* Negative Externality in Consumption :

Since there are no externalities in production, marginal social cost (MSC) and marginal private cost (MPC) are equal and competitive supply curve reflects the common marginal cost. However, on the demand side, the demand curve reflects only the marginal private benefit (MPB) and since the marginal social benefit (MSB) is less than the MPB, the MSB curve is below the MPB curve. This is illustrated in figure 3.

The optimal quantity is Q_0, where MSB = MSC. In the absence of intervention, the quantity supplied and consumed ~~is~~ is Q_1, the price is P_1. Thus, there is an overproduction of the commodity as compared to the socially optimal level. To restrict output to Q_0, the price has to be raised to P_0. But the supply price for Q_0 is C_0. Hence, a tax equal to $(P_0 - C_0)$ needs to ~~...~~ be imposed.

The price consumers is, thus, P_0, which equals the marginal private cost of production C_0 plus the externality in consumption $(P_0 - C_0)$. The revenue generated from the tax is used to compensate those who are hurt by the external cost arising from the consumption of the product.

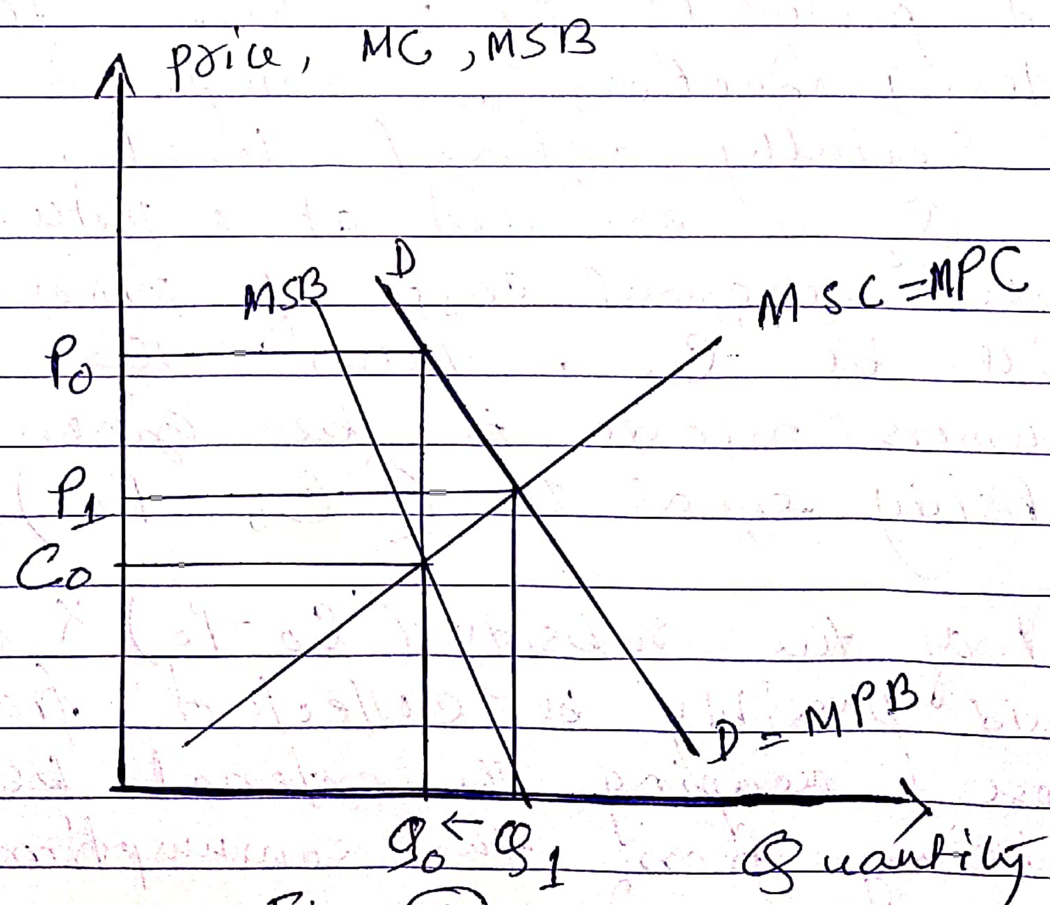

Fig. 3

[Negative Externality in Consumption]