1.1.6 Free market economies, mixed economies and command economies

a) The distinction between free market, mixed and command economies: reference to Adam Smith, Friedrich Hayek and Karl Marx
b) The advantages and disadvantages of a free market economy and a command economy
c) The role of the state in a mixed economy

- Free market economy:
  1. Private ownership of resources
  2. Market forces determine prices
  3. Producers aim to maximise profits
  4. Consumers aim to maximise satisfaction
  5. Resources are allocated by the price mechanism
- Mixed economy: A mixture of the free market economy and command economy. Some resources are allocated by the price mechanism while others are allocated by the state. What differs between countries is the degree of that mix.
- In practice, there are no absolute free market or command economies most are mixed economies as there would have to be no public or private sectors
- The third sector is the voluntary sector. This includes charities and non-profit organisations.
- Command economies:
  1. Public (state) ownership of resources
  2. Price determination by the state
  3. Producers aim to meet production target set by the state
  4. Resources are allocated by the state
  5. There is a greater equality of income and wealth
  6. Collective property rights
- Market failure occurs when the price mechanism fails to allocate resources efficiently and when free markets result in undesirable outcomes
- Ways government deals with market failure:
  1. They might change the law, or offer tax breaks, or create some other kind of incentive to try and influence people's behaviour
  2. They can intervene by buying or providing goods and services
- Adam Smith 1723-1790:
  1. Founder of classical economics and key advocate of market economy
  2. He believed individuals should follow their self-interests which indirectly promotes the good of society
  3. Consequently, producers would respond to consumer wants so there is little waste
  4. He believed governments should just be limited to providing public goods such as defence and justice
  5. He said there could be no monopolies and low barriers to entry
- Friedrich Hayek 1899-1992:
  1. The Road to Serfdom (1944) argues that attempts by government to determine the answers to economic questions are doomed to failure because state planning would require force which restricts freedom and

    governments lack the information to allocate them so they wouldn't allocate it in the most beneficial way
  2. He called the price mechanism a signalling device between consumers and producers and said it will allocate resources more efficiently than governments
  3. People know more about their personal, individual needs so will allocate resources more efficiently
- Karl Marx 1818-1883:
  1. He thought capitalism was inherently unstable because workers are exploited by owners of factors of production (bourgeoisie) so there would be a communist revolution (by the proletariat)
  2. Capitalists exploit the workers to create profit so workers earn wages below their value
  3. Capitalists have an incentive to replace labour with machines which drives down wages
  4. Competition leads to firms going bust and monopolies, and therefore the bourgeoisie, developing
  5. His ideas contained little about how command economies would work so communist countries collapsed which led to people discrediting his ideas
- Advantages of a free market economy:
  1. Consumer sovereignty- their needs are put first
  2. Flexibility
  3. No officials needed
  4. Competition promotes an efficient allocation of resources
  5. Increased choice
  6. Economic and political freedom
  7. Innovation and entrepreneurship is encouraged
- Disadvantages of a free market economy:
  1. Inequality- people who can't work can't receive income
  2. Trade cycles- they can suffer from instability from booms and slumps
  3. Imperfect information- means consumers may be unable to make rational decisions
  4. Non-profit goods may not be made
  5. Exploitation of consumers
  6. Monopolies- can cause market dominance
  7. Externalities- costs and benefits to third parties e.g. pollution
- Advantages of a command economy:
  1. Greater equality
  2. Macroeconomic stability
  3. No exploitation
  4. Full employment
  5. External benefits and costs are considered
  6. Can make goods beneficial to society
- Disadvantages of a command economy:
  1. Inefficiency as there is no profit motivation
  2. Lack of incentives to take risks
  3. Restriction on freedom of choice
  4. Shortages and surpluses due to state miscalculations
  5. Lack of information may lead to poor decision making

- Role of state in a mixed economy:
    1. Defence and internal security
    2. Provision of public goods
    3. Provision of essential public services e.g. education and housing
    4. Re-distribution of income from the rich to the poor
- Rationing is a way of allocating scarce goods and services when market demand exceeds available supply
- Rationing is controversial as discrimination can happen and it raises important issues of equity/ fairness in terms of access to scarce resources
- Rationing in a free market is done through the price mechanism: the market price determines which consumers have the effective demand to purchase and who does not.