Taxation and Government Intervention

Chapter 7-1

Laugher Curve

Two economists meet on the street.
Q. How’s your wife?
A. Relative to what?

Producer and Consumer Surplus

- **Consumer surplus** – the value the consumer gets from buying a product less its price.
- It is the area underneath the demand curve and above the price an individual pays.
Producer and Consumer Surplus

- **Producer surplus** – the value the producer sells a product for less the cost of producing it.

- It is the area above the supply curve but below the price the producer receives.

Producer and Consumer Surplus

- The combination of consumer and producer surplus is as large as it can be at market equilibrium.

Producer and Consumer Surplus

- The diagram shows the relationship between price, quantity, consumer surplus, producer surplus, supply, demand, and how they interact at market equilibrium.

Price

Quantity

$10 $9 $8 $7 $6 $5 $4 $3 $2 $1 $0

Consumer Surplus

Producer Surplus

Supply

Demand

1 2 3 4 5 6 7 8 9 10
Producer and Consumer Surplus

- The combined consumer and producer surplus falls when price is above market equilibrium.

- The combination of producer and consumer surplus is maximized at market equilibrium.

CS = \( \frac{1}{2} \times 5 \times 5 = 12.5 \) = Area of blue triangle
PS = \( \frac{1}{2} \times 5 \times 5 = 12.5 \) = Area of red triangle

Producer and Consumer Surplus
Producer and Consumer Surplus

If price is $6,
Consumer Surplus: 
CS = 1/2 ($4x4) = $8

Lost surplus = 1/2($2x1) = $1

Producer Surplus gains 2x4 = 8
units of lost consumer surplus

Combined consumer and
producer surplus decreases
when price is above
equilibrium.