

Subject: Microeconomic Theory I

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What is consumer surplus?

When there is a difference between the price that you pay in the market and the value that you place on the product, then the concept of consumer surplus becomes a useful one to look at. This is an important idea that you can use on many occasions in your exams.

Topic video on consumer surplus

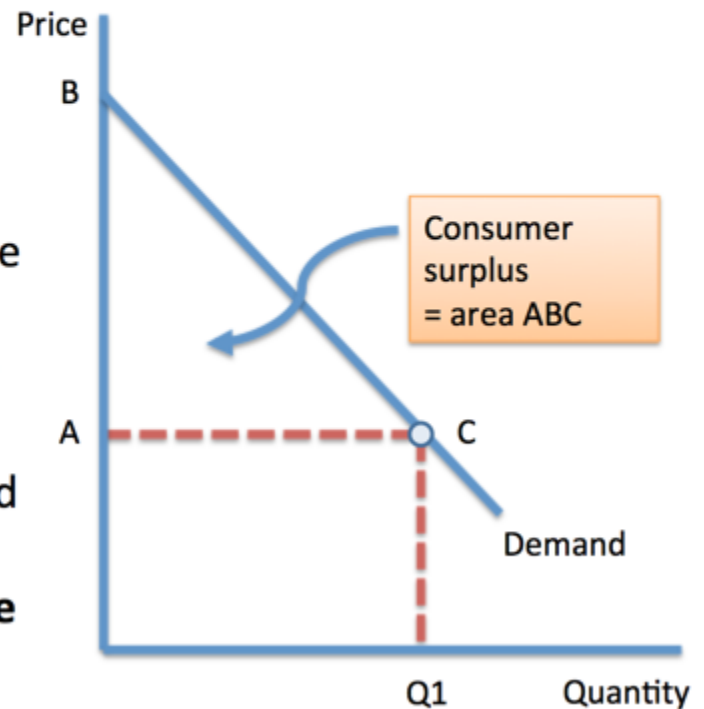
Consumer surplus and economic welfare

- **Consumer surplus** is a measure of the **welfare** that people gain from consuming goods and services
- Consumer surplus is defined as the difference between the total amount that consumers are **willing and able to pay** for a good or service (indicated by the demand curve) and the total amount that they actually do pay (i.e. the market price).
- Consumer surplus is shown by the area under the demand curve and above the price.

What is Consumer Surplus?

Consumer surplus is a measure of the economic welfare that people gain from purchasing and then consuming goods and services

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Consumer surplus

Consumer surplus and price elasticity of demand

How is consumer surplus affected by the elasticity of a demand curve?

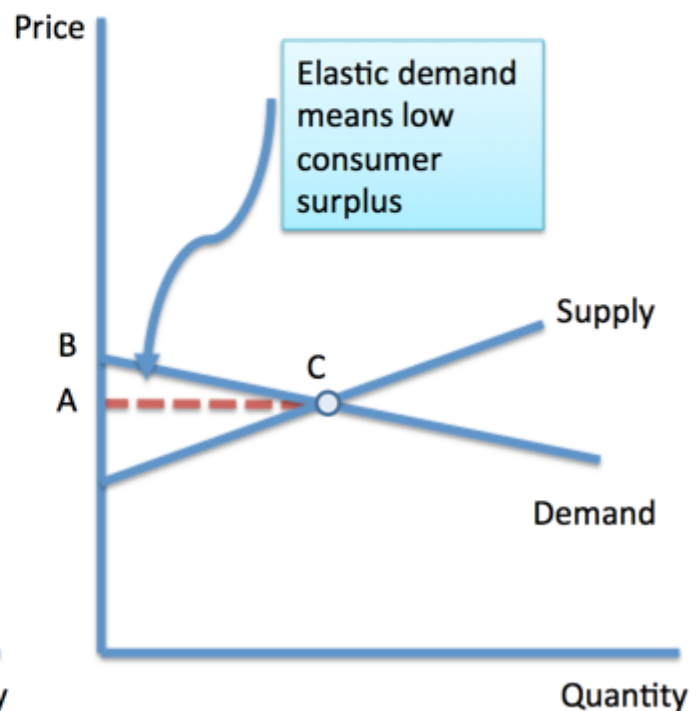
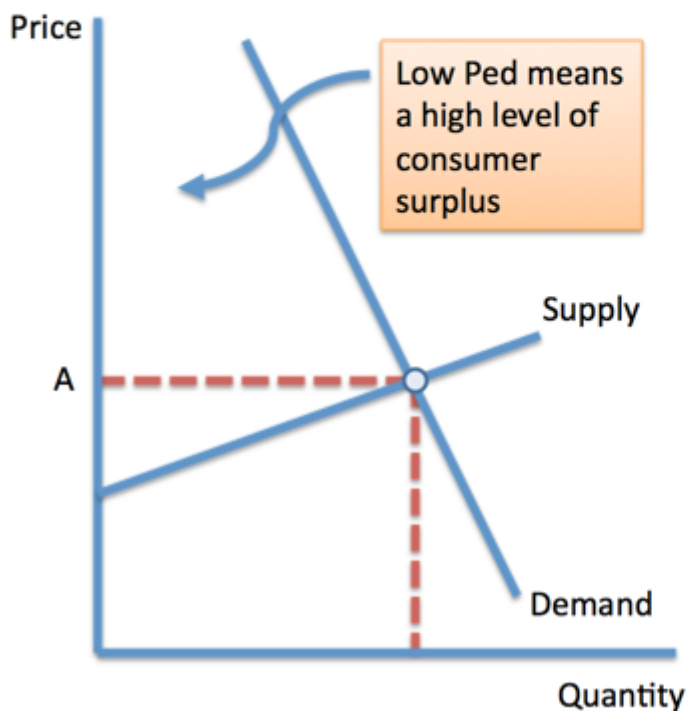
1. When the demand for a good or service is **perfectly elastic**, consumer surplus is zero because the price that people pay matches exactly what they are willing to pay.
2. In contrast, when demand is **perfectly inelastic**, consumer surplus is infinite. In this situation, demand does not respond to a price change. Whatever the price, the quantity demanded remains the same. Are there any examples of products that have such zero price elasticity of demand? Perhaps the closest we get is a life-saving product with no obvious substitutes - in this situation, consumers' willingness to pay will be extremely high
3. The majority of demand curves in markets are assumed to be downward sloping. When demand is inelastic (i.e. $Ped < 1$), there is a greater potential consumer surplus because there are some buyers willing to pay a high price to continue consuming the product.

Businesses often raise prices when demand is inelastic so that they can turn consumer surplus into producer surplus!

Consumer surplus with elastic and inelastic demand curves

Consumer Surplus and Price Elasticity of Demand

When demand is inelastic, there is a greater consumer surplus because there are some buyers willing to pay a high price to continue consuming the product

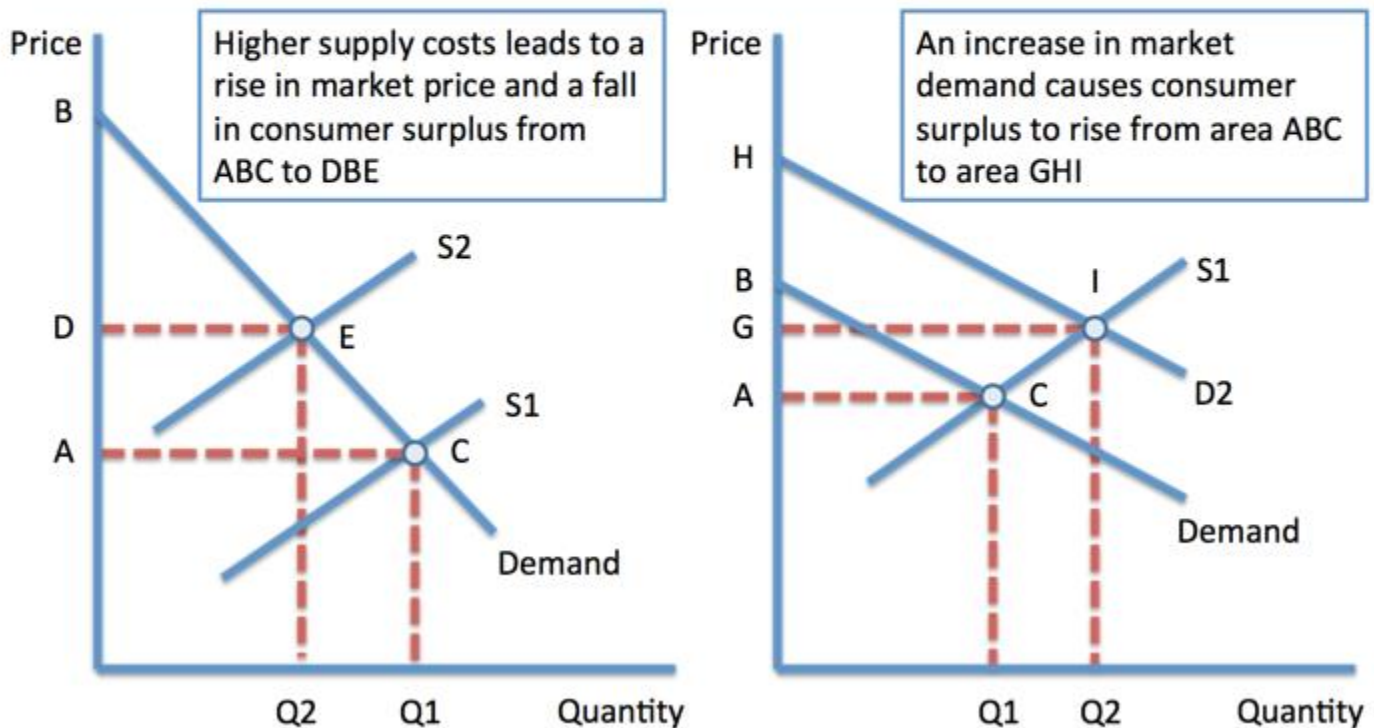


PED and consumer surplus

When there is a shift in the demand curve leading to a change in the equilibrium market price and quantity, then the level of consumer surplus will change too

Consumer Surplus and Changes in Market Prices

The level of consumer surplus changes as the market price for a good or service changes – here are two examples



Changes in consumer surplus

Price discrimination and consumer surplus

- Producers often take advantage of consumer surplus when setting prices
- If a business can identify groups of consumers within their market who are willing and able to pay different prices for the same products, then sellers use **price discrimination** – this is a way of turning consumer surplus into producer surplus, but simply to make higher revenues and profits.
- Airlines and train companies are expert at this, extracting from consumers the price they are willing and able to pay for flying to different destinations at various times of the day, and exploiting **variations in elasticity of demand** for different types of passenger service.

- You will always get a better deal / price with airlines such as EasyJet and Ryan Air if you are prepared to book in advance. The airlines are happy to sell tickets more cheaply because they get the benefit of cash-flow together with the guarantee of a seat being filled. The nearer the time to take-off, the higher the price
- If a businessman is desperate to fly from Newcastle to Paris in 24 hours time, his or her demand is said to be price inelastic and the corresponding price for the ticket will be much higher.

Price discrimination and market power

One of the main arguments against firms with **monopoly power** is that they can exploit their monopoly position by raising prices in markets where demand is inelastic, extracting consumer surplus from buyers and increasing profit margins at the same time.

Books

1. Pindyck and Rubinfeld with Mehta (2005), Microeconomics- latest available Edition in market.
2. D.N Dwivedi (2016), Microeconomics Theory and Application-- latest available Edition in market.
3. Koutsoyiannis, A., Modern Microeconomics, Macmillan, London.