OCR Economics A-level

Microeconomics

Topic 1: Introduction to Microeconomics

1.2 The Allocation of Resources

Notes

Resource allocation:

- This refers to how resources are distributed among producers and how goods and services are distributed among consumers.

Incentives on economic agents for resource allocation:

- Economic agents respond to incentives, which can allocate scarce resources to provide the highest utility to each agent.
- For the entrepreneur in a firm, the incentive for taking risks is profit.
- Rewards are positive incentives which will make consumers better off, whilst penalties make them worse off.
- Where incentives are not given properly, resources will be misallocated.
- Prices in market economies provide signals to buyers and sellers, which is an incentive to purchase or sell the good. This changes their behaviour.
- For example, a high demand and high price for a good will give an incentive to firms to allocate more resources to producing that good.
- An entrepreneur wants to avoid loss and gain profit, which makes them want to innovate, so they can reduce their production costs, and improve the quality of their products.
- Firms need an incentive to engage in risk taking, so they innovate. Without innovation, production will cost more and there will be a misallocation of resources.

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 market economies and is the most common economic system today. There are different balances between command 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.

Economic efficiency: Productive and allocative efficiency:

- **Productive efficiency** occurs when resources are used to give the maximum possible output at the lowest possible cost.
- This helps maximise consumer welfare, but it can be wasteful if the goods and

services consumers want are not produced.

- Moreover, benefiting one consumer by allocating more resources to them means another consumer loses out. This is because all resources are used to their maximum productive potential, so there is no spare capacity.

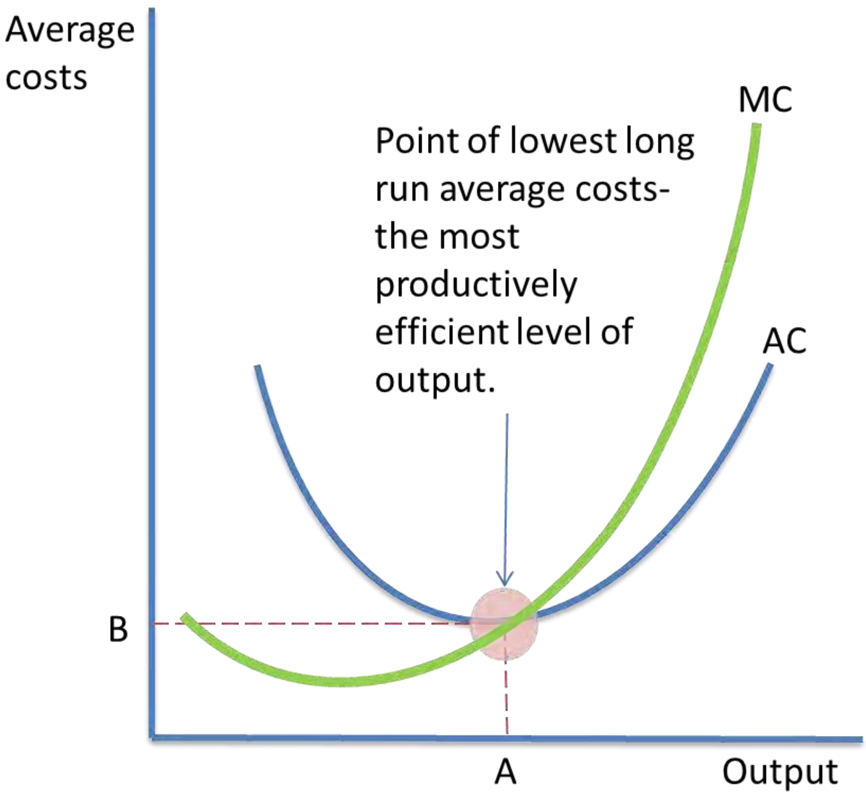
- **Allocative efficiency** occurs when resources are allocated to the best interests of society, where there is maximum social welfare and maximum utility.

- The goods and services consumers want might be produced where there is allocative efficiency, but they also need to be affordable. Productive efficiency helps keep the price down.

The conditions required for productive efficiency and allocative efficiency:

- Productive efficiency occurs when firms minimise their average total costs.

- This is when firms produce at the lowest point on the average cost curve. Since the MC curve cuts the AC curve at the lowest point, MC = AC is a point of productive efficiency. All points on the PPF curve are productively efficient.



- Allocative efficiency occurs when resources are distributed to the goods and services that consumers want. This maximises utility. It exists at P = MC, which means that consumers pay for the value of the marginal utility they derive from consuming the good or service. Free markets are considered to be allocatively efficient.