enforcement costs (e.g. inspectors) may be required.

**Now test yourself**

Tested

**8** A firm producing chemicals pays another firm for its raw materials and pays an average wage of £35 000 to its workers. It discharges its waste into a river adjacent to the factory which causes the fish to die. Fishermen downstream suffer from a loss of income. Farmers pay the chemical company £100 per kilo for the fertiliser produced by the chemical company.

- (a) In the above extract, which are private costs and which are external costs?  
 (b) What factors make it difficult to determine how much tax to place on a company producing external costs?

**Answer on p. 104**

## Positive externalities (external benefits)

These are benefits to third parties — i.e. other than to the producer or consumer directly involved in the transaction. They are spillover benefits from the production or consumption which the market fails to take into account.

### External benefits of consumption

Revised

**External benefits** of consumption include:

- commercially owned bees pollinating the fruit trees of local farmers
- households with well-kept gardens increasing the market value of neighbouring properties
- a chemical firm discharging clean water increasing the productivity of a trout farm downstream

**External benefits** are benefits in excess of private benefits which affect third parties who are not part of the transaction.