Chapter 3
Consumer and Producer Theory

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ABSTRACT

This chapter takes an in-depth look at consumer and producer economic theories. Both theories play a central role in decision making by individuals, businesses, and the government. To help understand how these theories function, the chapter provides an overview of the economic "laws" of supply and demand. The chapter continues with an exploration of government intervention in the marketplace, including the subjects of market failure, regulation, incentives, price controls, taxation, governmental hiring, and the purchase of private sector goods by public sector entities. To conclude, the chapter links government actions to consumer and producer economic theories in its daily operations as a means to enhance efficiency, effectiveness, and equitable service delivery.

INTRODUCTION

The study of economics has its roots in one basic principle: the amount of supply available of a particular good/service versus the amount of demand for the same good/service. Producer theory considers how firms work to determine the supply of goods that maximizes profits. Consumer theory looks at how individual preferences affect the demand for certain goods in the marketplace. Both theories seek to explain the functionality of the market system. Government plays a role by intervening in the marketplace through the creation of rules and regulations that influence the amount of supply and demand available for consumers to consume and producers to produce. Government also stands to learn from private sector marketplace activities that, if applied in the public sector, could make the bureaucratic system more efficient, effective, and equitable in service delivery.

The chapter begins by illustrating the basics of supply and demand theories and their role as the basis of economic theory in a capitalist system. This discussion is followed by an explanation of consumer and producer theory, which considers actions taken by those in the marketplace in an effort to enhance

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the amount of supply or demand of goods. The chapter continues by exploring several means used by government to intervene in the marketplace. To conclude, the chapter examines of how the public sector bureaucracy considers the use of consumer and producer theories as part of the policy development and implementation process, and how it relates to the use of strategic management principles in the public sector.

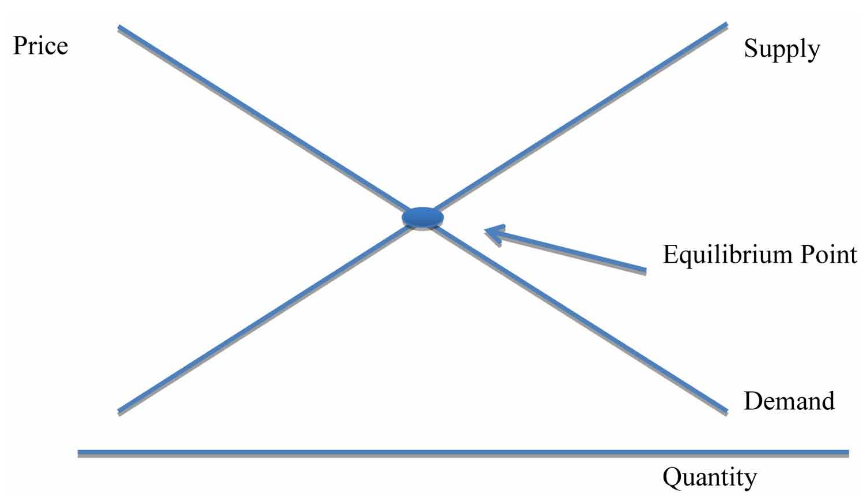
SUPPLY AND DEMAND

The interaction of supply and demand defines basically every possible economic event. Simply put, the "law of supply" states that the quantity of a product supplied increases as prices rise, and declines as the price drops. Conversely the "law of demand" suggests the amount of demand rises as prices fall, and declines as prices rise (Ehrbar, 2008; Henderson, 2008). This basic premise of supply and demand is widely accepted and easily recognized by economists and non-economists alike. After all, our own behavior at the grocery store, for instance, can change as prices of goods decline when items are on sale, or when prices rise due to things like a poor growing season or animal disease leading to a limitation in the amount of crops or meat produced (Henderson, 2008).

In a market economy, the optimal point sought by those producing and consuming a good is when the amount of supply produced is balanced with the amount of demand for that particular good. If prices are above that optimal point, sales will decline as demand is reduced. If prices are too low, consumers may like it but suppliers will reduce the amount of goods produced, leaving some amount of demand unfulfilled (Ehrbar, 2008). Figure 1 demonstrates the supply and demand curve, with the equilibrium point illustrated where the lines intersect.

The supply and demand curve shown in Figure 1 portrays the quantity of a good produced and sold respectively at a particular price. Markets in which producers determine their own prices allow for

Figure 1. Supply and demand curve



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