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CONSUMERS, PRODUCERS, AND THE EFFICIENCY OF MARKETS

When consumers go to grocery stores to buy their turkeys for Thanksgiving dinner, they may be disappointed that the price of turkey is as high as it is. At the same time, when farmers bring to market the turkeys they have raised, they wish the price of turkey were even higher. These views are not surprising: Buyers always want to pay less, and sellers always want to get paid more. But is there a “right price” for turkey from the standpoint of society as a whole?

In previous chapters we saw how, in market economies, the forces of supply and demand determine the prices of goods and services and the quantities sold. So far, however, we have described the way markets allocate scarce resources without directly addressing the question of whether these market allocations are desirable. In other words, our analysis has been *positive* (what is) rather than *normative* (what

**IN THIS CHAPTER
YOU WILL . . .**

Examine the link between buyers' willingness to pay for a good and the demand curve

Learn how to define and measure consumer surplus

Examine the link between sellers' costs of producing a good and the supply curve

Learn how to define and measure producer surplus

See that the equilibrium of supply and demand maximizes total surplus in a market

welfare economics

the study of how the allocation of resources affects economic well-being



should be). We know that the price of turkey adjusts to ensure that the quantity of turkey supplied equals the quantity of turkey demanded. But, at this equilibrium, is the quantity of turkey produced and consumed too small, too large, or just right?

In this chapter we take up the topic of **welfare economics**, the study of how the allocation of resources affects economic well-being. We begin by examining the benefits that buyers and sellers receive from taking part in a market. We then examine how society can make these benefits as large as possible. This analysis leads to a profound conclusion: The equilibrium of supply and demand in a market maximizes the total benefits received by buyers and sellers.

As you may recall from Chapter 1, one of the *Ten Principles of Economics* is that markets are usually a good way to organize economic activity. The study of welfare economics explains this principle more fully. It also answers our question about the right price of turkey: The price that balances the supply and demand for turkey is, in a particular sense, the best one because it maximizes the total welfare of turkey consumers and turkey producers.

CONSUMER SURPLUS

We begin our study of welfare economics by looking at the benefits buyers receive from participating in a market.

WILLINGNESS TO PAY

Imagine that you own a mint-condition recording of Elvis Presley's first album. Because you are not an Elvis Presley fan, you decide to sell it. One way to do so is to hold an auction.

Four Elvis fans show up for your auction: John, Paul, George, and Ringo. Each of them would like to own the album, but there is a limit to the amount that each is willing to pay for it. Table 7-1 shows the maximum price that each of the four possible buyers would pay. Each buyer's maximum is called his **willingness to pay**, and it measures how much that buyer values the good. Each buyer would be eager to buy the album at a price less than his willingness to pay, would refuse to

willingness to pay

the maximum amount that a buyer will pay for a good

Table 7-1

FOUR POSSIBLE BUYERS' WILLINGNESS TO PAY

BUYER	WILLINGNESS TO PAY
John	\$100
Paul	80
George	70
Ringo	50

buy the album at a price more than his willingness to pay, and would be indifferent about buying the album at a price exactly equal to his willingness to pay.

To sell your album, you begin the bidding at a low price, say \$10. Because all four buyers are willing to pay much more, the price rises quickly. The bidding stops when John bids \$80 (or slightly more). At this point, Paul, George, and Ringo have dropped out of the bidding, because they are unwilling to bid any more than \$80. John pays you \$80 and gets the album. Note that the album has gone to the buyer who values the album most highly.

What benefit does John receive from buying the Elvis Presley album? In a sense, John has found a real bargain: He is willing to pay \$100 for the album but pays only \$80 for it. We say that John receives *consumer surplus* of \$20. **Consumer surplus** is the amount a buyer is willing to pay for a good minus the amount the buyer actually pays for it.

consumer surplus

a buyer's willingness to pay minus the amount the buyer actually pays

Consumer surplus measures the benefit to buyers of participating in a market. In this example, John receives a \$20 benefit from participating in the auction because he pays only \$80 for a good he values at \$100. Paul, George, and Ringo get no consumer surplus from participating in the auction, because they left without the album and without paying anything.

Now consider a somewhat different example. Suppose that you had two identical Elvis Presley albums to sell. Again, you auction them off to the four possible buyers. To keep things simple, we assume that both albums are to be sold for the same price and that no buyer is interested in buying more than one album. Therefore, the price rises until two buyers are left.

In this case, the bidding stops when John and Paul bid \$70 (or slightly higher). At this price, John and Paul are each happy to buy an album, and George and Ringo are not willing to bid any higher. John and Paul each receive consumer surplus equal to his willingness to pay minus the price. John's consumer surplus is \$30, and Paul's is \$10. John's consumer surplus is higher now than it was previously, because he gets the same album but pays less for it. The total consumer surplus in the market is \$40.

USING THE DEMAND CURVE TO MEASURE CONSUMER SURPLUS

Consumer surplus is closely related to the demand curve for a product. To see how they are related, let's continue our example and consider the demand curve for this rare Elvis Presley album.

We begin by using the willingness to pay of the four possible buyers to find the demand schedule for the album. Table 7-2 shows the demand schedule that corresponds to Table 7-1. If the price is above \$100, the quantity demanded in the market is 0, because no buyer is willing to pay that much. If the price is between \$80 and \$100, the quantity demanded is 1, because only John is willing to pay such a high price. If the price is between \$70 and \$80, the quantity demanded is 2, because both John and Paul are willing to pay the price. We can continue this analysis for other prices as well. In this way, the demand schedule is derived from the willingness to pay of the four possible buyers.

Figure 7-1 graphs the demand curve that corresponds to this demand schedule. Note the relationship between the height of the demand curve and the buyers' willingness to pay. At any quantity, the price given by the demand curve shows

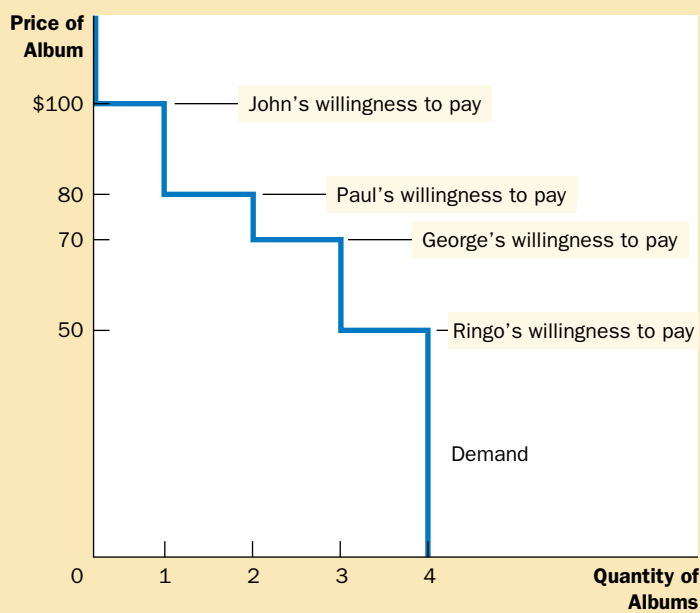
Table 7-2

THE DEMAND SCHEDULE FOR THE BUYERS IN TABLE 7-1

PRICE	BUYERS	QUANTITY DEMANDED
More than \$100	None	0
\$80 to \$100	John	1
\$70 to \$80	John, Paul	2
\$50 to \$70	John, Paul, George	3
\$50 or less	John, Paul, George, Ringo	4

Figure 7-1

THE DEMAND CURVE. This figure graphs the demand curve from the demand schedule in Table 7-2. Note that the height of the demand curve reflects buyers' willingness to pay.



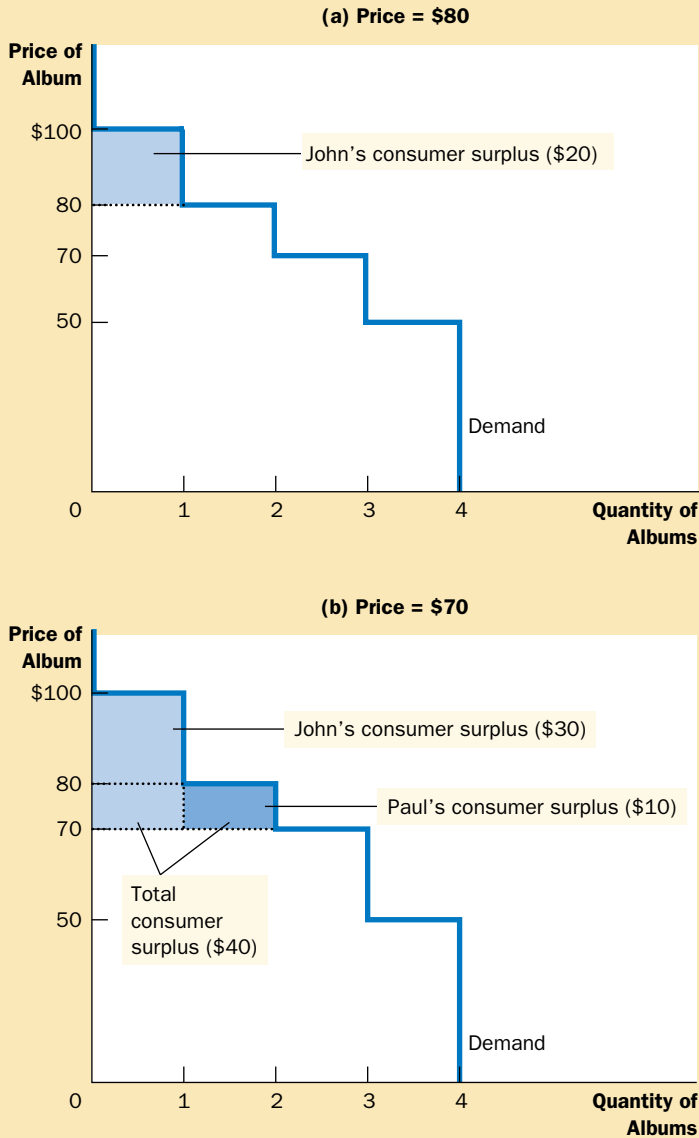
the willingness to pay of the *marginal buyer*, the buyer who would leave the market first if the price were any higher. At a quantity of 4 albums, for instance, the demand curve has a height of \$50, the price that Ringo (the marginal buyer) is willing to pay for an album. At a quantity of 3 albums, the demand curve has a height of \$70, the price that George (who is now the marginal buyer) is willing to pay.

Because the demand curve reflects buyers' willingness to pay, we can also use it to measure consumer surplus. Figure 7-2 uses the demand curve to compute consumer surplus in our example. In panel (a), the price is \$80 (or slightly above), and the quantity demanded is 1. Note that the area above the price and below the demand curve equals \$20. This amount is exactly the consumer surplus we computed earlier when only 1 album is sold.

Panel (b) of Figure 7-2 shows consumer surplus when the price is \$70 (or slightly above). In this case, the area above the price and below the demand curve

Figure 7-2

MEASURING CONSUMER SURPLUS WITH THE DEMAND CURVE. In panel (a), the price of the good is \$80, and the consumer surplus is \$20. In panel (b), the price of the good is \$70, and the consumer surplus is \$40.



equals the total area of the two rectangles: John's consumer surplus at this price is \$30 and Paul's is \$10. This area equals a total of \$40. Once again, this amount is the consumer surplus we computed earlier.

The lesson from this example holds for all demand curves: *The area below the demand curve and above the price measures the consumer surplus in a market.* The reason is that the height of the demand curve measures the value buyers place on the good, as measured by their willingness to pay for it. The difference between this willingness to pay and the market price is each buyer's consumer surplus. Thus, the total area below the demand curve and above the price is the sum of the consumer surplus of all buyers in the market for a good or service.

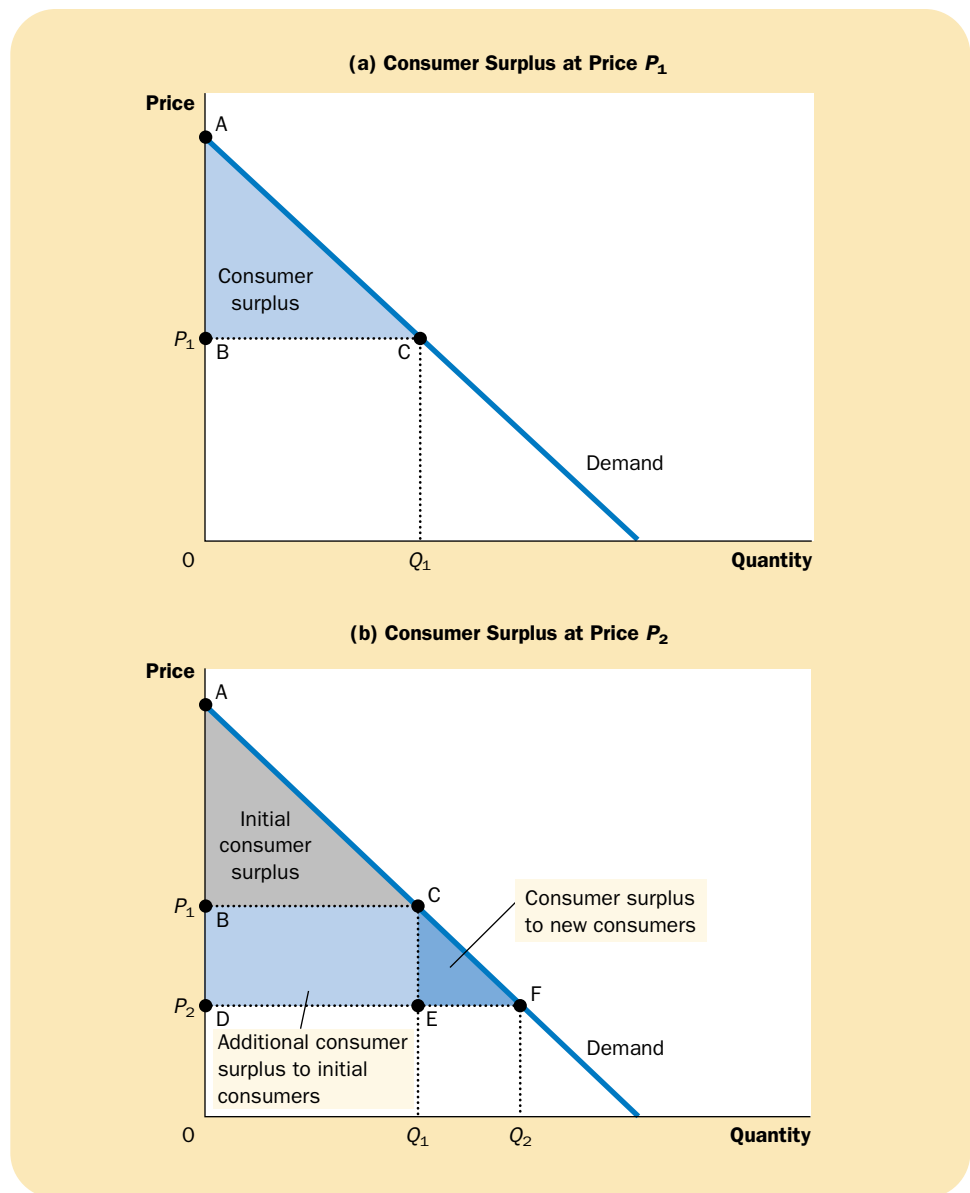
HOW A LOWER PRICE RAISES CONSUMER SURPLUS

Because buyers always want to pay less for the goods they buy, a lower price makes buyers of a good better off. But how much does buyers' well-being rise in response to a lower price? We can use the concept of consumer surplus to answer this question precisely.

Figure 7-3 shows a typical downward-sloping demand curve. Although this demand curve appears somewhat different in shape from the steplike demand curves in our previous two figures, the ideas we have just developed apply nonetheless: Consumer surplus is the area above the price and below the demand curve. In panel (a), consumer surplus at a price of P_1 is the area of triangle ABC.

Figure 7-3

HOW THE PRICE AFFECTS CONSUMER SURPLUS. In panel (a), the price is P_1 , the quantity demanded is Q_1 , and consumer surplus equals the area of the triangle ABC. When the price falls from P_1 to P_2 , as in panel (b), the quantity demanded rises from Q_1 to Q_2 , and the consumer surplus rises to the area of the triangle ADF. The increase in consumer surplus (area BCFD) occurs in part because existing consumers now pay less (area BCED) and in part because new consumers enter the market at the lower price (area CEF).



Now suppose that the price falls from P_1 to P_2 , as shown in panel (b). The consumer surplus now equals area ADF. The increase in consumer surplus attributable to the lower price is the area BCFD.

This increase in consumer surplus is composed of two parts. First, those buyers who were already buying Q_1 of the good at the higher price P_1 are better off because they now pay less. The increase in consumer surplus of existing buyers is the reduction in the amount they pay; it equals the area of the rectangle BCED. Second, some new buyers enter the market because they are now willing to buy the good at the lower price. As a result, the quantity demanded in the market increases from Q_1 to Q_2 . The consumer surplus these newcomers receive is the area of the triangle CEF.

WHAT DOES CONSUMER SURPLUS MEASURE?

Our goal in developing the concept of consumer surplus is to make normative judgments about the desirability of market outcomes. Now that you have seen what consumer surplus is, let's consider whether it is a good measure of economic well-being.

Imagine that you are a policymaker trying to design a good economic system. Would you care about the amount of consumer surplus? Consumer surplus, the amount that buyers are willing to pay for a good minus the amount they actually pay for it, measures the benefit that buyers receive from a good *as the buyers themselves perceive it*. Thus, consumer surplus is a good measure of economic well-being if policymakers want to respect the preferences of buyers.

In some circumstances, policymakers might choose not to care about consumer surplus because they do not respect the preferences that drive buyer behavior. For example, drug addicts are willing to pay a high price for heroin. Yet we would not say that addicts get a large benefit from being able to buy heroin at a low price (even though addicts might say they do). From the standpoint of society, willingness to pay in this instance is not a good measure of the buyers' benefit, and consumer surplus is not a good measure of economic well-being, because addicts are not looking after their own best interests.

In most markets, however, consumer surplus does reflect economic well-being. Economists normally presume that buyers are rational when they make decisions and that their preferences should be respected. In this case, consumers are the best judges of how much benefit they receive from the goods they buy.

QUICK QUIZ: Draw a demand curve for turkey. In your diagram, show a price of turkey and the consumer surplus that results from that price. Explain in words what this consumer surplus measures.

PRODUCER SURPLUS

We now turn to the other side of the market and consider the benefits sellers receive from participating in a market. As you will see, our analysis of sellers' welfare is similar to our analysis of buyers' welfare.

COST AND THE WILLINGNESS TO SELL

Imagine now that you are a homeowner, and you need to get your house painted. You turn to four sellers of painting services: Mary, Frida, Georgia, and Grandma. Each painter is willing to do the work for you if the price is right. You decide to take bids from the four painters and auction off the job to the painter who will do the work for the lowest price.

cost
the value of everything a seller must give up to produce a good

Each painter is willing to take the job if the price she would receive exceeds her cost of doing the work. Here the term **cost** should be interpreted as the painters' opportunity cost: It includes the painters' out-of-pocket expenses (for paint, brushes, and so on) as well as the value that the painters place on their own time. Table 7-3 shows each painter's cost. Because a painter's cost is the lowest price she would accept for her work, cost is a measure of her willingness to sell her services. Each painter would be eager to sell her services at a price greater than her cost, would refuse to sell her services at a price less than her cost, and would be indifferent about selling her services at a price exactly equal to her cost.

When you take bids from the painters, the price might start off high, but it quickly falls as the painters compete for the job. Once Grandma has bid \$600 (or slightly less), she is the sole remaining bidder. Grandma is happy to do the job for this price, because her cost is only \$500. Mary, Frida, and Georgia are unwilling to do the job for less than \$600. Note that the job goes to the painter who can do the work at the lowest cost.

producer surplus
the amount a seller is paid for a good minus the seller's cost

What benefit does Grandma receive from getting the job? Because she is willing to do the work for \$500 but gets \$600 for doing it, we say that she receives *producer surplus* of \$100. **Producer surplus** is the amount a seller is paid minus the cost of production. Producer surplus measures the benefit to sellers of participating in a market.

Now consider a somewhat different example. Suppose that you have two houses that need painting. Again, you auction off the jobs to the four painters. To keep things simple, let's assume that no painter is able to paint both houses and that you will pay the same amount to paint each house. Therefore, the price falls until two painters are left.

In this case, the bidding stops when Georgia and Grandma each offer to do the job for a price of \$800 (or slightly less). At this price, Georgia and Grandma are willing to do the work, and Mary and Frida are not willing to bid a lower price. At a price of \$800, Grandma receives producer surplus of \$300, and Georgia receives producer surplus of \$200. The total producer surplus in the market is \$500.

Table 7-3

THE COSTS OF FOUR POSSIBLE SELLERS

SELLER	COST
Mary	\$900
Frida	800
Georgia	600
Grandma	500

USING THE SUPPLY CURVE TO MEASURE PRODUCER SURPLUS

Just as consumer surplus is closely related to the demand curve, producer surplus is closely related to the supply curve. To see how, let's continue our example.

We begin by using the costs of the four painters to find the supply schedule for painting services. Table 7-4 shows the supply schedule that corresponds to the costs in Table 7-3. If the price is below \$500, none of the four painters is willing to do the job, so the quantity supplied is zero. If the price is between \$500 and \$600, only Grandma is willing to do the job, so the quantity supplied is 1. If the price is between \$600 and \$800, Grandma and Georgia are willing to do the job, so the quantity supplied is 2, and so on. Thus, the supply schedule is derived from the costs of the four painters.

Figure 7-4 graphs the supply curve that corresponds to this supply schedule. Note that the height of the supply curve is related to the sellers' costs. At any quantity, the price given by the supply curve shows the cost of the *marginal seller*, the

PRICE	SELLERS	QUANTITY SUPPLIED
\$900 or more	Mary, Frida, Georgia, Grandma	4
\$800 to \$900	Frida, Georgia, Grandma	3
\$600 to \$800	Georgia, Grandma	2
\$500 to \$600	Grandma	1
Less than \$500	None	0

Table 7-4

THE SUPPLY SCHEDULE FOR THE SELLERS IN TABLE 7-3

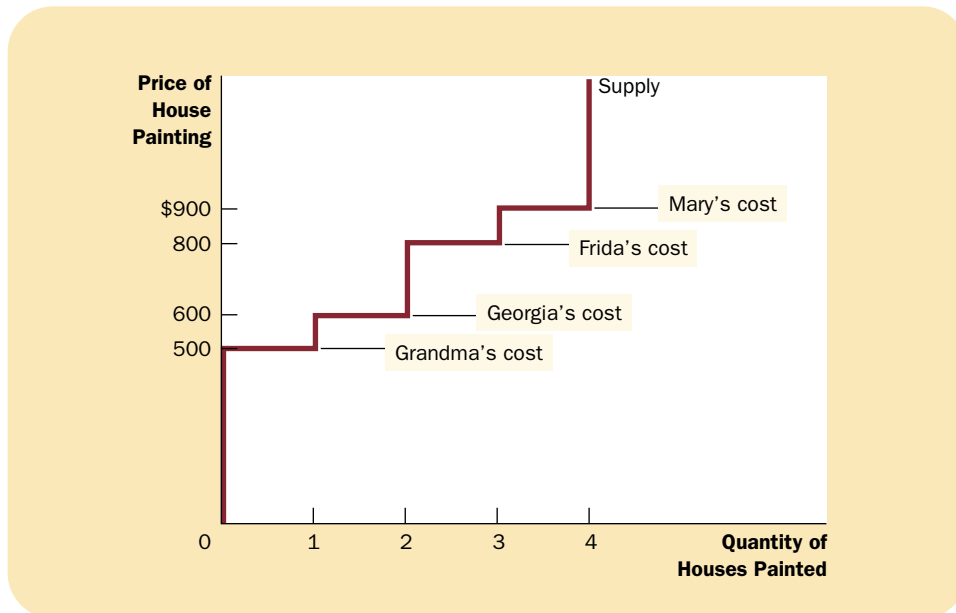


Figure 7-4

THE SUPPLY CURVE. This figure graphs the supply curve from the supply schedule in Table 7-4. Note that the height of the supply curve reflects sellers' costs.

seller who would leave the market first if the price were any lower. At a quantity of 4 houses, for instance, the supply curve has a height of \$900, the cost that Mary (the marginal seller) incurs to provide her painting services. At a quantity of 3 houses, the supply curve has a height of \$800, the cost that Frida (who is now the marginal seller) incurs.

Because the supply curve reflects sellers' costs, we can use it to measure producer surplus. Figure 7-5 uses the supply curve to compute producer surplus in our example. In panel (a), we assume that the price is \$600. In this case, the quantity supplied is 1. Note that the area below the price and above the supply curve equals \$100. This amount is exactly the producer surplus we computed earlier for Grandma.

Panel (b) of Figure 7-5 shows producer surplus at a price of \$800. In this case, the area below the price and above the supply curve equals the total area of the two rectangles. This area equals \$500, the producer surplus we computed earlier for Georgia and Grandma when two houses needed painting.

The lesson from this example applies to all supply curves: *The area below the price and above the supply curve measures the producer surplus in a market.* The logic is straightforward: The height of the supply curve measures sellers' costs, and the difference between the price and the cost of production is each seller's producer surplus. Thus, the total area is the sum of the producer surplus of all sellers.

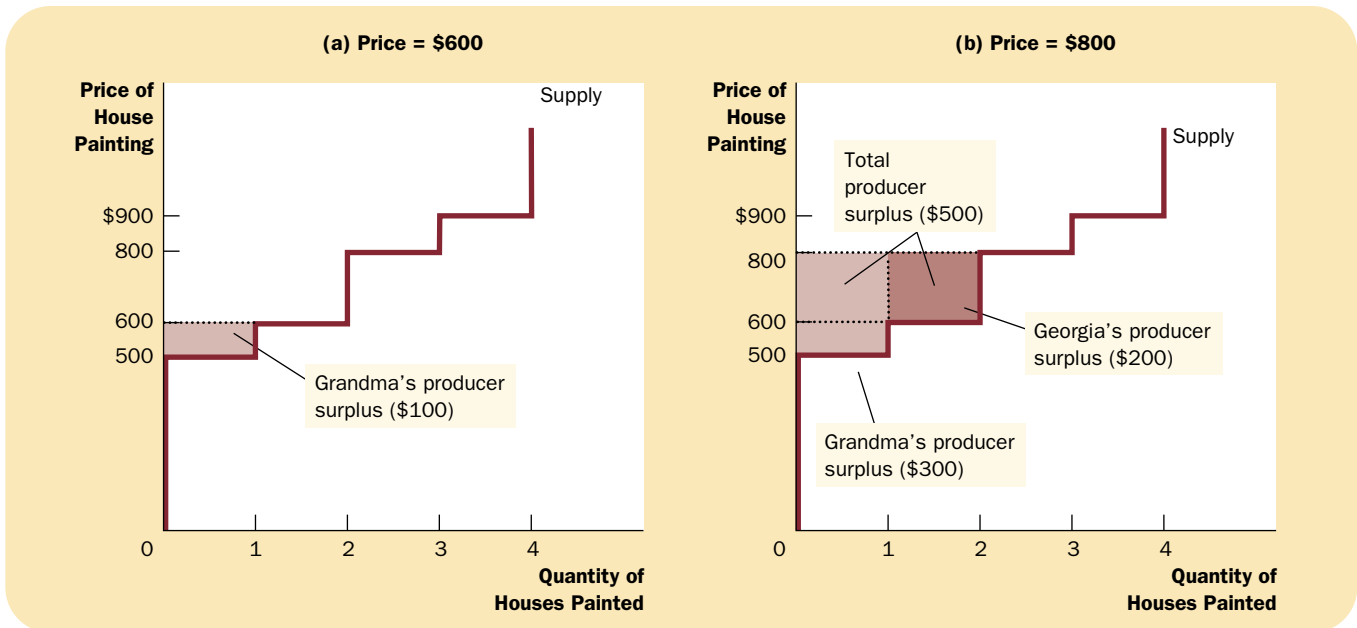


Figure 7-5

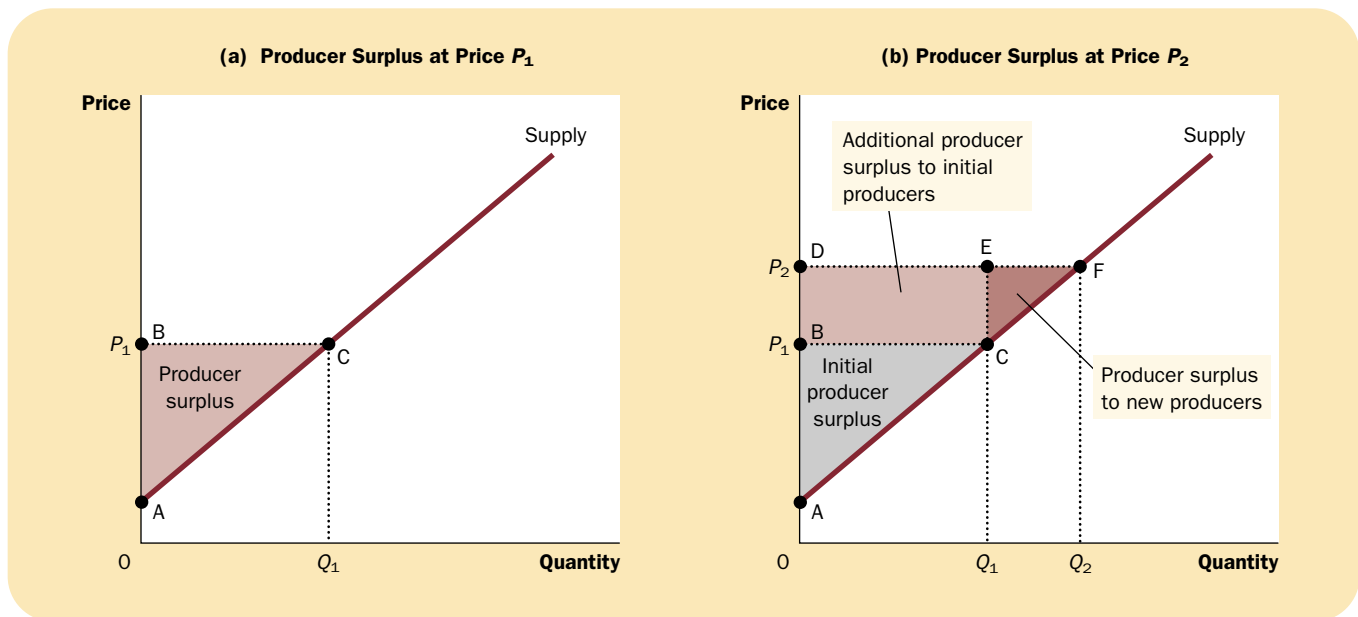
MEASURING PRODUCER SURPLUS WITH THE SUPPLY CURVE. In panel (a), the price of the good is \$600, and the producer surplus is \$100. In panel (b), the price of the good is \$800, and the producer surplus is \$500.

HOW A HIGHER PRICE RAISES PRODUCER SURPLUS

You will not be surprised to hear that sellers always want to receive a higher price for the goods they sell. But how much does sellers' well-being rise in response to a higher price? The concept of producer surplus offers a precise answer to this question.

Figure 7-6 shows a typical upward-sloping supply curve. Even though this supply curve differs in shape from the steplike supply curves in the previous figure, we measure producer surplus in the same way: Producer surplus is the area below the price and above the supply curve. In panel (a), the price is P_1 , and producer surplus is the area of triangle ABC.

Panel (b) shows what happens when the price rises from P_1 to P_2 . Producer surplus now equals area ADF. This increase in producer surplus has two parts. First, those sellers who were already selling Q_1 of the good at the lower price P_1 are better off because they now get more for what they sell. The increase in producer surplus for existing sellers equals the area of the rectangle BCED. Second, some new sellers enter the market because they are now willing to produce the good at the higher price, resulting in an increase in the quantity supplied from Q_1 to Q_2 . The producer surplus of these newcomers is the area of the triangle CEF.



HOW THE PRICE AFFECTS PRODUCER SURPLUS. In panel (a), the price is P_1 , the quantity demanded is Q_1 , and producer surplus equals the area of the triangle ABC. When the price rises from P_1 to P_2 , as in panel (b), the quantity supplied rises from Q_1 to Q_2 , and the producer surplus rises to the area of the triangle ADF. The increase in producer surplus (area BCFD) occurs in part because existing producers now receive more (area BCED) and in part because new producers enter the market at the higher price (area CEF).

Figure 7-6

As this analysis shows, we use producer surplus to measure the well-being of sellers in much the same way as we use consumer surplus to measure the well-being of buyers. Because these two measures of economic welfare are so similar, it is natural to use them together. And, indeed, that is exactly what we do in the next section.

QUICK QUIZ: Draw a supply curve for turkey. In your diagram, show a price of turkey and the producer surplus that results from that price. Explain in words what this producer surplus measures.

MARKET EFFICIENCY

Consumer surplus and producer surplus are the basic tools that economists use to study the welfare of buyers and sellers in a market. These tools can help us address a fundamental economic question: Is the allocation of resources determined by free markets in any way desirable?

THE BENEVOLENT SOCIAL PLANNER

To evaluate market outcomes, we introduce into our analysis a new, hypothetical character, called the benevolent social planner. The benevolent social planner is an all-knowing, all-powerful, well-intentioned dictator. The planner wants to maximize the economic well-being of everyone in society. What do you suppose this planner should do? Should he just leave buyers and sellers at the equilibrium that they reach naturally on their own? Or can he increase economic well-being by altering the market outcome in some way?

To answer this question, the planner must first decide how to measure the economic well-being of a society. One possible measure is the sum of consumer and producer surplus, which we call *total surplus*. Consumer surplus is the benefit that buyers receive from participating in a market, and producer surplus is the benefit that sellers receive. It is therefore natural to use total surplus as a measure of society's economic well-being.

To better understand this measure of economic well-being, recall how we measure consumer and producer surplus. We define consumer surplus as

$$\text{Consumer surplus} = \text{Value to buyers} - \text{Amount paid by buyers.}$$

Similarly, we define producer surplus as

$$\text{Producer surplus} = \text{Amount received by sellers} - \text{Cost to sellers.}$$

When we add consumer and producer surplus together, we obtain

$$\begin{aligned} \text{Total surplus} &= \text{Value to buyers} - \text{Amount paid by buyers} \\ &+ \text{Amount received by sellers} - \text{Cost to sellers.} \end{aligned}$$

The amount paid by buyers equals the amount received by sellers, so the middle two terms in this expression cancel each other. As a result, we can write total surplus as

$$\text{Total surplus} = \text{Value to buyers} - \text{Cost to sellers.}$$

Total surplus in a market is the total value to buyers of the goods, as measured by their willingness to pay, minus the total cost to sellers of providing those goods.

If an allocation of resources maximizes total surplus, we say that the allocation exhibits **efficiency**. If an allocation is not efficient, then some of the gains from trade among buyers and sellers are not being realized. For example, an allocation is inefficient if a good is not being produced by the sellers with lowest cost. In this case, moving production from a high-cost producer to a low-cost producer will lower the total cost to sellers and raise total surplus. Similarly, an allocation is inefficient if a good is not being consumed by the buyers who value it most highly. In this case, moving consumption of the good from a buyer with a low valuation to a buyer with a high valuation will raise total surplus.

In addition to efficiency, the social planner might also care about **equity**—the fairness of the distribution of well-being among the various buyers and sellers. In essence, the gains from trade in a market are like a pie to be distributed among the market participants. The question of efficiency is whether the pie is as big as possible. The question of equity is whether the pie is divided fairly. Evaluating the equity of a market outcome is more difficult than evaluating the efficiency. Whereas efficiency is an objective goal that can be judged on strictly positive grounds, equity involves normative judgments that go beyond economics and enter into the realm of political philosophy.

In this chapter we concentrate on efficiency as the social planner's goal. Keep in mind, however, that real policymakers often care about equity as well. That is, they care about both the size of the economic pie and how the pie gets sliced and distributed among members of society.

efficiency

the property of a resource allocation of maximizing the total surplus received by all members of society

equity

the fairness of the distribution of well-being among the members of society

EVALUATING THE MARKET EQUILIBRIUM

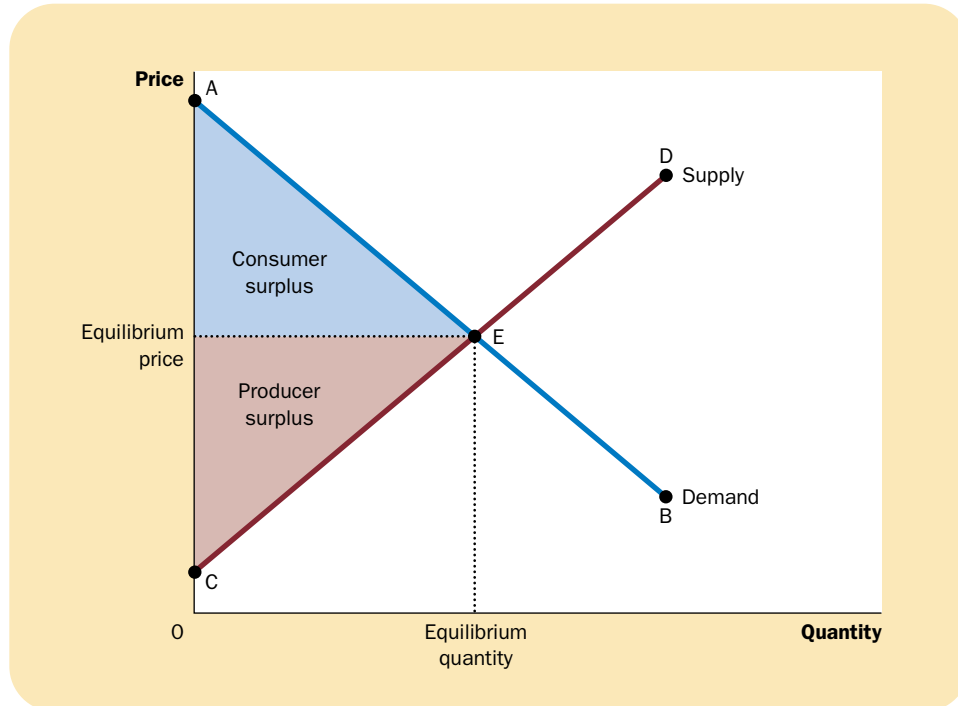
Figure 7-7 shows consumer and producer surplus when a market reaches the equilibrium of supply and demand. Recall that consumer surplus equals the area above the price and under the demand curve and producer surplus equals the area below the price and above the supply curve. Thus, the total area between the supply and demand curves up to the point of equilibrium represents the total surplus from this market.

Is this equilibrium allocation of resources efficient? Does it maximize total surplus? To answer these questions, keep in mind that when a market is in equilibrium, the price determines which buyers and sellers participate in the market. Those buyers who value the good more than the price (represented by the segment AE on the demand curve) choose to buy the good; those buyers who value it less than the price (represented by the segment EB) do not. Similarly, those sellers whose costs are less than the price (represented by the segment CE on the supply curve) choose to produce and sell the good; those sellers whose costs are greater than the price (represented by the segment ED) do not.

These observations lead to two insights about market outcomes:

Figure 7-7

CONSUMER AND PRODUCER SURPLUS IN THE MARKET EQUILIBRIUM. Total surplus—the sum of consumer and producer surplus—is the area between the supply and demand curves up to the equilibrium quantity.



1. Free markets allocate the supply of goods to the buyers who value them most highly, as measured by their willingness to pay.
2. Free markets allocate the demand for goods to the sellers who can produce them at least cost.

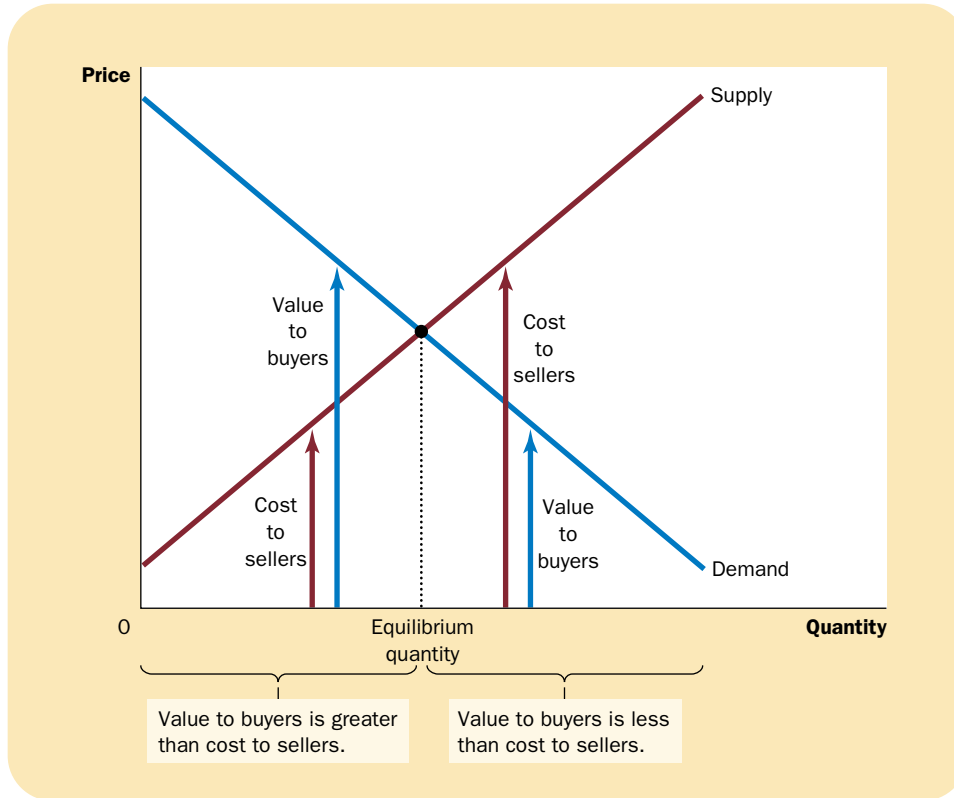
Thus, given the quantity produced and sold in a market equilibrium, the social planner cannot increase economic well-being by changing the allocation of consumption among buyers or the allocation of production among sellers.

But can the social planner raise total economic well-being by increasing or decreasing the quantity of the good? The answer is no, as stated in this third insight about market outcomes:

3. Free markets produce the quantity of goods that maximizes the sum of consumer and producer surplus.

To see why this is true, consider Figure 7-8. Recall that the demand curve reflects the value to buyers and that the supply curve reflects the cost to sellers. At quantities below the equilibrium level, the value to buyers exceeds the cost to sellers. In this region, increasing the quantity raises total surplus, and it continues to do so until the quantity reaches the equilibrium level. Beyond the equilibrium quantity, however, the value to buyers is less than the cost to sellers. Producing more than the equilibrium quantity would, therefore, lower total surplus.

These three insights about market outcomes tell us that the equilibrium of supply and demand maximizes the sum of consumer and producer surplus. In other words, the equilibrium outcome is an efficient allocation of resources. The job of the benevolent social planner is, therefore, very easy: He can leave the market

**Figure 7-8**

THE EFFICIENCY OF THE EQUILIBRIUM QUANTITY. At quantities less than the equilibrium quantity, the value to buyers exceeds the cost to sellers. At quantities greater than the equilibrium quantity, the cost to sellers exceeds the value to buyers. Therefore, the market equilibrium maximizes the sum of producer and consumer surplus.

outcome just as he finds it. This policy of leaving well enough alone goes by the French expression *laissez-faire*, which literally translated means “allow them to do.”

We can now better appreciate Adam Smith’s invisible hand of the marketplace, which we first discussed in Chapter 1. The benevolent social planner doesn’t need to alter the market outcome because the invisible hand has already guided buyers and sellers to an allocation of the economy’s resources that maximizes total surplus. This conclusion explains why economists often advocate free markets as the best way to organize economic activity.

QUICK QUIZ: Draw the supply and demand for turkey. In the equilibrium, show producer and consumer surplus. Explain why producing more turkey would lower total surplus.

CONCLUSION: MARKET EFFICIENCY AND MARKET FAILURE

This chapter introduced the basic tools of welfare economics—consumer and producer surplus—and used them to evaluate the efficiency of free markets. We showed that the forces of supply and demand allocate resources efficiently. That is,

IN THE NEWS

Ticket Scalping



IF AN ECONOMY IS TO ALLOCATE ITS SCARCE resources efficiently, goods must get to those consumers who value them most highly. Ticket scalping is one example of how markets reach efficient outcomes. Scalpers buy tickets to plays, concerts, and sports events and then sell the tickets at a price above their original cost. By charging the highest price the market will bear, scalpers help ensure that consumers with the greatest willingness to pay for the tickets actually do get them. In some places, however, there is debate over whether this market activity should be legal.

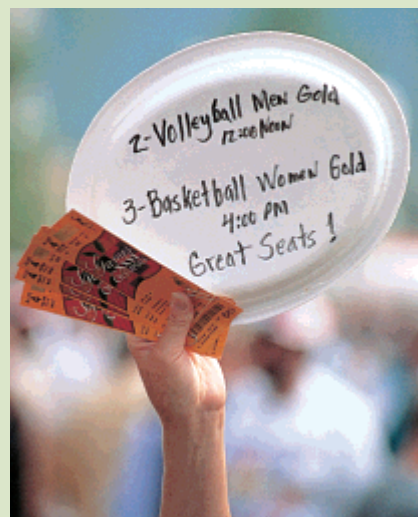
Tickets? Supply Meets Demand on Sidewalk

BY JOHN TIERNEY

Ticket scalping has been very good to Kevin Thomas, and he makes no apologies. He sees himself as a classic American entrepreneur: a high school dropout from the Bronx who taught himself a trade, works seven nights a week, earns \$40,000 a year, and at age twenty-six has \$75,000 in savings, all by providing a public service outside New York's theaters and sports arenas.

He has just one complaint. "I've been busted about 30 times in the last year," he said one recent evening, just after making \$280 at a Knicks game. "You learn to deal with it—I give the cops a fake name, and I pay the fines when I have to, but I don't think it's fair. I look at scalping like working as a stockbroker, buying low and selling high. If people are willing to pay me the money, what kind of problem is that?"

It is a significant problem to public officials in New York and New Jersey,



THE INVISIBLE HAND AT WORK

who are cracking down on street scalpers like Mr. Thomas and on licensed ticket brokers. Undercover officers are enforcing new restrictions on reselling tickets at marked-up prices, and the attorneys general of the two states are pressing well-publicized

even though each buyer and seller in a market is concerned only about his or her own welfare, they are together led by an invisible hand to an equilibrium that maximizes the total benefits to buyers and sellers.

A word of warning is in order. To conclude that markets are efficient, we made several assumptions about how markets work. When these assumptions do not hold, our conclusion that the market equilibrium is efficient may no longer be true. As we close this chapter, let's consider briefly two of the most important of these assumptions.

First, our analysis assumed that markets are perfectly competitive. In the world, however, competition is sometimes far from perfect. In some markets, a single buyer or seller (or a small group of them) may be able to control market prices. This ability to influence prices is called *market power*. Market power can cause markets to be inefficient because it keeps the price and quantity away from the equilibrium of supply and demand.

Second, our analysis assumed that the outcome in a market matters only to the buyers and sellers in that market. Yet, in the world, the decisions of buyers and

cases against more than a dozen ticket brokers.

But economists tend to see scalping from Mr. Thomas's perspective. To them, the governments' crusade makes about as much sense as the old campaigns by Communist authorities against "profiteering." Economists argue that the restrictions inconvenience the public, reduce the audience for cultural and sports events, waste the police's time, deprive New York City of tens of millions of dollars of tax revenue, and actually drive up the cost of many tickets.

"It is always good politics to pose as defender of the poor by declaring high prices illegal," says William J. Baumol, the director of the C. V. Starr Center for Applied Economics at New York University. "I expect politicians to try to solve the AIDS crisis by declaring AIDS illegal as well. That would be harmless, because nothing would happen, but when you outlaw high prices you create real problems."

Dr. Baumol was one of the economists who came up with the idea of sell-

ing same-day Broadway tickets for half price at the TKTS booth in Times Square, which theater owners thought dangerously radical when the booth opened in 1973. But the owners have profited by finding a new clientele for tickets that would have gone unsold, an illustration of the free-market tenet that both buyers and sellers ultimately benefit when price is adjusted to meet demand.

Economists see another illustration of that lesson at the Museum of Modern Art, where people wait in line for up to two hours to buy tickets for the Matisse exhibit. But there is an alternative on the sidewalk: Scalpers who evade the police have been selling the \$12.50 tickets to the show at prices ranging from \$20 to \$50.

"You don't have to put a very high value on your time to pay \$10 or \$15 to avoid standing in line for two hours for a Matisse ticket," said Richard H. Thaler, an economist at Cornell University. "Some people think it's fairer to make everyone stand in line, but that forces everyone to engage in a totally unpro-

ductive activity, and it discriminates in favor of people who have the most free time. Scalping gives other people a chance, too. I can see no justification for outlawing it." . . .

Politicians commonly argue that without anti-scalping laws, tickets would become unaffordable to most people, but California has no laws against scalping, and ticket prices there are not notoriously high. And as much as scalpers would like to inflate prices, only a limited number of people are willing to pay \$100 for a ticket. . . .

Legalizing scalping, however, would not necessarily be good news for everyone. Mr. Thomas, for instance, fears that the extra competition might put him out of business. But after 16 years—he started at age ten outside of Yankee Stadium—he is thinking it might be time for a change anyway.

SOURCE: *The New York Times*, December 26, 1992, p. A1.

sellers sometimes affect people who are not participants in the market at all. Pollution is the classic example of a market outcome that affects people not in the market. Such side effects, called *externalities*, cause welfare in a market to depend on more than just the value to the buyers and the cost to the sellers. Because buyers and sellers do not take these side effects into account when deciding how much to consume and produce, the equilibrium in a market can be inefficient from the standpoint of society as a whole.

Market power and externalities are examples of a general phenomenon called *market failure*—the inability of some unregulated markets to allocate resources efficiently. When markets fail, public policy can potentially remedy the problem and increase economic efficiency. Microeconomists devote much effort to studying when market failure is likely and what sorts of policies are best at correcting market failures. As you continue your study of economics, you will see that the tools of welfare economics developed here are readily adapted to that endeavor.

Despite the possibility of market failure, the invisible hand of the marketplace is extraordinarily important. In many markets, the assumptions we made in this

chapter work well, and the conclusion of market efficiency applies directly. Moreover, our analysis of welfare economics and market efficiency can be used to shed light on the effects of various government policies. In the next two chapters we apply the tools we have just developed to study two important policy issues—the welfare effects of taxation and of international trade.

Summary

- ◆ Consumer surplus equals buyers' willingness to pay for a good minus the amount they actually pay for it, and it measures the benefit buyers get from participating in a market. Consumer surplus can be computed by finding the area below the demand curve and above the price.
 - ◆ Producer surplus equals the amount sellers receive for their goods minus their costs of production, and it measures the benefit sellers get from participating in a market. Producer surplus can be computed by finding the area below the price and above the supply curve.
 - ◆ An allocation of resources that maximizes the sum of consumer and producer surplus is said to be efficient.
- ◆ Policymakers are often concerned with the efficiency, as well as the equity, of economic outcomes.
 - ◆ The equilibrium of supply and demand maximizes the sum of consumer and producer surplus. That is, the invisible hand of the marketplace leads buyers and sellers to allocate resources efficiently.
 - ◆ Markets do not allocate resources efficiently in the presence of market failures such as market power or externalities.

Key Concepts

welfare economics, p. 142
willingness to pay, p. 142
consumer surplus, p. 143

cost, p. 148
producer surplus, p. 148

efficiency, p. 153
equity, p. 153

Questions for Review

1. Explain how buyers' willingness to pay, consumer surplus, and the demand curve are related.
2. Explain how sellers' costs, producer surplus, and the supply curve are related.
3. In a supply-and-demand diagram, show producer and consumer surplus in the market equilibrium.
4. What is efficiency? Is it the only goal of economic policymakers?
5. What does the invisible hand do?
6. Name two types of market failure. Explain why each may cause market outcomes to be inefficient.

Problems and Applications

1. An early freeze in California sours the lemon crop. What happens to consumer surplus in the market for lemons? What happens to consumer surplus in the market for lemonade? Illustrate your answers with diagrams.
2. Suppose the demand for French bread rises. What happens to producer surplus in the market for French bread? What happens to producer surplus in the market for flour? Illustrate your answer with diagrams.

3. It is a hot day, and Bert is very thirsty. Here is the value he places on a bottle of water:

Value of first bottle	\$7
Value of second bottle	5
Value of third bottle	3
Value of fourth bottle	1

- From this information, derive Bert's demand schedule. Graph his demand curve for bottled water.
 - If the price of a bottle of water is \$4, how many bottles does Bert buy? How much consumer surplus does Bert get from his purchases? Show Bert's consumer surplus in your graph.
 - If the price falls to \$2, how does quantity demanded change? How does Bert's consumer surplus change? Show these changes in your graph.
4. Ernie owns a water pump. Because pumping large amounts of water is harder than pumping small amounts, the cost of producing a bottle of water rises as he pumps more. Here is the cost he incurs to produce each bottle of water:

Cost of first bottle	\$1
Cost of second bottle	3
Cost of third bottle	5
Cost of fourth bottle	7

- From this information, derive Ernie's supply schedule. Graph his supply curve for bottled water.
 - If the price of a bottle of water is \$4, how many bottles does Ernie produce and sell? How much producer surplus does Ernie get from these sales? Show Ernie's producer surplus in your graph.
 - If the price rises to \$6, how does quantity supplied change? How does Ernie's producer surplus change? Show these changes in your graph.
5. Consider a market in which Bert from Problem 3 is the buyer and Ernie from Problem 4 is the seller.
- Use Ernie's supply schedule and Bert's demand schedule to find the quantity supplied and quantity demanded at prices of \$2, \$4, and \$6. Which of these prices brings supply and demand into equilibrium?
 - What are consumer surplus, producer surplus, and total surplus in this equilibrium?
 - If Ernie produced and Bert consumed one less bottle of water, what would happen to total surplus?

- If Ernie produced and Bert consumed one additional bottle of water, what would happen to total surplus?
6. The cost of producing stereo systems has fallen over the past several decades. Let's consider some implications of this fact.
- Use a supply-and-demand diagram to show the effect of falling production costs on the price and quantity of stereos sold.
 - In your diagram, show what happens to consumer surplus and producer surplus.
 - Suppose the supply of stereos is very elastic. Who benefits most from falling production costs—consumers or producers of stereos?
7. There are four consumers willing to pay the following amounts for haircuts:

Jerry: \$7 Oprah: \$2 Sally Jessy: \$8 Montel: \$5

There are four haircutting businesses with the following costs:

Firm A: \$3 Firm B: \$6 Firm C: \$4 Firm D: \$2

Each firm has the capacity to produce only one haircut. For efficiency, how many haircuts should be given? Which businesses should cut hair, and which consumers should have their hair cut? How large is the maximum possible total surplus?

8. Suppose a technological advance reduces the cost of making computers.
- Use a supply-and-demand diagram to show what happens to price, quantity, consumer surplus, and producer surplus in the market for computers.
 - Computers and adding machines are substitutes. Use a supply-and-demand diagram to show what happens to price, quantity, consumer surplus, and producer surplus in the market for adding machines. Should adding machine producers be happy or sad about the technological advance in computers?
 - Computers and software are complements. Use a supply-and-demand diagram to show what happens to price, quantity, consumer surplus, and producer surplus in the market for software. Should software producers be happy or sad about the technological advance in computers?
 - Does this analysis help explain why Bill Gates, a software producer, is one of the world's richest men?

9. Consider how health insurance affects the quantity of health care services performed. Suppose that the typical medical procedure has a cost of \$100, yet a person with health insurance pays only \$20 out-of-pocket when she chooses to have an additional procedure performed. Her insurance company pays the remaining \$80. (The insurance company will recoup the \$80 through higher premiums for everybody, but the share paid by this individual is small.)
- Draw the demand curve in the market for medical care. (In your diagram, the horizontal axis should represent the number of medical procedures.) Show the quantity of procedures demanded if each procedure has a price of \$100.
 - On your diagram, show the quantity of procedures demanded if consumers pay only \$20 per procedure. If the cost of each procedure to society is truly \$100, and if individuals have health insurance as just described, will the number of procedures performed maximize total surplus? Explain.
 - Economists often blame the health insurance system for excessive use of medical care. Given your analysis, why might the use of care be viewed as “excessive”?
 - What sort of policies might prevent this excessive use?
10. Many parts of California experienced a severe drought in the late 1980s and early 1990s.
- Use a diagram of the water market to show the effects of the drought on the equilibrium price and quantity of water.
 - Many communities did not allow the price of water to change, however. What is the effect of this policy on the water market? Show on your diagram any surplus or shortage that arises.
 - A 1991 op-ed piece in *The Wall Street Journal* stated that “all Los Angeles residents are required to cut their water usage by 10 percent as of March 1 and another 5 percent starting May 1, based on their 1986 consumption levels.” The author criticized this policy on both efficiency and equity grounds, saying “not only does such a policy reward families who ‘wasted’ more water back in 1986, it does little to encourage consumers who could make more drastic reductions, [and] . . . punishes consumers who cannot so readily reduce their water use.” In what way is the Los Angeles system for allocating water inefficient? In what way does the system seem unfair?
 - Suppose instead that Los Angeles allowed the price of water to increase until the quantity demanded equaled the quantity supplied. Would the resulting allocation of water be more efficient? In your view, would it be more or less fair than the proportionate reductions in water use mentioned in the newspaper article? What could be done to make the market solution more fair?