

# CIE Economics AS-level

## Topic 1: Basic Economic Ideas and Resource Allocation

### **d) Resource allocation in different economic systems and issues of transition**

Notes



## Decision making in market, planned and mixed economies

### Free market economies:

- Also known as *laissez-faire economies*, where governments leave markets to their own devices, so 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.
- Adam Smith and Friedrich Hayek were famous free market economists. Adam Smith's famous theory of the invisible hand of the market can be applied to free market economies and the price mechanism, which describes how prices are determined by the 'spending votes' of consumers and businesses. Smith recognised some of the issues with monopoly power that could arise from a free market, however. Hayek argued that government intervention makes the market worse. For example, shortly after the 1930s crash, he argued that the Fed caused the crash by keeping interest rates low, and encouraging investments which were not economically worthwhile: 'malinvestments'.
  
- **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.

-  **Planned economy:**

- This is where the government allocates all of the scarce resources in an economy to where they think there is a greater need. It is also referred to as central planning.
- Karl Marx saw the free market as unstable. He saw profits created in the free market as coming from the exploitation of labour, and by not paying workers to cover the value of their work. He argued for the “common ownership of the means of production”.

- **What to produce:** determined by what the government prefers
- **How to produce it:** governments and their employees
- **For whom to produce it:** who the government prefers

- **Advantages:**

- 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:**

- 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.

-  **Mixed economy:**



- This has features of both planned and free economies and is the most common economic system today. There are different balances between planned and free economies in reality, though. The UK is generally considered quite central, 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.

### **The role of the factor enterprise in a modern economy**

-  This considers what the role of the entrepreneur is in a market economy.
-  Entrepreneurs generate ideas and stimulate the onset of innovation. Entrepreneurs are rewarded for their risks with profit.
-  Governments can support enterprise by motivating firms and encouraging them to invest.
-  Enterprise can help create wealth and jobs in the economy.

