

# Chapter 2

## Market Systems

### What are market systems?

These are mechanisms of allocating resources in the economy. Resources may be allocated by government when it makes decisions to answer the central economic problem. On the other hand the questions may be answered through the free interaction of demand and supply in the economy.

### State and explain the three main market systems.

#### **1. The free market or price or capitalist System**

The free market system is where the decision about what is produced is the outcome of millions of separate individual decisions made by consumers, producers and owners of productive services. The decisions reflect private preferences and interests. For the free enterprise to operate there must be a price system/mechanism. The price system is the situation where the vital economic decisions in the economy are reached through the workings of the market price. There is no government intervention. Thus, everything – houses, labour, food, land etc come to have its market price, and it is through the workings of the market prices that the "What?", "How?", and "For whom?" decisions are taken. The free market thus gives rise to what is called Consumer Sovereignty – a situation in which consumers are the ultimate dictators, subject to the level of technology, of the kind and quantity of commodities to be produced. Consumers are said to exercise this power by bidding up the prices of the goods they want most; and suppliers, following the lure of higher prices and profits, produce more of the goods.

### What are The features of a free market system?

#### (i) Ownership of Means of Production

Individuals are free to own the means of production i.e. land, capital and enjoy incomes from them in the form of rent, interest and profits.

#### (ii) Freedom of Choice and Enterprise

Entrepreneurs are free to invest in businesses of their choice, produce any product of their choice, workers are free to sell their labour in occupations and industries of their choice; Consumers are free to consume products of their choice.

(iii) Self Interest as the Dominating Motive

Firms aim at maximising their profits, workers aim at maximising their wages, landowners aim at maximising their return from their land, and consumers at maximising their satisfaction

(iv) Competition

Economic rivalry or competition envisages a situation where, in the market for each commodity, there are a large number of buyers and sellers. It is the forces of total demand and total supply which determine the market price, and each participant, whether buyer or seller, must take this price as given since it's beyond his or her influence or control.

(v) Reliance on the Price Mechanism

Price mechanism is where the prices are determined on the market by supply and demand, and consumers base their expenditure plans and producers their production plans on market prices.

Price mechanism rations the scarce goods and services in that, those who can afford the price will buy and those who cannot afford the price will not pay.

(vi) Limited Role of Government

In these systems, apart from playing its traditional role of providing defence, police service and such infrastructural facilities as roads for public transport, the Government plays a very limited role in directly economic profit making activities.

**Describe how Resources are allocated in a free market**

There are no central committees organising the allocation of resources

The major price and allocation decisions are made in the markets. The market being the process by which the buyers and sellers of a good interact to determine its price and quantity.

If more is wanted of any commodity say wheat – a flood of new orders will be placed for it. As the buyers scramble around to buy more wheat, the sellers will raise the price of wheat to ration out a limited supply. And the higher price will cause more wheat to be produced. The reverse will also be true.

People, by being willing to spend money, signal to producers what it is they wish to be produced.

Thus what things will be produced will is determined by the dollar of consumers.

The “How?” questions is answered because one producer has to compete with others in the market; if that producer can not produce as cheaply as possible then customers will be lost to competitors.

The “for whom?” question is answered by the fact that anyone who has the money and is willing to spend it can receive the goods produced. Who has the money is determined by supply and demand in the markets.

### **State and explain the Advantages and disadvantages of a Free Market System**

**Incentive:** People are encouraged to work hard because opportunities exist for individuals to accumulate high levels of wealth.

**Choice:** People can spend their money how they want; they can choose to set up their own firm or they can choose for whom they want to work.

**Competition:** Through competition, less efficient producers are priced out of the market; more efficient producers supply their own products at lower prices for the consumers and use factors of production more efficiently. The factors of production which are no longer needed can be used in production elsewhere. Competition also stimulates new ideas and processes, which again leads to efficient use of resources.

A free market also **responds well to changes:** in consumer wishes, that is, it is flexible. Because the decision happen in response to change in the market there is no need to use additional resources to make decisions, record them and check on whether or not they are being carried out.

***Task: In your own words explain the follwing advantages***

**Encourages Foreign Direct Investment**

**Reduces political risks explain**

### **Disadvantages of a Free Economy**

The free market gives rise to certain inefficiencies called market failures i.e. where the market system fails to provide an optimal allocation of resources. These include:

**Unequal distribution of wealth:** The wealthier members of the society tend to hold most of the economic and political power, while the poorer members have much less influence. There is an

unequal distribution of resources and sometimes production concentrates on luxuries i.e. the wants of the rich. This can lead to excessive numbers of luxury goods being produced in the economy. It may also result to social problems like crimes, corruption, etc.

**Public goods:** These are goods which provide benefits which are not confined to one individual household i.e. possess the characteristic of non-rival consumption and non-exclusion. The price mechanism may therefore not work efficiently to provide these services e.g. defence, education and health services.

**Externalities:** Since the profit motive is all important to producers, they may ignore social costs production, such as pollution. Alternatively, the market system may not reward producers whose activities have positive or beneficial effects on society.

**Wasted or reduced competition:** some firms may use expensive advertising campaigns to sell “new” products which are basically the same as may other products currently on sale. Other firms, who control most of the supply of some goods may choose to restrict supply and therefore keep prices artificially high; or, with other suppliers, they may agree on the prices to charge and so price will not be determined by the interaction of supply and demand.

Production of **demerit goods** eg drugs, and alcohol since they are profitable.

**Underproduction of merit goods**( socially acceptable goods /services)

Task: What is the difference between merit and demerit goods?

## **2. What is The Command or PLANNED market economy?**

Is a system where all major economic decisions are made by a government ministry or planning organisation. Here all questions about the allocation of resources are determined by the government.

**What is the Feature of this system?**

The command economies relies exclusively on the state. The government will decide what is made, how it is made, how much is made and how distribution takes place. The resources –

factors of production – on behalf of the producers and consumers. Price levels are not determined by the forces of supply and demand but are fixed by the government.

### **State and explain any Advantages and Disadvantages of Planned System**

- i) **Uses of resources:** Central planning can lead to the full use of all the factors of production, so reducing or ending unemployment.
- ii **Large scale production:** Economies of scale become possible due to mass production taking place.
- iii. **Public services:** “Natural monopolies” such as the supply of domestic power or defence can be provided efficiently through central planning.
- iv) **Basic services:** There is less concentration on making luxuries for those who can afford them and greater emphasis on providing a range of goods and services for all the population.
- v) **There are less dramatic differences in wealth** and income distribution than in market economy

### **Disadvantages of the Planned System**

The centrally planned economies suffer from the following limitations:

**Lack of choice:** Consumers have little influence over what is produced and people may have little to say in what they do as a career.

**Little incentive:** Since competition between different producers is not as important as in the market economy, there is no great incentive to improve existing systems of production or work. Workers are given no real incentives to work harder and so production levels are not as high as they could be.

**Centralised control:** Because the state makes all the decisions, there must be large influential government departments. The existence of such a powerful and large bureaucracy can lead to inefficient planning and to problems of communication. Furthermore, government officials can become over privileged and use their position for personal gain, rather than for the good of the rest of the society.

### **Describe how Resources are allocated in a command market**

In such economies, the government influences economic activity in a variety of ways and for a variety of purposes.

What is produced, how it produced, for who it is produced is determined by the government through:

- (a) Direct control over macroeconomic forces can be exercised through policy on tax, spending and interest rates.
- (b) Taxes, subsidies and direct controls can affect the relative prices of goods and services.
- (c) Government-owned institutions can provide goods and services directly, free or at low cost at the point of consumption.

### **3. Describe The Mixed Economy.**

There are no economies in the world which are entirely 'market' or planned, all will contain elements of both systems.

The degree of mix in any one economy is the result of a complex interaction of cultural, historic and political factors. For example the USA which is a typical example of a largely work-based society, but the government still plans certain areas of the economy such as defence and provides very basic care for those who cannot afford medical insurance.

#### **What are the Features of this system?**

The mixed economy includes elements of both market and planned economies.

The government operates and controls the public sector, which typically consists of a range of public services such as health and education, as well as some local government services.

The private sector is largely governed by the force of mechanism and "market forces", although in practice it is also controlled by various regulations and laws.

Some services may be subsidised, provided at a loss but kept for the benefit of society in general (many national railways, for example, are loss making), other services such as education or the police may be provided free of charge (though they are paid for through the taxation system).

The private sector is regulated, i.e. influenced by the price mechanism but also subject to some further government control, such as through pollution, safety and employment regulation.

### **What are the Advantages and disadvantages of the Mixed Economy?**

Necessary services are provided in a true market economy, services which were not able to make profit would not be provided.

Incentive: Since there is a private sector where individuals can make a lot of money, incentives still exist in the mixed economy.

Competition: Prices of goods and services in the private sector are kept down through competition taking place.

### **Disadvantages of Mixed Economy**

Large monopolies can still exist in the private sector, and so competition does not really take place

There is likely to be a lot of bureaucracy and “red tape” due to existence of a public sector.

## **Summary**

The way in which the choices about resource allocation are made, the way value is measured, and the forms of ownership of economic wealth will also vary according to the type of **economic system** that exists in a society.

(a) In a **centrally planned** (or **command**) **economy**, the decisions and choices about resource allocation are made by the **government**. Monetary values are attached to resources and to goods and services, but it is the government that decides what resources should be used, how much should be paid for them, what goods should be made and, in turn, what their price should be. This approach is based on the theory that only the government can make fair and proper provision for all members of society.

(b) In a **free market economy**, the decisions and choices about resource allocation are left to **market forces of supply and demand**, and the workings of the **price mechanism**. This

approach is based on the observable fact that it generates more wealth in total than the command approach.

(c) In a **mixed economy** the decisions and choices are made partly by free market forces of supply and demand, and partly by government decisions. Economic wealth is divided between the **private sector** and the **public sector**. This approach attempts to combine the efficiency of the market system with the centrally planned system's approach to fair and proper distribution.

***Task: Discuss how the central economic problem is solved by the different market systems you know from your knowledge of economics.***