1. INTRODUCTION

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On Coordination, Extremes, and
The Design of Economic Organizations

2. RESOURCE ALLOCATION WITH EXTERNALITIES

Externalities are economic conditions in which the actions of one party affect the welfare of another who is not directly involved. They arise from the fact that the market does not fully account for the costs and benefits associated with certain actions. This misalignment can lead to inefficient resource allocation, as the market fails to internalize the external costs or benefits.

The presence of externalities can distort market outcomes. For example, in the case of pollution, the pollution itself (a negative externality) is not accounted for by the market. This can lead to overproduction of goods that generate pollution, as producers do not fully internalize the external costs imposed on others.

In such cases, government intervention, such as taxes or subsidies, can be used to correct for the misallocation of resources. By imposing a tax on the production of goods that generate pollution, the government can internalize the external costs and align market outcomes with social welfare.

In summary, understanding and addressing externalities is crucial for efficient economic resource allocation. It requires not only analyzing market outcomes but also considering the broader social implications of economic activities.