Handout 11-1

THIRD-PARTY COSTS AND BENEFITS

Name ____ Class ____________

Third-party costs and benefits—or externalities—are the effects of production or consumption of a good or service on people (the third parties) who are not involved in the transaction.

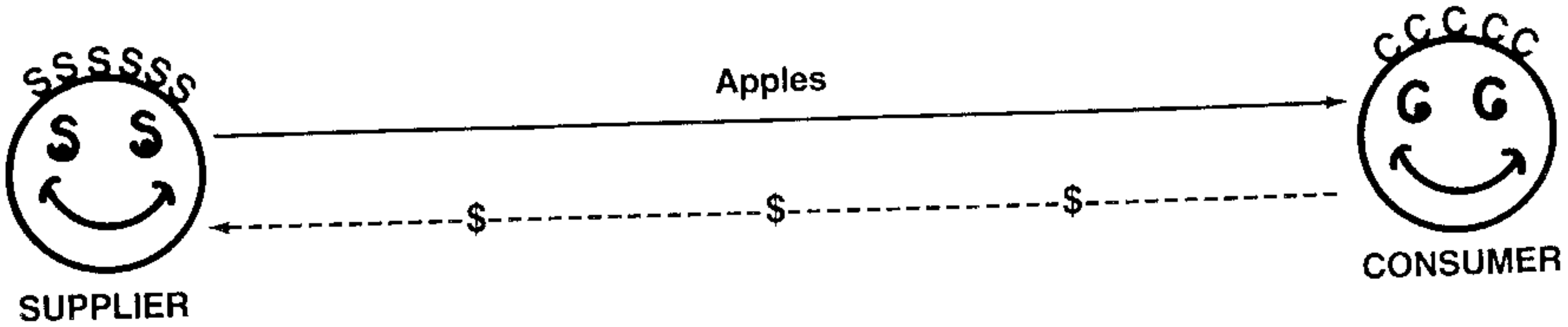
To understand externalities, let's first look at a transaction that has none. Figure 1 shows the market interaction between a supplier and a consumer of a good. Let's say they are producing and consuming organically grown apples. The supplier is one of several producers of apples, and the consumer is one of many consumers of apples. In the transaction, our apple eater receives the apples and in turn pays the farmer, as indicated by the lines. The supplier has absorbed many costs of production but is satisfied with the transaction because of the payment received from the consumer. The consumer is happy with the transaction because of the benefit derived from eating the apples. In such transactions, the producers and consumers bear all the costs and benefits. Suppliers pay all costs of production; no one else bears any costs or receives any benefits from engaging in production. Consumers receive the benefit of consumption; their consumption brings no costs or benefits to others.

Organically grown apples are used in the transaction described above because real-world examples of products free from external benefits and costs are hard to find. If the apple farmer had used fertilizer and pesticide, many other people might have been affected. What might some of these effects have been?

External costs and external benefits are directly opposite to each other. If the external effect is negative, it is called a negative externality or an external cost. If the external effect is beneficial, it is called a positive externality or an external benefit.

Figure 1

Private Transaction of a Good



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Adapted from an exercise developed by John Pisciotta, Stevens Professor of Private Enterprise, Baylor University, Waco, Texas