WJEC (Eduqas) Economics AS-level

Microeconomics

Topic 4: Resource Allocation

4.1 How resources are allocated in a free market economy

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.

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.
- The free market operates on the assumptions of a large number of buyers and sellers and of perfect information between buyers and sellers.
- 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.

- A **product market** is where goods and services are produced by firms and then sold to consumers. Consumers use their income from selling resources, such as labour, to buy the goods and services.
- **Factor markets** are where the services of land, labour, capital and enterprise- the factors of production, are sold and bought. For example, the labour market is a factor market,
- Changes in one of these markets can affect another, because of the interrelationship between the markets.

- In reality, economic agents do not behave rationally. Acting rationally means making a decision that results in the most optimal level of utility or benefit for the consumer. This can lead to a misallocation of resources.