Free Market Economy

- Usually associated with a **pure capitalist system**, where **land** and **capital** are **privately owned**.
- ALL economic **decisions** are taken by **firms** which act in their own **self-interest**.
- Individuals are **free** to make their **own economic choices**.
- Consumers are free to **decide what to buy with their incomes**.
- Workers are **free to choose where and how much to work**.
- Firms are free to choose **what to sell** and **what production method to use.**

Advantages of the Free Market Economy

1. Free market economy **functions automatically**.
   - **No need for costly and bureaucracies** to co-ordinate economic decisions.
   - The economy can **respond quickly** to **changing demand** and **supply conditions**.

2. **Competition** among firms will **keep costs** and **prices low.**
   - Consumers will **not buy from firms that charge high prices** and that **do not produce the products they want.**
   - The **more firms competing**, the more **responsive they will be to consumer wishes**.

3. Promotion of **efficiency** between firms, workers and consumers.
   - The more **efficiently firms** can **combine their factors of production**, the **more profit** they will make.
   - The more **efficiently workers** work, the **more secure their jobs will be** and the **higher their wages.**
   - The more carefully **consumers** decide what to buy, **the greater the value for money they will receive.**

4. **Consumer Sovereignty** (power): The concept of the consumer as the one whom, his **spending ultimately determines** which **goods** and services **will be produced in the economy.**

5. **Changes** in consumer **tastes** and **demand** for **workers** are **signaled quickly** and automatically through the **price mechanism** and **market forces.**
   - **Consumers** and **workers** have **more economic freedom** than in planned economy to pursue their **own self-interest.**
   - Producers can choose **what to make** and can select the **prices** that they believe **consumers will pay** and will **cover their costs.**
   - Workers can **move from job to job** in search of the **highest pay.**

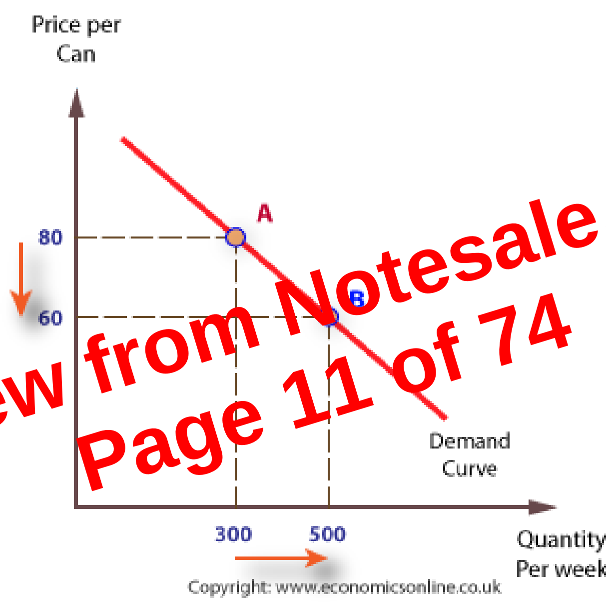
Demand

*The quantity of a product consumers **are willing** and **able to** buy at different prices in a specified time period.*

Effective Demand: When consumers **desire** to buy a product is **backed up by an ability to pay for it. Consumers** must have **sufficient real purchasing power**.

Demand & Price Relationship

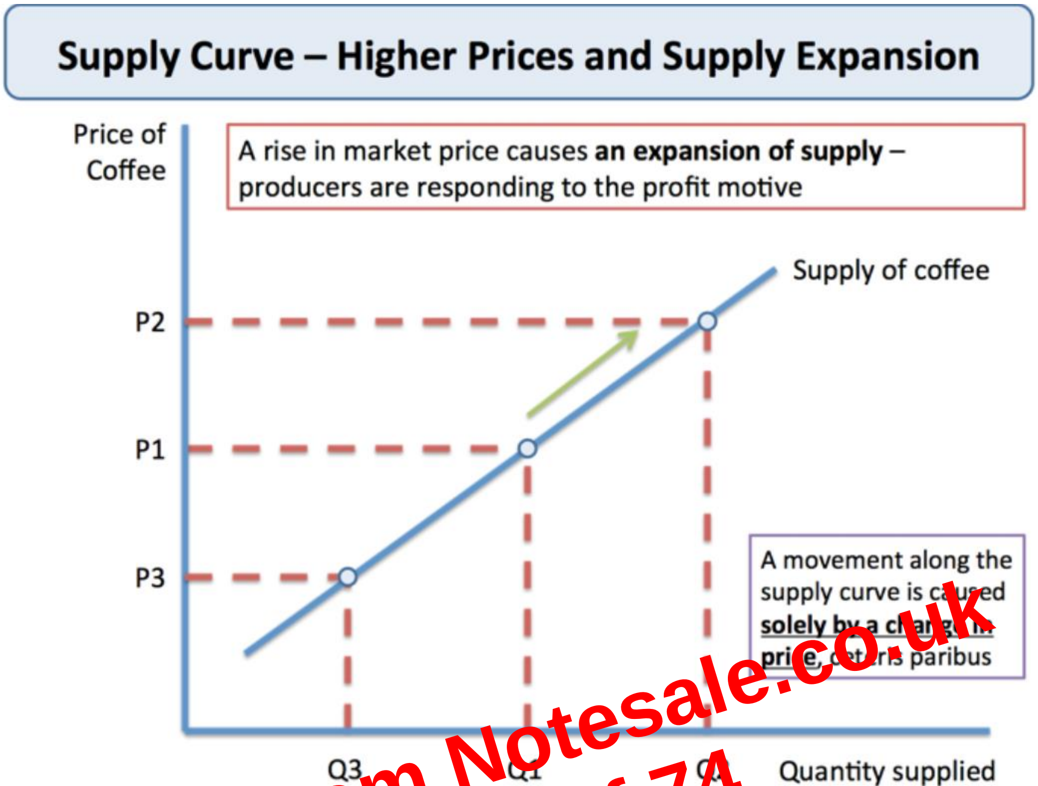
- Normally there is an **Inverse Relationship** between price of good **X** and the quantity demanded to good **X (PRICE RISES, DEMAND FALLS) (PRICES FALLS, DEMAND RISES)**

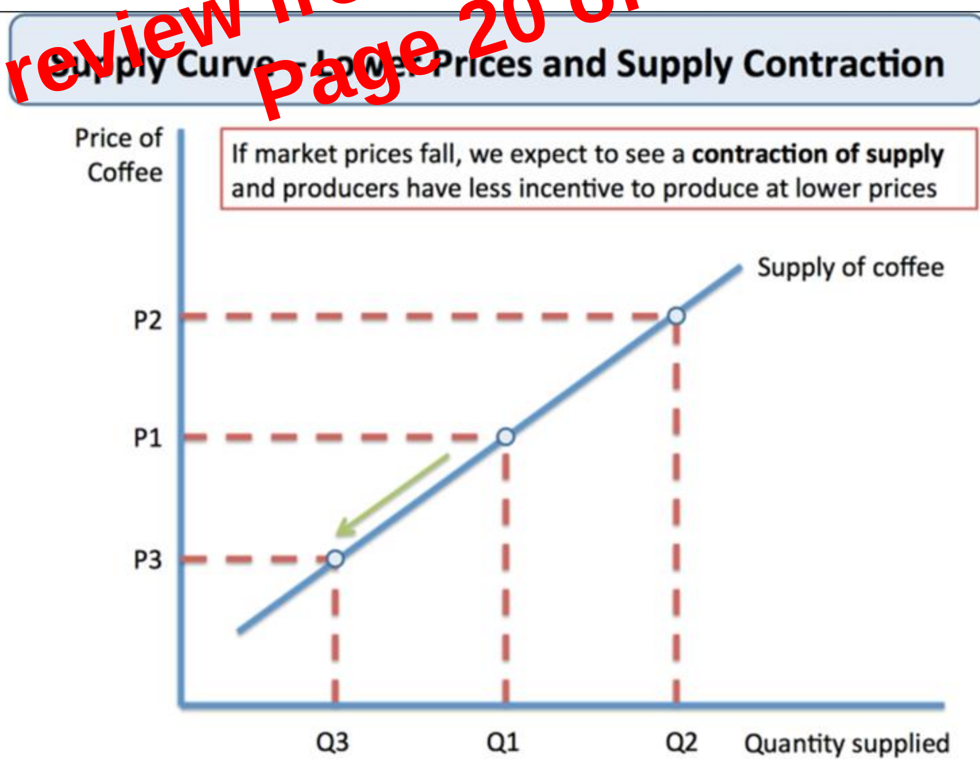


Downward sloping Demand Curve

- The Downward slope of the demand curve is based on two effects:
  1. **The substitution effect:** When there is a **Rise in the price** the consumer will tend to buy **more** of a **relatively lower- priced** good and **less** of a **higher priced** one.
  2. **The income effect:** This is the effect of a **change in real income** on the **quantity demanded**, with **relative prices unchanged.**

Movements along and shifts in the supply curve





Perfectly Inelastic Demand (Ped = 0)

If the co-efficient of price elasticity of demand = zero, demand is perfectly inelastic i.e. demand does not vary with a change in price

- A perfectly inelastic demand curve is an extreme case for it implies that consumers are willing and able to pay any price for the product. If supply falls, equilibrium market price can rise without any contraction in the quantity demanded

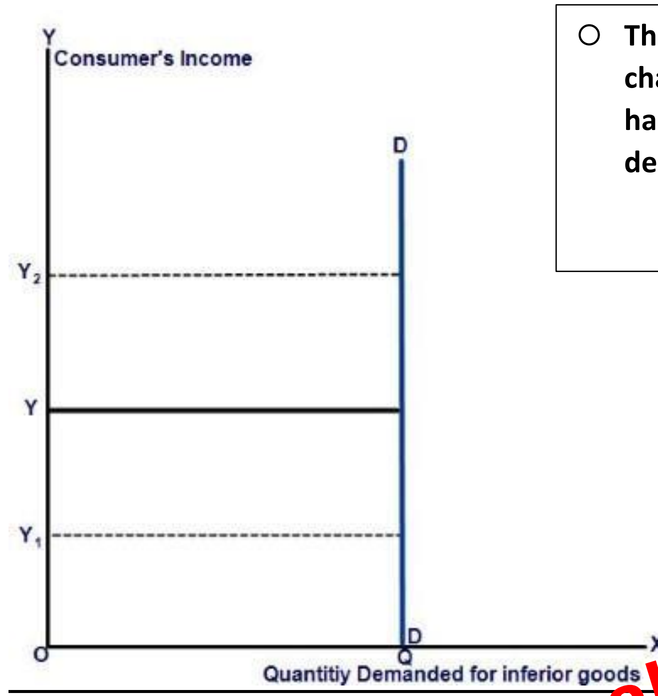
Unitary Elastic Demand (Ped = 1)

A demand curve with unitary price elasticity has a coefficient of PED equal to 1 (unity) throughout

- With a demand curve of unitary price elasticity, a change in price is met with a proportionate change in demand
- This means that total spending by consumers on the product will remain the same at each price level

<u>Unitary Elastic Demand:</u> When the price and Quantity Demanded change by the same proportion.

ZERO Income Elasticity Demand Diagram



- **This occurs when a change in income has NO effect on the demand for goods**

To Summarize:

- **NORMAL GOODS – ALWAYS POSITIVE; Between 0-1**
- **LUXURY GOODS- ALWAYS POSITIVE; OVER 1**
- **INFERIOR GOODS- ALWAYS NEGATIVE**

Significance of Income Elasticity of Demand

- **High Income Elasticity**
  - **Demand** is **sensitive** to **changes** in **real incomes**
  - Demand is therefore **Cyclical** – in an economic expansion, demand will grow strongly. In a recession demand may fall.
  - Can be difficult for businesses to accurately forecast demand and make capital investment decisions.
- **Low Income Elasticity**
  - Demand is **more stable during fluctuations** in the economic cycle.
  - Over time, the share of consumer spending on inferior goods and normal necessities **tends to decline.**
  - Long run- businesses need to invest in/ focus on products with a higher income elasticity of demand if they want to increase total profits.

<u>Cross Elasticity of Demand</u>

Cross Price Elasticity of Demand (XED): Measures *the* ***proportionate response*** *of the* ***quantity demanded*** *of* ***one good*** *to the* ***proportionate change*** *in the price* ***of another****.*

<u>OR</u>

Cross Price Elasticity of Demand (XED): *Is the* ***sensitivity*** *of* ***Demand*** *for* ***one product*** *(good A) to a* ***change*** *in the* ***price*** *of* ***another product*** *(Good B)*

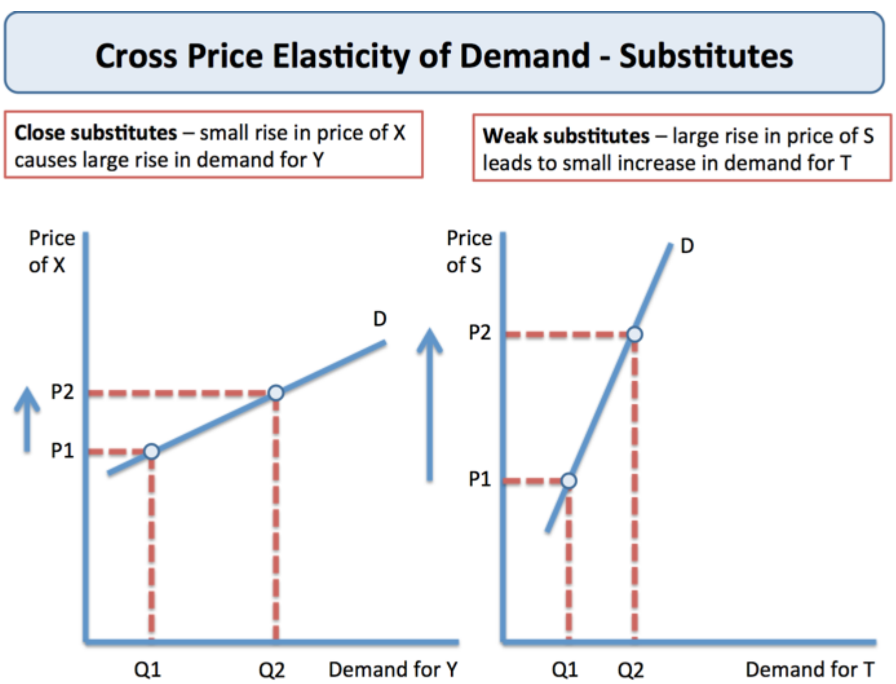
$$XED = \frac{\%\ Change\ in\ Quantity\ Demanded\ of\ Good\ A}{\%\ Change\ in\ Price\ of\ another\ Good\ B}$$

<u>XED – Substitutes vs Complements</u>

- Two goods which are **<u>substitutes</u>** will have a **positive cross elasticity**, where an **increase** in the **price** of **one good**, **leads** to an **increase** in the **quantity demanded** of a **substitute**.
- Two goods which are **<u>complements,</u>** Will have **negative cross elasticity**, where an **increase** in the **price** of **one good** will **leads** to a **fall** in **demand** of a **complement**.

<u>Cross Elasticity of Demand (XED) – Substitutes (POSITIVE)</u>

- **An increase in the price of one good will lead to an increase in demand for the rival product(Substitutes)**
  - → ***Weak Substitutes – <u>INELASTIC XED <1</u>***
  - → ***Strong Substitutes – <u>ELASTIC XED >1</u>***



Determinants of PES

1. **Level of Spare capacity:**
   - A **High level** of **spare capacity** (e.g. Under-utilized machinery) in a firm means that it can **raise production quickly**, so supply tend to be **ELASTIC**
   - A Firm or industry **operating** at **full capacity** is **unable** to **raise output quickly** and so supply tends to be **INELASTIC**

2. **The state of the economy:**
   - In a **recession**, there are many **unemployed resources** and so there is a **high level** of **spare capacity**; **firms** find it **relatively easier** to **raise supply** thus supply is **ELASTIC.**

3. **Level of stocks of finished goods in a firm:**
   - A **high level** of **stocks** means that **firms** can **increase supply quickly**, so supply is **ELASTIC.**
   - A **firm operating** with **low stocks** is **unable** to **raise output quickly** and so supply tends to be **INELASTIC.**

4. **Perishability of the product:**
   - Some Goods **cannot** be **stockpiled** such as **agricultural goods** like **flowers**; these goods are typically **inelastic** in supply.
   - **Manufactured** goods tend to be **non-perishable** and so can be **stockpiled** by firms in order to **meet anticipated increase** in **demand**. **Thus, supply tends to be more ELASTIC. (Fridges, Freezers)**

5. **The ease of entry to an industry:**
   - **High barriers to entry** to an **industry** mean it will be **difficult** for **new firms** to **enter**, **even** with the **attraction** of **high prices** and **profits**.
   - **Existing producers** may **deliberately create entry barriers**, so **supply** may be **restricted** and **INELASTIC**.

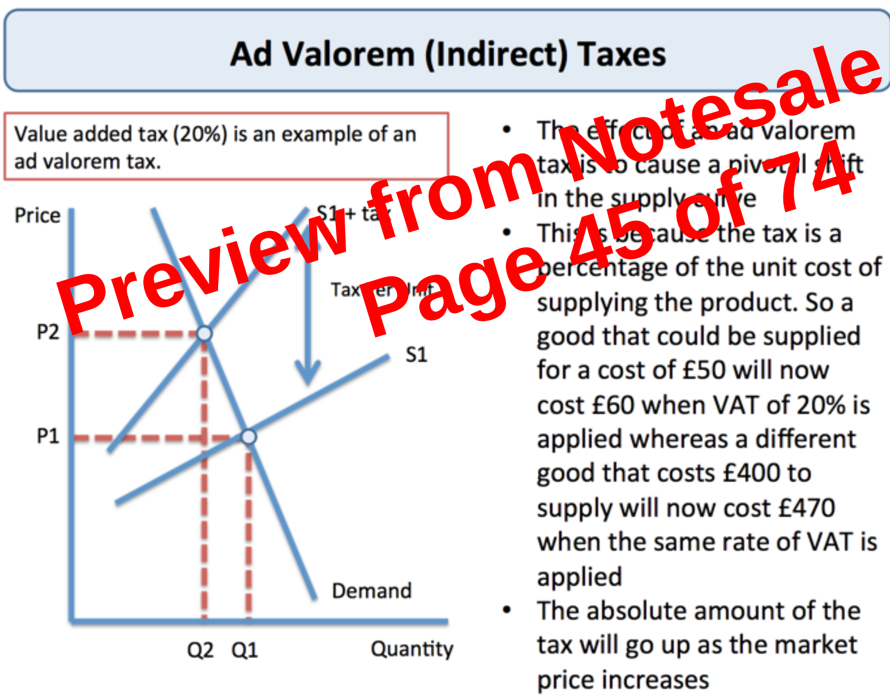
Indirect Taxes and Subsidies

Indirect Taxes: are taxes on expenditure imposed by the government on producers and include taxes such as Value added tax (VAT), excise duties and taxes on gambling.

- Most likely to be used to reduce the number of resources allocated to the product and therefore can be used to tackle problems associated with negative externalities.
- They cause an increase in the cost of productions and so cause the supply curve to shift to the left.

VAT is an example of an **AD VALOREM** (The tax levied increases in proportion to the value of good base as a percentage)

EXCISE DUTIES are an example of a **specific or unit** tax, where the amount of tax levied does not change with the value of goods but with the amount of goods purchased. (based on units)

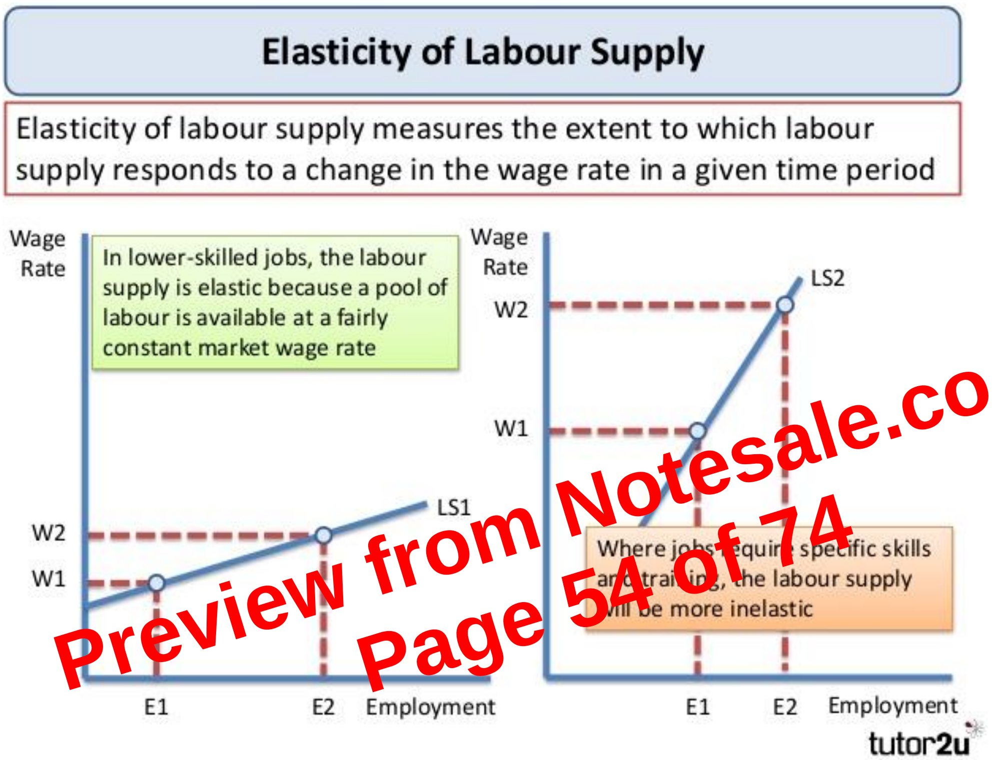


- At any given wage rate fewer workers wish to supply themselves for work perhaps because of higher marginal tax rates or higher unemployment benefits.
- At any given level of employment, workers are not prepared to work for their previous wages because they are now in a trade union.

  Effect of a fall in the supply of labour:

  → **Increase in Equilibrium wage rate.**

  → **Decrease in Equilibrium level of employment**



<u>Elasticity of supply of labour</u>

1) **<u>Skills, Qualifications and experience required:</u>** If these are high then the supply of labour will tend to be inelastic.
2) **<u>Level of unemployment in the economy:</u>** If unemployment is high then supply is likely to be more elastic.
3) **<u>The Mobility of labour</u>** (the willingness and ability of labour to move to another job): Elasticity of supply for labour will be higher when there are alternative jobs in the same location, when alternative jobs required similar skills and when people have good information about these jobs.

The price elasticity of supply of labour measures the responsiveness of labour supply to a change in wage rate. If price elasticity of supply is elastic(>1) then workers respond quickly if wages rise and supply will expand.

On the other hand if PES is inelastic (<1) then the response by workers will be smaller.

Government measures to increase the occupational mobility of Labour

A. Increasing the provision of training schemes, subsidies to private sector companies to offer training services.

B. Increasing provision of further education, vocational education courses offer training in specific work-based skills and work experience to students.

C. Increasing the provision of higher education by increasing access to student loans and limiting tuition fees might help.

D. Information about opportunities in other occupations where workers may not be aware of the possibility of pursuing an alternative career.

Structural Unemployment

→ Structural unemployment arises because of the immobility of labour. It occurs when a pattern of demand and production changes, leaving workers unemployed in labour markets where demand has shrunk.

→ Moreover, structural unemployment can also be present at a time when there are skill shortages and many vacancies. Unemployed workers in an area cannot take the jobs on offer since they do not have the right skills.

Market Stabilisation

Commodity markets

Commodities refer to raw materials used in the production of goods like agriculture produce, metals and fuels.

- There tends to be a **single global price for commodities** determined by supply and demand. **Commodity markets are notorious for exhibiting price volatility.**
- Agricultural markets in particular are prone to strong fluctuations in price, as supply can be unpredictable.
- There is a time-lag problem, owing to the fact that crops can take up to a year to grow and animals several years to raise meaning that farmers have to base their decisions on how much to plant or raise to sell in future.
- **These Fluctuating prices are bad for producers, because it leads to unstable income, and also bad for consumers, for whom many of these goods are necessitates.**

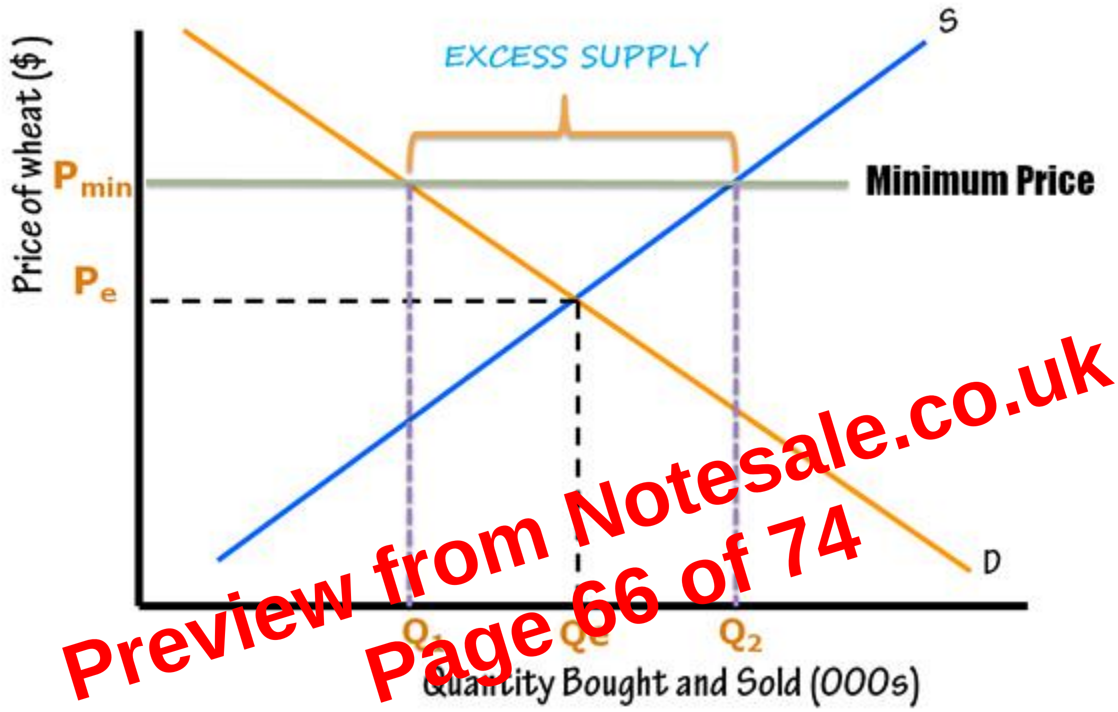
Government intervention to fix market failure

Governments can tackle these problems in the following ways:

1) **Minimum and Maximum Prices**
2) **Buffer Stock Scheme**

Minimum Prices

- Governments introduce a **guaranteed minimum price,** where goods cannot be sold below this which may stabilise commodity prices and producer incomes.
- This means **Producers know in advance that they will receive a certain price** no matter how much is produced. This is designed to ensure **greater certainty** and therefore act as an **incentive** to producers to supply sufficient quantities.
- **Minimum prices are set above the market price means that supply will exceed demand and so there will be a glut.**



Government dealing with excess supply (surplus)

Method 1: The Government could buy the surplus and store it.

- ➢ This in turn creates problems since the government has to use the wheat it buys.
- ➢ Solutions include:
  1) **Selling wheat mountains to third world countries at rock bottom prices.**
  2) **Selling wheat back to farmers to feed their animals.**
  3) **Offering at a reduced price to those in need in the EU**
  4) **Simply DESTORYING IT**

Method 2: The second solution to the problem of excess supply is to restrict production

- ➢ Governments can either force, or pay farmers to reduce the size of their herbs or leave part of their land uncultivated.

Relocating Industry

- *Regional Policy* aimed to take work to the workers rather than the other way around.
- Labour was too immobile to expect workers to move to regions where there were job vacancies,

Asymmetric Information

- Public information/advertisements designed to close the information gap.
- Private sector organisations, the media and the internet: information gaps may be closed by publications which inform consumers about issues concerning products and services.
- To discourage the production and consumption of unhealthy goods and services, i.e tobacco, alcohol and drugs which are often overprovided in the market.
- Government provision of information, along with other measures plays an important role in reducing market failure.

State Provision of Public Goods

- ✓ The usual policy the government uses is to provide public goods financed through taxation.
- ✓ Ensures that the product or service is provided
- ✓ Politicians will determine the amount of resources allocated to these public goods without reference to the electorate.

Government Failure

Government Failure: Occurs when it intervenes in the market but this intervention leads to a loss of economic welfare rather than a gain.

Reasons why Government Failure Occurs:

1) **Distortion of price signals**
2) **Unintended consequences**
3) **Excessive administration costs**
4) **Information Gaps**

Distortion of price signals

Distortion of price signals: *The actions of government which distort (change) the operation of the price mechanism and so misallocation resources.*

Maximum Price controls: Leads to an excess demand or shortage.

- Long term implications include a reduction in both the quality and the quantity of rental housing available, possibly leading to an increase in the number of homeless.

Minimum Price controls: Leads to an excess supply or surplus.

- Long term implications include problems of disposing of food surpluses, which are perishable and expensive to store, as well as an opportunity cost in the case of surplus.