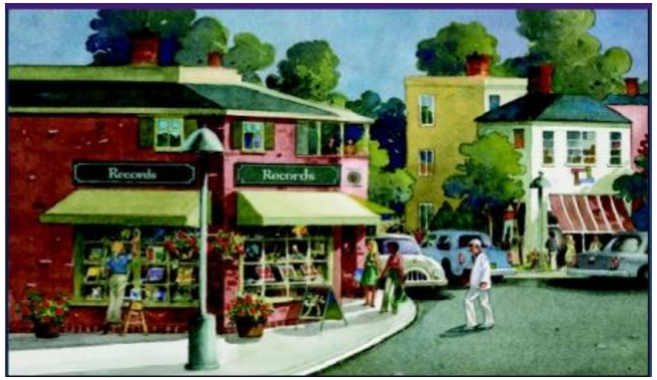


Markets and Welfare

Consumers, Producers, and the Efficiency of Markets

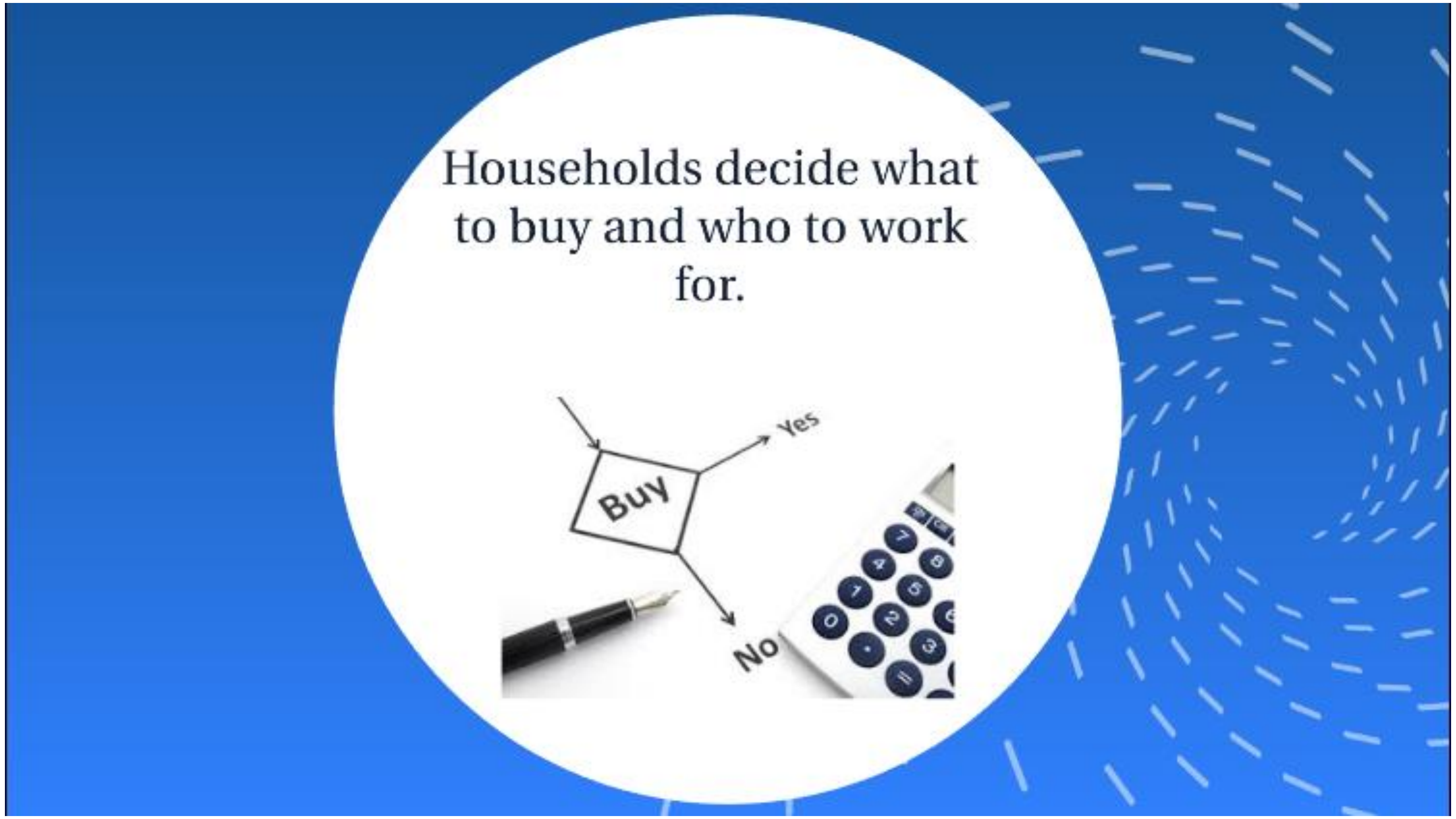
Tural ABBASOV

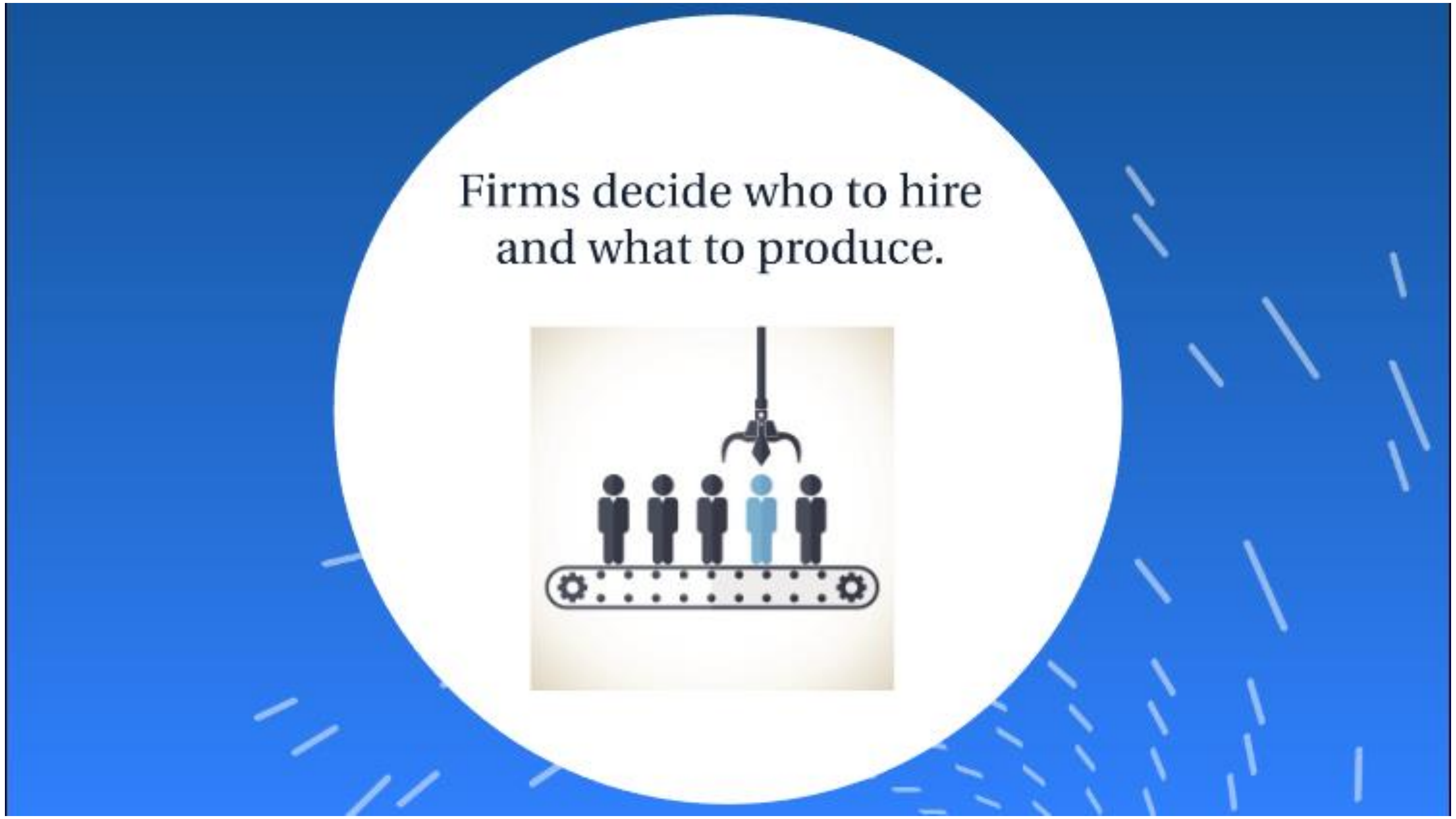
Firms decide who to hire and what to produce.
Invisible Hand
Markets Are Usually a Good Way to Organize Economic Activity
(Principle 6, «Ten Principles of Economics»)
Households decide what to buy and who to work for.
In a market econ- omy, the decisions of a central plann...
A market economy is an economy that allocat...

- **Market:** a group of buyers and sellers (need not be in a single location)
- "Organize economic activity" means determining
  - what goods to produce
  - how to produce them
  - how much of each to produce
  - who gets them

A market economy is an economy that allocates resources through decisions of many firms and house holds as they interact in markets for goods and services


In a market economy, the decisions of a central planner are replaced by the decisions of millions of firms and households.


Households decide what to buy and who to work for.
Buy
Yes
No


Firms decide who to hire
and what to produce.

Invisible Hand

Means the market of suppliers and consumers that guides suppliers to produce quality goods at the lowest price and consumers to purchase these goods.

A Doctor wants to earn a very high income good salary, a...

A Doctor wants to earn a very high income good salary, and also helps people live longer and improves peoples` lives. Both sides benefit.

Adam Smith and the «Invisible Hand»

«An Inquiry into the Nature and Causes of the Wealth of Nations», 1776

Adam Smith,
1723-1790

"Households and firms interacting in markets act as if they are guided by an "**invisible hand**" that leads them to desirable market outcomes"

Adam Smith and the «Invisible Hand»

Adam Smith, 1723-1790

«An Inquiry into the Nature and Causes of the Wealth of Nations», 1776

"Every individual…neither intends to promote the public interest, nor knows how much he is promoting it….

He intends only his own gain, and he is in this, as in many other cases, led by an "**invisible hand**" to promote an end which was no part of his intention.

Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."

- Communist countries – central planning
  - Government officials (central planners)
    - Allocate economy's scarce resources
      - Decided
        - What goods & services were produced
        - How much was produced
        - Who produced & consumed these goods & services
    - Theory: only the government could organize economic activity to promote economic well-being for the country as a whole

The Free Market vs. Central Planning

- Suppose resources were allocated not by the market, but by a central planner who cares about society's well-being.
- To allocate resources efficiently and maximize total surplus, the planner would need to know every seller's cost and every buyer's WTP for every good in the entire economy.
- This is impossible, and why centrally-planned economies are never very efficient.

The Free Market vs. Government Intervention

- The market equilibrium is efficient. No other outcome achieves higher total surplus.
- Government cannot raise total surplus by changing the market's allocation of resources.
- ***Laissez faire*** (French for "allow them to do"): the notion that govt should not interfere with the market.

Welfare Economics

- **Welfare economics** studies how the allocation of resources affects economic well-being (social welfare).
- **Welfare economics** is the study of economic efficiency and income distribution, as well as how they affect the overall well-being of people in the economy.
- the **allocation of resources** refers to:
  - how much of each good is produced
  - which producers produce it
  - which consumers consume it

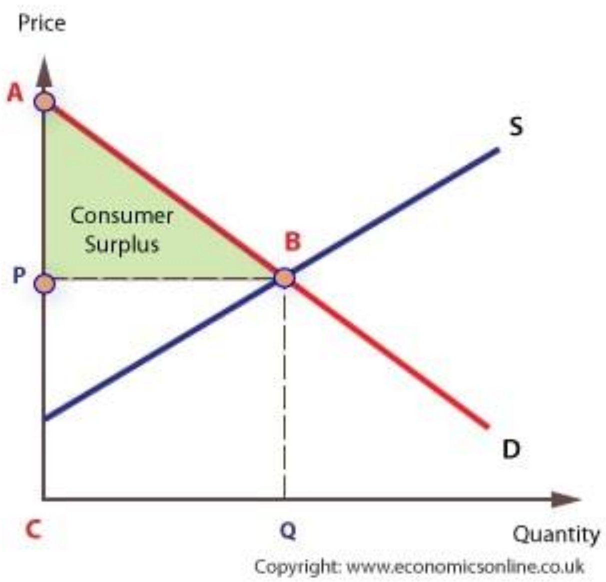
Welfare Economics

- ✓ **Consumer Surplus**
- ✓ **Producer Surplus**
- ✓ **Market Efficiency**

✓ Consumer Surplus

What is 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 satisfy the preferences of buyers.



Consumer surplus = Value to buyers (Willingness to Pay Price) – Amount paid by buyers (Market Price)

✓ Consumer Surplus

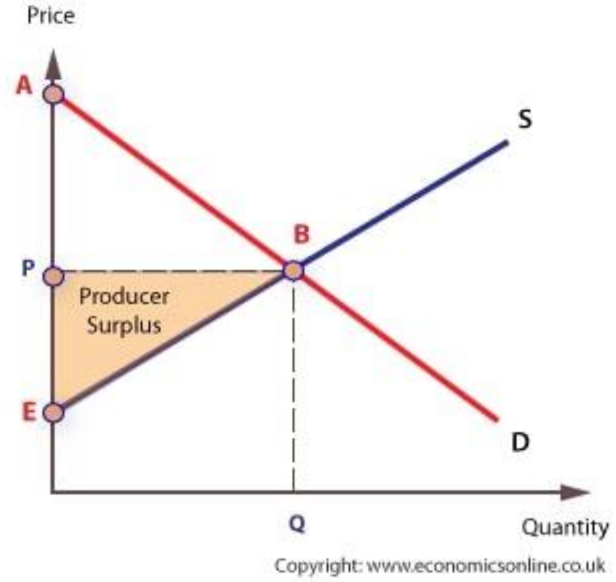
KEY TAKEAWAYS

- ✓ **Consumer surplus happens when the price consumers pay for a product or service is less than the price they're willing to pay.**
- ✓ **Consumer surplus is the benefit or good feeling of getting a good deal.**
- ✓ **Consumer surplus always increases as the price of a good falls and decreases as the price of a good rises.**

✓ Producer Surplus

What is producer surplus?

<u>Producer surplus</u> is the difference between how much a person would be willing to accept for given quantity of a good versus how much they can receive by selling the good at the market price.
The difference or surplus amount is the benefit the producer receives for selling the good in the market.



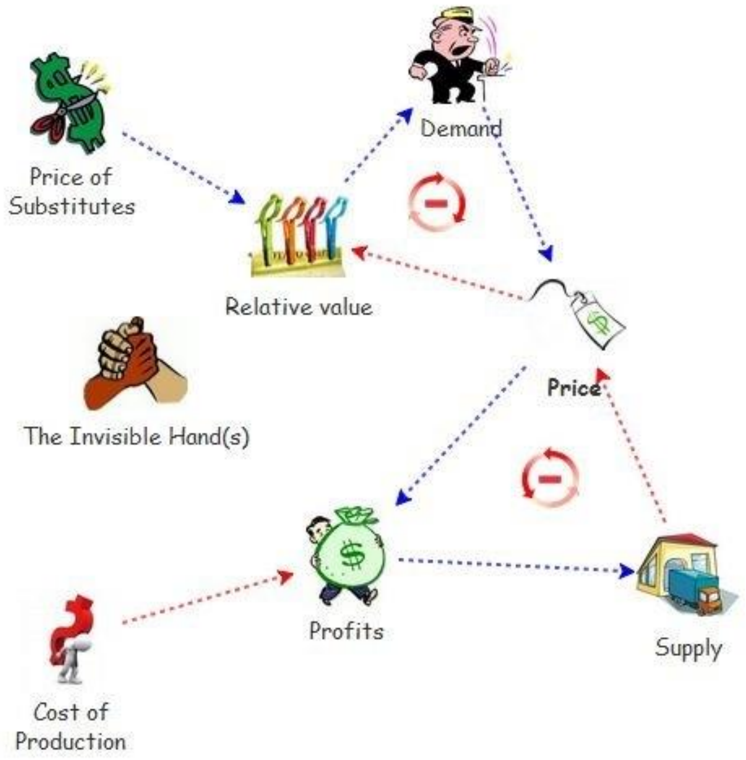
Producer surplus = Amount received by sellers (Market Selling Price) – Cost to sellers (Economic Cost)

✓ Producer Surplus

KEY TAKEAWAYS

- ✓ **Producer surplus is the total amount that a producer benefits from producing and selling a quantity of a good at the market price.**
- ✓ **The total revenue that a producer receives from selling their goods minus the total cost of production equals the producer surplus.**
- ✓ **Producer surplus plus consumer surplus represents the total benefit to everyone in the market from participating in production and trade of the good.**

The Market's Allocation of Resources



- In a market economy, the allocation of resources is decentralized, determined by the interactions of many self-interested buyers and sellers.
- Is the market's allocation of resources desirable? Or would a different allocation of resources make society better off?
- To answer this, we use total surplus as a measure of society's well-being, and we consider whether the market's allocation is *efficient*.

  (Policymakers also care about *equality*, though are focus here is on efficiency.)

✓ Market Efficiency

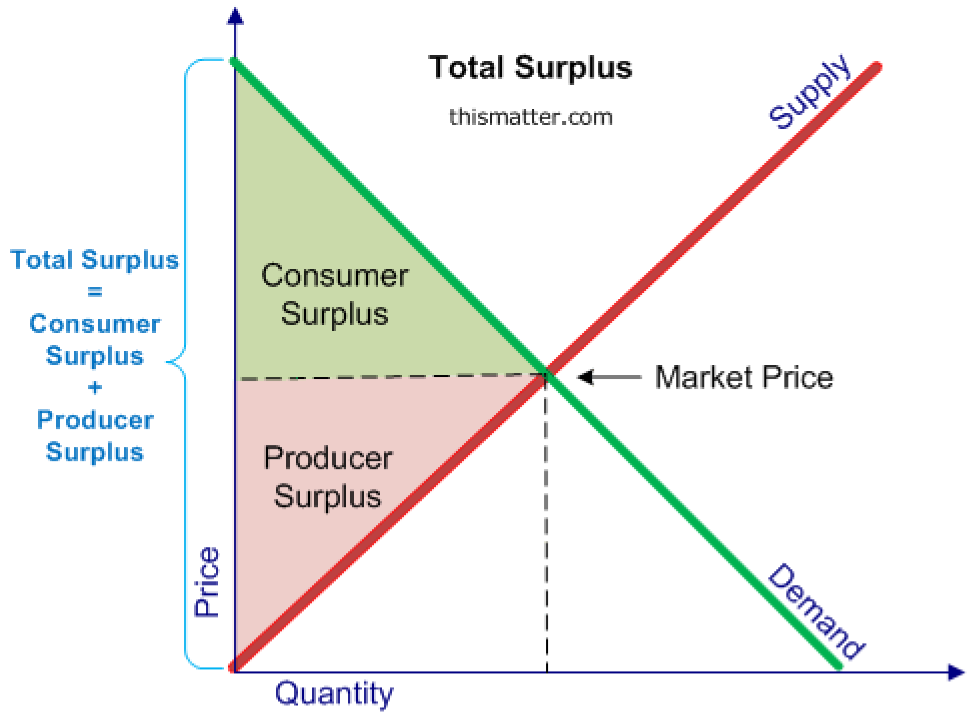
An allocation of resources is efficient if it maximizes total surplus. Efficiency means:

- **The goods are consumed by the buyers who value them most highly.**
- **The goods are produced by the producers with the lowest costs.**
- **Raising or lowering the quantity of a good would not increase total surplus.**

As a term **«Efficiency means that total surplus is maximized, that the goods are produced by sellers with lowest cost, and that they are consumed by buyers who most value them.»**

Under perfect competition, the market outcome is efficient. Altering it would reduce total surplus.

To measure of society's well-being, we use total surplus, the sum of consumer and producer surplus



When we add consumer and producer surplus together, we obtain

Total surplus= Value to buyers (Willingness to Pay Price) - Amount paid by buyers(Actual Purchase Price) + Amount received by sellers (Actual Selling Price) - Cost to sellers (Economic Cost)

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

Total surplus= Value to buyers (Willingness to Pay Price) - ~~Amount paid by buyers(Actual Purchase Price) + Amount received by sellers (Actual Selling Price)~~ - Cost to sellers (Economic Cost)

Total surplus = Value to buyers (Willingness to Pay Price) – Cost to sellers (Economic Cost)

CS, PS, and Total Surplus

CS = (value to buyers) – (amount paid by buyers)

= buyers' gains from participating in the market

PS = (amount received by sellers) – (cost to sellers)

= sellers' gains from participating in the market

Total surplus = CS + PS

= total gains from trade in a market

= (value to buyers) – (cost to sellers)

P.S. "participating in the market" means buying and selling.


THANKS
FOR YOUR ATTENTION!!
ANY QUESTIONS?
NO?
GREAT! BYE!