Describe the relationship between the concepts of consumer surplus, moral hazard,...

Experience, Human Nature

Consumer surplus is maximized under a system of free markets because every agent in the economy is responding to price signals. If a good's price is high, the consumer knows that he must give up quantities of other goods to get it, and will be sparing in his consumption of that good. If a good's price is low, the consumer knows that he can consume it without significantly curtailing his consumption of other goods, and will be inclined to consume more of it (Leach 7). However, Leach (8) stated that this price signaling mechanism works less well under certain types of intervention. For example, it works less well if commodity prices no longer represent the true cost of producing goods, or if the prices of resources no longer indicate their relative scarcity. It also works less well if agents are prevented from responding to price signals. Interventions of this kind include taxes and subsidies and quantity constraints (Leach 8). Hence, in a free, competitive market, the increased presence of interventions (e. g. taxes and quantity constraints) reduces the capacity of agents to respond to price-signals, and then surplus is not maximized but lessened. The lost surplus is called the welfare cost. However, Leach noted that there are also intervention types that do not harm this price-signaling mechanism such as the case of redistribution (8). In the case of a subsidy, which is the opposite of tax imposition, although both of the consumers and producers enjoy an increase in their surpluses, the gains in consumer and producer surplus would again be exceeded by the government's loss of surplus, thus incurring a welfare cost (Leach 14). Leach (12) cites that the welfare cost in this case occurs because the subsidy encourages trades that are not mutually beneficial. Each of these units was sold by a producer who placed a value of at least p* on the unit, and bought by a consumer who placed a value of no more than p* on it. Each of the transactions transferred a unit of goods from someone who placed a relatively high value on it, to another who placed a relatively low value on it. To extend this analysis to illustrate moral hazard, because consumers now enjoy an increase in their surplus without even the need to shell out more money because the government will shoulder it, consumers are then inclined to inefficiently use these resources because they know they can always pay for a marginal unit of that good at a lower cost than if it they were paying for the true cost of producing that good (i. e., without the government shouldering some part of the cost of that good).

Works Cited

Leach, John. 'Consumer and Producer Surplus' in A Course in Public Economics. John Leach, 2002. Retrieved 14 May 2006