**Economics Notes – Chapter 2 – The Allocation of Resources: How the market works; Market Failure**

**2.1 Types of Economic Systems**

1. Free Market Economy – open to market forces
2. Command Economy – centralized planning
3. Mixed Economy

**Free Market Economy**

**2.1.1A Features of a Free Market Economy**

* Private ownership
* Firms control labour and capital usage
* E.g. neighbourhood hair salon, bubble tea shops
* Freedom of choice
* Private firms can choose to produce what, how much and for whom
* Guided by self-interest
* Firms are motivated by profit
* Consumers are motivated by self-interest (maximize private benefits)
* Lower degree of state control
* Functions based on price mechanism
* 3 fundamental questions

**Features of a Free Market Economy**

The free market economy relies on the use of market mechanism to conduct resource allocation where the government will only conduct the administration of laws that regulate the economy. It has the following characteristics:

* + - Private ownership of property
		- Freedom of choice and enterprise
		- Competition
		- Maximization of personal benefits
		- Price is determined freely by market demand and supply

## Pros and Cons of Free Market Economy

### Advantages

* + - Price mechanism leads to allocative efficiency – absence of glut or excess as the consumer demand and production condition is efficiently reflected and determined (assuming perfect market/information)
		- No need for complex and costly government interference – speedy allocation as it is based on price signal, avoiding administration cost and time lag.
		- Competition forces firms to keep cost and price low, which consumers benefit from.

### Disadvantages (Effects of market failures)

* + - Lack of perfect market information and mobility of resources will make it impossible for the economy to attain the efficiency of allocation of resources. Industries may not be able to attain production at socially optimum level.
		- Power and property rights are unequally distributed: The have and the have-nots, creating extensive unequal distribution of income and wealth.
		- To maximise private benefits, firms have the incentive to collude and increase market power and price. This undermines the welfare of consumers🡪Consumer exploitation occurs as the lack of perfect information causes consumers to pay more than they should.

**2.1.1B Advantages of a Free Market Economy**

* Ensures efficient allocation of resources
* Because firms guided by market forces
* Market equilibrium
* Stimulate economic growth
* Increase production of goods and services
* Higher employment and output
* Better address problem of scarcity

**2.1.1C Disadvantages of a Free Market Economy**

* Price mechanism is not perfect
* Free market forces may lead to underproduction of certain goods
* Due to imperfect market information
* Income inequality
* Skill-biased wage differences
* E.g. Blue-collared and white-collared workers
* Economic instability
* Inflation
* Unemployment
* Creation of monopoly
* Results in consumer exploitation
* E.g. Microsoft

**Command Economy**

**2.1.2A Features of a Command Economy**

* Factors of production owned by the state
* Central planning
* Government as the decision-making body in the production of goods and services

**2.1.2B Advantages of a Command Economy**

* Can directly pursue economic goals
* Direct access to the resources available
* Ensure the provision of public goods
* E.g. street lamps, public parks, overhead bridges
* Too costly for individual and private firms to produce public goods
* Ensures efficient manpower allocation
* Government has direct access to the labour supply
* Minimize income inequality
* Through direct wage setting
* Affects income level of individuals

**2.1.2C Disadvantages of a Command Economy**

* Bureaucratic red tape
* Hinders decision-making process
* Need to go through many channels of administration
* Low productivity levels
* No incentive to work hard because of wage regulation
* Undermines production levels
* Higher social discontentment
* May give rise to social and economic instability
* E.g. strikes, protests
* No freedom – cannot decide job
* Inefficient resource allocation
* May not be able to match demand and supply

**Mixed Economy**

**2.1.3A Features of a Mixed Economy**

Shares both features of (i) Free Market and (ii) Command Economy

* Direct and indirect government intervention
* Direct intervention in the provision of public goods
* Innovation requires indirect intervention as private firms are more motivated without excessive government regulation

**2.1.3B Advantages of a Mixed Economy**

* Ensures efficient resource allocation
* Sustained economy growth
* Greater economic stability
* E.g. Job fairs, subsidies to employers and workers, job training, skills upgrading

**2.1.3C Disadvantages of a Mixed Economy**

* Imperfect resource allocation
* Unequal distribution of benefits