

## Handout 11-1 (concluded)

power. Among the third-party benefits might be flood control for downstream residents and a lake for recreation. People whose homes are no longer subject to floods or who fish, swim, and go boating in the lake would also benefit from the dam. However, in the absence of a subsidy or other nonmarket means of reducing producer costs, goods with external benefits tend to be underproduced in an unregulated market. Thus, if the dam must be paid for from electricity charges only, it might not be built, because the electricity charge alone may not be sufficient to permit the dam to operate at a profit.

Because an unregulated market overproduces products with external costs and underproduces products with external benefits, government may intervene to correct these situations. For instance, the government sometimes takes action designed to raise the

price of products that impose external costs. It can require firms to meet certain pollution standards. This increases costs of production, decreases supply, and raises the equilibrium price. Less of the product will be produced than in an unregulated market. There also will be less pollution.

The government sometimes subsidizes the production of products with external benefits. If the government finances part of the cost of a hydroelectric dam, the dam may become practical to build. If the power company had to pay all the costs, it might not build the dam: consumer demand for a recreational lake is not reflected in the demand for electricity.

Private market decisions that are motivated by self-interest tend to ignore external costs and benefits. In those situations, a case may be made for government intervention.