The Effect of Externalities on Incentives

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JEL Classification: H11, L11, L12

Key words: externalities, incentives, individual rationality, price discrimination

Summary

This paper investigates the effect of externalities on incentives. We model the price discrimination by the monopolist in the situation in which the consumers have mutual externalities. We categorize pre-determined externalities in the economy into separable (or not-preclusive) and non-separable (or preclusive) externalities. Our analysis founds out that those two types of externalities lead to the different effects on the monopolistic supply through the different individual rationality conditions. The positive (negative) separable externality brings a less (more) supply than the social optimal levels for all types of consumer. On the other hand, the positive (negative) non-separable externality brings a more (less) supply to a higher demand consumer and a less (more) supply to a lower demand consumer.