* Positive Externality in production :

This case is illustrated in figure 2.In this case, since there are external benefits, the MSC curve is below the MPC curve (MSC < MPC). Since the demand curve gives the marginal social (private) benefit, the optimal level of output Q_0 is given by the intersection of the demand curve with the MSC curve. However, If left alone the competitive market will produce Q_1 where the demand curve intersects the MPC curve. Thus, too little will be produced from the social point of view. At the level of output Q_0, producers receive a price of P_0 but their marginal cost is C_0. Thus, output can ~~not~~ be increased by providing the producers a subsidy equal to $(C_0 - P_0)$. The consumers pays the marginal cost of production C_0 minus the external benefit $(C_0 - P_0)$ or a price P_0.

The net benefit

to the society from the subsidy ~~is~~ is given by the area AEH in figure 2. This is the excess of social benefit over social cost for the extra units produced as the result of the subsidy.

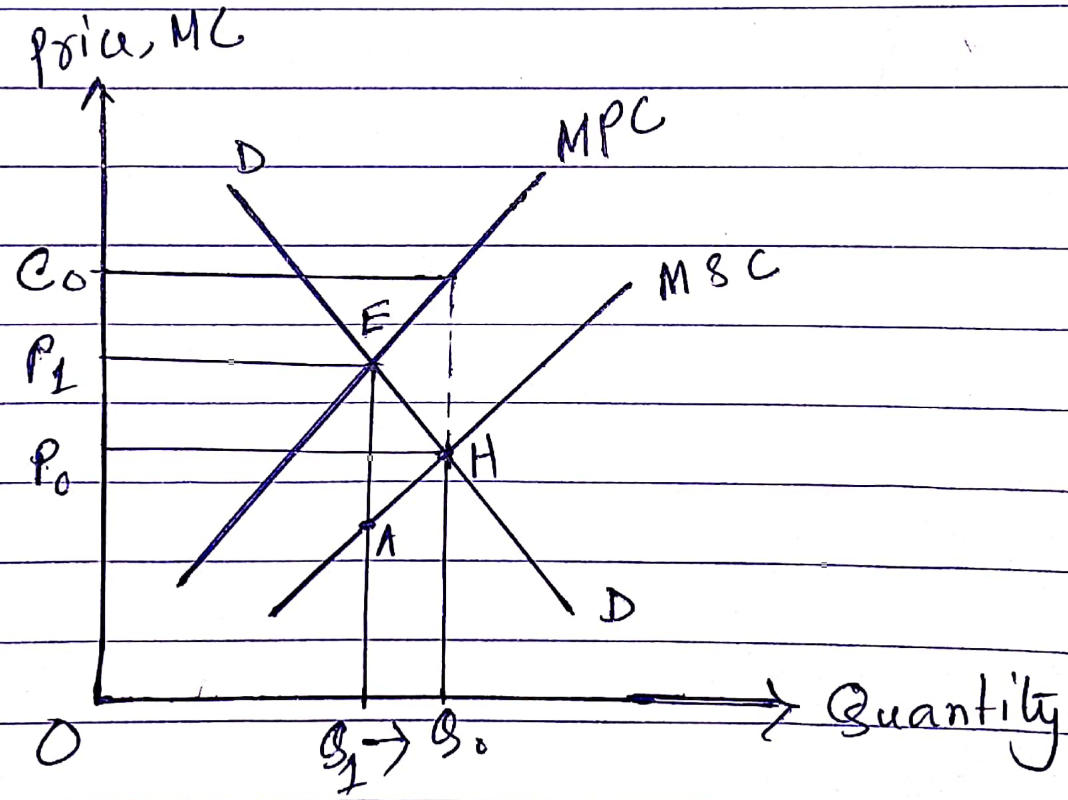

Fig. 2

[Positive Externality in Production]