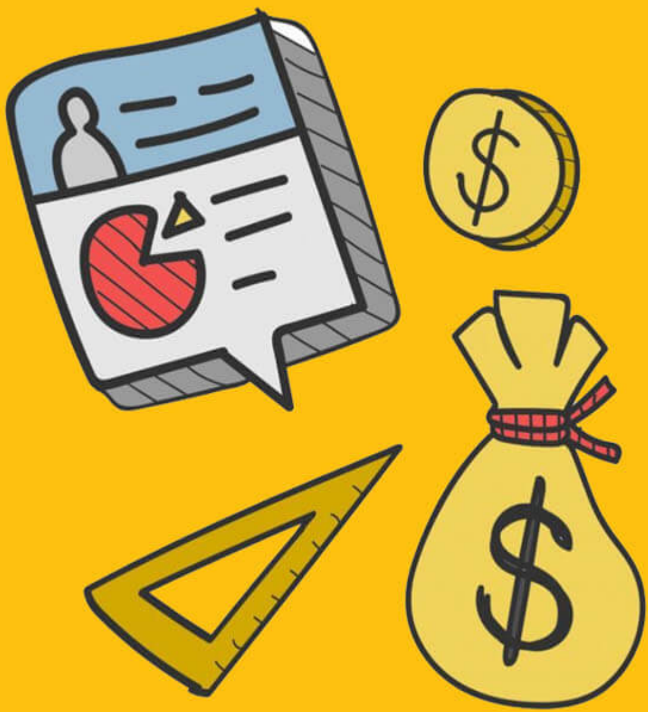
How Markets and Prices Allocate Resources



AQA A Level Economics Revision Notes

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The Price Mechanism

Functions:

- The price mechanism determines the market price. Adam Smith called this 'the invisible hand of the market'.
- Resources are allocated through the price mechanism in a free market economy. The economic problem of scarce resources is solved through this mechanism. The price moves resources to where they are demanded or where there is a shortage, and removes resources from where there is a surplus.

- The price mechanism uses three main functions to allocate resources:
  - **Rationing**

    When there are scarce resources, price increases due to the excess of demand. The increase in price discourages demand and consequently **rations** resources. For example, plane tickets might rise as seats are sold, because spaces are running out. This is a disincentive to some consumers to purchase the tickets, which rations the tickets.
  - **Incentive**

    This encourages a change in behaviour of a consumer or producer. For example, a high price would encourage firms to supply more to the market, because it is more profitable to do so.
  - **Signalling**

    The price acts as a signal to consumers and new firms entering the market. The price changes show where resources are needed in the market. A high price **signals** firms to enter the market because it is profitable. However, this encourages consumers to reduce demand and therefore leave the market. This shifts the demand and supply curves.

- The price mechanism is the way in which the basic economic problem is resolved in a market economy.

The advantages and disadvantages of the price mechanism and of extending its use into new areas of activity

- The price mechanism is an impersonal method of allocating resources.
- Introducing the price mechanism into some fields of human activity could be undesirable.
- In the price mechanism, the invisible hand can signal what the cost of purchasing a good is to a consumer. It also acts as a signal to producers to tell them what revenue they will receive.
- The price mechanism allows the consumer to gain sovereignty in the market. They have ‘spending votes’ in the market, which enables them to choose what is bought and sold.
- Generally, the free market allows for an efficient allocation of resources.
- However, there may be inequality in income and wealth with the price mechanism. It does not consider what the distribution of income is. Those with money have buying power, whilst those without money are left out.
- Essentially, the price mechanism and the free market ignore equality. To evaluate, it can be argued that inequality exists, but the degree of inequality may vary between capitalist societies.
- In a free market, there is the under-provision of public and merit goods, which requires government intervention.