2 The allocation of resources

2.1 Microeconomics and macroeconomics,
2.2 The role of markets in allocating resources
2.1 Microeconomics and macroeconomics

**Microeconomics** focuses on individual markets and decisions by individual households and firms.

Microeconomics deals with smaller, discrete economic agents and their reaction to changing events. For example, it looks at individual consumers and how they make their decisions about demand and Expenditure; individual firms and how they make decisions, such as what to produce and how much; and individual industries and how they may be affected by such things as government action.

**Macroeconomics** focuses on the economy as a whole, e.g. it considers the price level for the economy as a whole, rather than for one market.

Macroeconomics takes a wider view and considers such things as measuring all the economic activity in the economy, inflation, unemployment, and the distribution of income in the whole economy.
2.2 The role of markets in allocating resources

**Allocative Mechanism**: an allocative mechanism is a method of taking decisions about the different uses that can be made of factors of production. A mechanism is needed for economic goods that are scarce. Free goods in sufficient supply to satisfy demand, such as air or sunshine, do not need an allocative mechanism.

There are three different types of allocative mechanism:

- market economies
- planned economies
- mixed economies
Different Economic systems

In reality, all economies are mixed to some degree, but vary in the extent to which the Government intervenes. Since the 1980s the UK Government has reduced its provision of goods and services (e.g. through privatization) and increased the role of the private sector. This trend has been followed in many other countries, e.g. following the decline of Communism in Eastern Europe. UK privatizations include British Gas and British Telecom. However, in 2008 the UK government nationalised Northern Rock and Bradford & Bingley banks.
Market Economies

This is where the allocation of resources is left to the market forces of demand and supply through the operation of the price mechanism.

**Market Economy (or market system):** an economy where decisions about the allocation of resources are taken through the price mechanism.

**Market:** a way in which buyers and sellers come together to exchange products.

**Adam Smith:** one of the founding fathers of Economics (1723-90) and author of *The Wealth of Nations*, published in 1776.

- Decision are made by individual buyers and sellers who act in their own self interest; producers aim to maximize their profit; consumers aim to maximize their utility.
- The price mechanism allocates resources.
Advantages and Disadvantages of Free market Economy

**Advantages:**
- Resources are allocated by market forces and the price mechanism (called the Invisible Hand by Adam Smith), there is no Government intervention.
- The profit motive provides an incentive to reduce costs and be innovative.
- The free market maximizes community surplus if there are no features and imperfections.

**Disadvantages:**
- Demerit goods will be over-provide, driven by high price and thus high profit motive.
- Merit goods will be under-provided, since they will only be produced for those who can afford them and not for all.
- Resources may be used too quickly and the environment may be damaged by pollution, as firms seek to make high profits and to minimize costs.
- Some members of the society will not be able to look after themselves, such as orphans, the sick, and long term unemployed, and will not survive.
- Large firms may grow and dominate industries, leading to high prices, a loss of efficiency, and excessive power.
Planned/ Command Economy

**Planned (or command) economy**: an economy where decisions about the allocation of resources are taken by the state

Planned economies, also known as command economies, involve the allocation of scarce resources through government intervention with no (or very little) scope for market forces to operate

- decisions made by central planning agency
- State (government) ownership of resources
- prices set by the State
- motive for production is social welfare
- lack of market forces
Advantages and Disadvantages of Planned Economy

Advantages:
• The Government can influence the distribution of income to make it more equal
• The Government can determine which goods are supplied e.g. it can prevent the production of socially undesirable goods

Disadvantages:
• Total production, investment, trade, and consumption, even in a small economy, are too complicated to plan efficiently and there will be misallocation of resources, shortages, and surpluses.
• Because there is no price system in operation, resources will not be used efficiently. Arbitrary decisions will not be able to make the best use of resources.
• Incentives tend to be distorted. Workers with guaranteed employment and managers who gain no share of profits are difficult to motivate, output and/or quality will suffer.
• The dominance of government may lead to a loss of personal liberty and freedom of choice.
• Governments may not share the same aims as the majority of the population and yet, by power, may implement plans that are not popular, or are even corrupt.
Mixed Economy

**Mixed economy**: an economy where the allocation of resources is decided both by market forces and by the state.

A mixed economy combines elements of both market economies and planned economies, i.e. there is some degree of state ownership and state intervention but in many areas of the economy market forces will be allowed to operate.

It could be argued that all economies today are, to some extent, mixed economies. However, there are large differences between, say, China, where the government still plays an important role in the allocation of resources, and the United States, where the government has only a limited role in the allocation of resources.
Advantages and Disadvantages of Mixed economy

**Advantages:**
1. It Encouragement to Private Sector
2. It has Freedom of choices.
3. It ensures optimum Use of Resources
4. It has advantages of economic planning.
5. It has lesser Economic Inequalities
6. It has competition and Efficient Production
7. Social Welfare exist here
8. Economic Development can be achieved

**Disadvantages:**
1. The mixed economy can leave the less competitive members of society without support.
2. It doesn’t eliminate the possibility of monopolies.
3. It often produces high taxation responsibilities.
4. Organizations have restrictions in their overall size.
5. The state has the power to change its mind in a mixed economy.
6. It encourages people and agencies to go into debt.
7. It can encourage companies to become top-heavy.
8. It encourages special interest activities.
9. Private protections don’t need to exist in a mixed economy.
Problems of transition

**Transitional economy**: an economy which was previously a command or planned economy and which is now allowing a greater degree of scope for market forces to operate

A number of economies are going through a period of change where the extent of central planning is being reduced and market forces are being allowed to have a greater degree of influence. China is an example of such a *transitional economy*. There are, however, possible problems associated with transition, as Table 3 shows

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<thead>
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<th>Table 3 Problems of transitional economies</th>
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<tr>
<td><strong>Unemployment</strong></td>
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<td><strong>Inflation</strong></td>
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<td><strong>Output</strong></td>
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<td><strong>Welfare</strong></td>
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key resources allocation decisions

Whichever economic system is used, all countries must address three fundamental economic questions:

1 **What production should take place?** This question is about deciding which goods and services should be provided in the economy. For example, is it better for the economy to have more roads and airports or to have more schools and hospitals? As resources are limited in supply, decision-makers realise there is an opportunity cost in answering this question.

2 **How should production take place?** This question is about the methods and processes used to produce the desired goods and services. For example, decision-makers have to decide which combination of factors of production should be used in the production process.

3 **For whom should production take place?** This question is about which economic agents receive goods and services. For example, should any goods and services be provided free to everyone in the economy, irrespective of their willingness and ability to pay for these? Or should goods and services only be produced for those who can pay?
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