

OCR Economics AS-level **Microeconomics**

Topic 1: Scarcity and Choice

1.2 The market economy

Notes



Market economies:

- Also known as free market economies, or *laissez-faire economies*, where governments leave markets to their own devices. The market forces of supply and demand allocate scarce resources.
- Economic decisions are taken by private individuals and firms, and private individuals own everything. There is no government intervention.
- In reality, governments usually intervene by implementing laws and public services, such as property rights and national defence.

- **What to produce:** determined by what the consumer prefers
- **How to produce it:** producers seek profits
- **For whom to produce it:** whoever has the greatest purchasing power in the economy, and is therefore able to buy the good

- **Advantages:**
 - Firms are likely to be efficient because they have to provide goods and services demanded by consumers. They are also likely to lower their average costs and make better use of scarce resources. Therefore, overall output of the economy increases.
 - The bureaucracy from government intervention is avoided.
 - Some economists might argue the freedom gained from having a free economy leads to more personal freedom.

- **Disadvantages:**
 - The free market ignores inequality, and tends to benefit those who hold most of the wealth. There are no social security payments for those on low incomes.
 - There could be monopolies, which could exploit the market by charging higher prices.
 - There could be the overconsumption of demerit goods, which have large negative externalities, such as tobacco.
 - Public goods are not provided in a free market, such as national defence. Merit goods, such as education, are underprovided.



Government Intervention:

- When the government intervenes in a market economy, it is known as a **mixed economy**. This is the most common economic system today. There are different extents of government intervention. The UK is generally considered quite balanced, whilst the US is slightly more free (although the government spends around 35% of GDP) and Cuba is more centrally planned.
- The market is controlled by both the government and the forces of supply and demand.
- Governments often provide public goods such as street lights, roads and the police, and merit goods, such as healthcare and education.

- **What to produce:** determined by both consumer and government preferences
- **How to produce it:** determined by producers making profits and the government
- **For whom to produce it:** both who the government prefers and the purchasing power of private individuals.

- **Advantages of government intervention:**
 - It might be easier to coordinate resources in times of crises, such as wars.
 - The government can compensate for market failure, by reallocating resources. They might ensure everyone can access basic necessities.
 - Inequality in society could be reduced, and society might maximise welfare rather than profit.
 - The abuse of monopoly power could be prevented.

- **Disadvantages of government intervention:**
 - Governments fail, as do markets, and they may not be fully informed for what to produce.
 - They may not necessarily meet consumer preferences.
 - It limits democracy and personal freedom.

