



Economic systems

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The Free Market

The free-market economy



The free market economy is an economy where all economic decisions are taken by individual households and firms and with no government intervention.



Price mechanism

In a free-market economy, decisions on how resources are to be allocated are usually taken by the price mechanism.

The price mechanism determines the production, utilization of resources, and pricing.

This means that the forces of demand and supply determine:

- ▶ what goods and services will be produced,
- ▶ how they will be produced
- ▶ for whom will they be produced

Prices act to indicate the likely market value of particular resources.

The price mechanism works as follows.

1 2

Prices respond to shortages and surpluses.

1 Shortages result in prices rising.

2 Surpluses result in prices falling.

The Free Market Pros and Cons

Pros

1

Increased efficiency

The profit motive encourages producers to be more efficient. Competition between firms keeps prices down and acts as an incentive to firms to become more efficient. The more efficiently firms can combine their factors of production, the more profit they will make.

2

Consumer wishes

The more firms there are competing, the more responsive they will be to consumer wishes.

3

Innovation

Innovation is promoted because it provides a competitive edge.

4

Functions automatically

There is no need for costly and complex bureaucracies to coordinate economic decisions.

Cons

1

Merit goods will be under-produced and demerit goods will be over-produced.

2

Public goods cannot be provided by the free market because of their two characteristics, non-diminish ability and non-excludability.

3

Lack of competition and high profits may remove the incentive for firms to be efficient.

4

Power and property may be unequally distributed.

5

The practices of some firms may be socially undesirable. For example, a chemical works may pollute the environment.

The planned economy

Planned economy



In the planned economy, the government has a central role in all decisions that are made.

The command economy is usually associated with a socialist or communist economic system, where land and capital are collectively owned.

The main features of such an economic system are:

1

Production decisions (what, how and for whom production should take place) are decided by the government.

2

Hence, resources are controlled by the government on behalf of its citizens.

The planned economy Pros and Cons

Pros

1 With central planning, the government could take an overall view of the economy.

It could direct the nation's resources in accordance with specific national goals. For example, Unemployment could be largely avoided if the government carefully planned the allocation of labour in accordance with production requirements and labour skills

2 Economies of scale

Large state monopolies can achieve huge cost savings known as economies of scale . This is achieved by operating on a very large scale, such as a national supplier of electricity or postal services

3 National income could be distributed more equally or in accordance with needs.

A planned economic system enables basic needs to be met for everyone in society. For example, everyone in society has access to education, health care and employment.

4 The social repercussions of production and consumption (e.g. the effects on the environment) could be taken into account, provided the government was able to predict these effects and chose to take them into account.

Cons

1 Bureaucracy

Government intervention involves administrative costs. The more wide-reaching and detailed the intervention, the greater the number of people and material resources that will be involved. These resources may be used wastefully.

2 Lack of economic freedom

Complete state control over resource allocation would involve a considerable loss of individual liberty. As the state plans all production decisions, individuals do not have economic freedom to choose from competing goods and services. Workers would have no choice where to work.

3 Lack of incentives

As resources, jobs, goods and services are determined (planned) by the government, there is a lack of incentive to be innovative. The absence of a profit motive for firms means there is less of an incentive to produce more goods and services or to produce these at a higher quality.

4 Inefficiency

If there is no system of prices, or if prices are set arbitrarily by the state, planning is likely to involve the inefficient use of resources. It is argued that planned economies cannot detect consumer preferences resulting in shortages and surpluses

Mixed economy

Because of the problems of both free-market and command economies, all real-world economies are a mixture of the two systems.



In a mixed economy, some resources are owned by the public sector (government) and some are owned by the private sector.

Decisions on most important economic issues involve some form of planning (by private as well as public enterprises) and interaction between government, businesses and labour through the market mechanism.

The mixed economic system obtains the best of both the planned and market systems. For example, necessary services are provided for everyone whilst most other goods are competitively marketed.

Private ownership of productive resources operates alongside public ownership in many mixed economies.

The degree of public and private sector involvement in economic activity is determined by the government.



The private sector in a mixed economy

In the private sector, profit acts as the motive for firms to provide the goods and services demanded by consumers.

Producers and workers have incentives to work hard, to invest and to save.

There is a large degree of economic freedom with plenty of choice for private individuals and firms



The public sector in a mixed economy

In the public sector, the government may control the following:

Relative prices of goods and inputs, by taxing or subsidising them or by direct price controls.

Relative incomes, by the use of income taxes, welfare payments or direct controls over wages, profits, rents, etc.

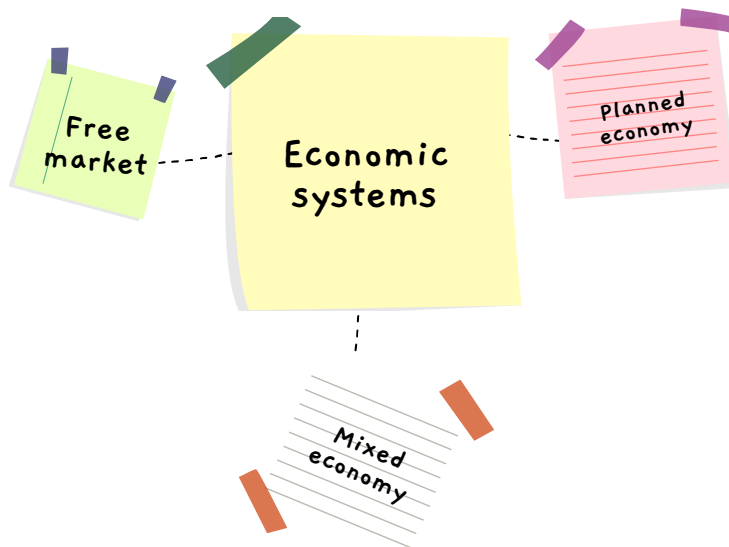
The pattern of production and consumption, by the use of legislation, by direct provision of goods and services, by taxes and subsidies or by nationalisation.

Issues of transition when central planning in an economy is reduced

The restructuring of the economy and the moves to privatise former state-run activities are accompanied by substantial job losses and the need for social reform



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The fundamental economic problem

The fundamental economic problem is:

'scarce resources in relation to unlimited wants.'

1 2 3

1 Scarcity: The excess of human wants over what can actually be produced to fulfil these wants

2 Resources: inputs available for the production of goods and services.

3 Wants: needs that are not always realised.

Choice

Choice underpins the concept that resources are scarce so choices have to be made by consumers, firms, and governments.



Sacrifice

Choice involves sacrifice. The more food you choose to buy, the less money you will have to spend on other goods.



Opportunity cost

In other words, the production or consumption of one thing involves the sacrifice of alternatives. This sacrifice of alternatives in the production (or consumption) of a good is known as its opportunity cost.

Opportunity cost is the cost expressed in terms of the best alternative that is forgone.

EXAMPLE

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Question

'Both the take-up rate and number of journeys per bus pass have been falling in recent years.'

Explain two factors which could lead to an increase in the demand for bus travel in the future.

(10 marks)

Category: Demand and supply

AQA AS ECONOMICS November 2020

Answer

Tip: Generally, AQA exam questions are accompanied by an extract (although we have not included it here for simplicity). To score higher marks, refer back to the data (facts and figures) given in the extract, when writing your essay! Note that in this question you are asked to 'explain TWO factors'. In this case, it's a good idea to break your essay into two parts: Factor 1 and factor 2.

(Step 1: Define 'demand' in the introduction)

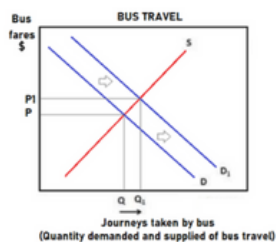
Demand refers to both the willingness and the ability of customers to pay a given price to buy a good or service. There are several factors which could lead to an increase in the demand for bus travel in the future.

(Step 2: Explain TWO factors which could increase the demand for bus travel)

Factor 1: A change in tastes or social norms will increase the demand for bus travel.

Today, travelling by bus has the image of being unpleasant, unreliable and for the 'lower class'. However, more awareness is being raised about air pollution, climate change and CO₂ emissions. People in the future may perceive bus travel as being more ecologically and economically efficient. Furthermore, with the introduction of smart lanes and electric buses, the experience of travelling by bus will improve with time. These factors will encourage people to take the bus.

If more people become aware that travelling by bus is environmentally friendly, more people will opt for bus travel to reduce their carbon footprint. The demand for bus travel will increase. The effect of an increase in demand for bus travel can be shown using a diagram. The diagram below shows the demand and supply curves of bus travel.



Initially, people are unaware of the environmental benefits of bus travel, the equilibrium price (bus fare) is P and the equilibrium quantity (number of journeys taken by bus) is Q . Following campaigns raising awareness about air pollution, more people will be encouraged to travel by bus instead of using their cars. The demand curve for bus travel shifts rightward from D to D_1 . The quantity demanded and supplied for bus travel increases from Q to Q_1 .

Factor 2: If the price of substitutes such as car travel increases, then people will turn to bus travel instead because of its more favourable relative price.

Substitutes are alternative goods and can satisfy the same want or need. Examples of substitutes are car travel and bus travel. For example, if the price of car travel increases significantly, people will look for cheaper alternatives, such as bus travel.

The cost of travelling by car can increase in the future, for instance, due to higher fuel prices. Consequently, if the cost of travelling by car goes up in the future, people will avoid travelling by car, and take the bus instead. The demand for bus travel will increase.

The government may also subsidise bus travel in the future, making bus fares cheaper. This will encourage people to switch away from using their cars to travelling by bus.

(Step 3: Conclude)

To conclude, the demand for bus travel could increase in the future if people perceive buses as being more ecologically and economically efficient. Also, if the price of substitutes such as car travel increases, then people will turn to bus travel instead because of its more favourable relative price.

MARKING SCHEME

- Relevant issues include:
- meaning of demand
 - lower relative price and/or greater availability compared with substitute goods
 - increased subsidy
 - changes in tastes and/or social norms
 - changes in income and/or consideration of bus travel as an inferior good
 - increased population and/or changes in age structure
 - the significance of elasticities

Level 3

- An answer that:
- identifies two valid factors
 - shows sound knowledge and understanding of relevant economic terminology, concepts and principles
 - includes good application of relevant economic principles and/or good use of data to support the response
 - includes well-structured analysis with a clear, logical chain of reasoning
 - may include a relevant diagram to support their explanation

EXAMPLE

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SKIM THE DATA
Start by skimming the data. Read the text quickly to get a general idea of meaning.

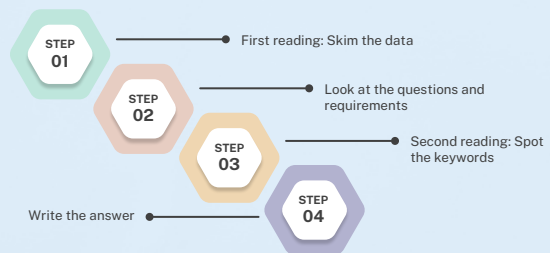
LOOK AT THE TITLE
Look at the title as it may give some clues about its content.

ANALYSE FACTS, FIGURES AND TABLES
Analyse facts, figures tables and diagrams. See if you know what they mean. Pick out any notable features of a chart or diagram.

COMPETITION IN THE SKIES OVER EUROPE

It was predicted that this would lead to an increase in the market share for the top five European airlines from 50% of the European market in 2019 to match the top five United States (US) airlines, which control 77% of the US market.

STEPS TO ANSWER A DATA RESPONSE QUESTION



Read the Requirements

Always read the requirement first as this enables you to focus on the detail of the question with the specific task in mind.

What is the point in reading a scenario if you don't know what you are looking for? If you don't read and understand the requirements carefully, then you will find that you are not actually answering the question. If you are not answering the question, then you are not earning marks.

Pay attention to (1) The content and (2) The instructions

Explain what is meant by a contestable market and discuss how making the airline market more **contestable** could benefit passengers.

... contestable market...benefit

THE CONTENT
When you read each part of the requirement, highlight the 'content'. This is simply what the question is about. This helps you to focus your mind on answering the actual question rather than answering what you thought the question was going to ask you.

THE INSTRUCTIONS
This instruction could be a whole variety of verbs ranging from numerical requirements such as calculate and apply, or more wordy requirements such as describe, interpret, outline or compare. The verb used has been carefully thought about by the examiner, taking into account any restrictions imposed by the syllabus.

Explain

Explain what is meant by a contestable market and discuss how making the airline market more contestable could benefit passengers.

(d) Explain two reasons why a government may privatise an industry. [4]

There are several reasons why a government may privatise an industry, such as air travel.

STRUCTURE

CLEAR HEADINGS

Reason 1: Privatising an industry may lead to an increase in government revenue.

The government may earn more tax revenue if it privatises a state-owned industry. This is because a privately owned industry has to pay corporation tax. A corporation tax is a tax levied on companies profits.

PARAGRAPHS

The sale of a state-owned enterprise to the private sector will also raise money for the government.

REFERENCE TO THE DATA

In the data, it was mentioned that a successful sale of Air India to the private sector would have raised money for the Indian government.

More tax revenue will enable the government to increase its spending on education, healthcare or infrastructure. This will help to promote development in the country.

SIMPLE ENGLISH

Reason 2: The government may privatise an industry because the industry is making a loss.

The need to use tax revenue to finance the loss-making industry will be reduced. The private sector may also manage the industry with greater efficiency and turn the loss into a profit. This is because the private sector, motivated to make a profit, will increase productivity and reduce costs.

EXAMPLE

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Questions

Paper and year

Topic

Answers and Explanations

Scarcity, Choice and Opportunity Cost Multiple Choice Questions

1. Which terms summarise the nature of the economic problem?
 A finite resources and limited wants
 B finite resources and unlimited wants
 C infinite resources and limited wants
 D infinite resources and unlimited wants
 [210/P220]

2. The government of a country with a rapidly increasing population decides to switch resources from investment to increased subsidies to farmers. What is the opportunity cost of this decision?
 A the profit earned by farmers
 B the rest of the land on which food is grown
 C the reduction in investment
 D the wages of the farm workers
 [210/P247]

3. Which economic change would increase the problem of scarcity?
 A a decrease in fish stocks
 B a discovery of a new oil field
 C an increase in labour productivity
 D a reduction in waste
 [110/P1/052]

4. What makes choice an important element in the basic economic problem?
 A increased demand leads to higher market prices.
 B limited resources have many alternative uses.

C Reaching a market equilibrium may take a long time.
 D Scarce economic resources are distributed equally.
 [10/P1/011]

A government of acid with their about to ending on the other side of the world.
 A conservation of resources
 B monetary policy
 C opportunity cost
 D substitution of factors
 [210/P252]

5. A firm decides stop manufacturing B and invest in C producing washing machines instead. What is the opportunity cost to the firm?
 A the additional washing machines produced
 B the cost of producing ovens
 C the cost of producing washing machines
 D the cost of the production of ovens
 [211/P201]

6. What is meant by the economic problem?
 A An unbalanced supply and demand
 B The need to choose between alternative uses of limited resources
 C The need to choose between public and private sectors
 D The need to choose between alternative uses of finite resources
 E The need to choose which methods to use to exploit all resources

1. A finite resource is a resource that cannot be replaced or renewed. It is a resource that is limited in quantity. Examples include fossil fuels, minerals, and land. A scarce resource is a resource that is in short supply relative to demand. It is a resource that is difficult to come by. Examples include diamonds, rare metals, and certain types of land. An unlimited resource is a resource that is not limited in quantity and can be replaced or renewed. Examples include air, water, and solar energy. An infinite resource is a resource that is not limited in quantity and can be replaced or renewed. Examples include air, water, and solar energy.

O level topics

01	Economic Problems
02	Factors of Production
03	Economic Systems
04	Demand, Supply and Equilibrium
05	Perfect Competition and Monopoly
06	Aims of Government and its Role
07	Market Failure
08	Public Expenditure vs Private Expenditure
09	Banks and Stock Exchanges
10	Labour Market
11	Motives for Spending, Saving and Borrowing
12	Different Types and Sizes of Firms
13	Production, Costs, Revenues and Profits

AS level topics

01	Basic Economic Ideas And Resource Allocation
02	Production Possibility Curves
03	Classification Of Goods And Services
04	The Price System And The Micro Economy
05	Price Elasticity
06	The Macro Economy
07	International Trade
08	Protectionism
09	Exchange Rates
10	Government Macro Intervention

A level topics

01	Law of Diminishing Marginal Utility, Indifference Curves and Budget Lines
02	Types of Cost, Revenue and Profit
03	Firms and Market Structures
04	Efficient resource allocation
05	Equity and Policies towards Income and Wealth Redistribution
06	Labour Market Forces
07	National Income Statistics
08	The Circular Flow of Income
09	Money Supply (theory)
10	Economic Growth, Economic Development and Sustainability
11	Government Macroeconomic Policy Aims

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Introducing Economics

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The basic economic problem
Scarcity, choice and opportunity cost
The Production Possibility Curve (PPC)
The economic problem
Economic systems



Chapter 2

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Topics

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Chapter 3

Economic systems

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Economic systems

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The Free Market Pros and Cons

The planned economy

The planned economy Pros and Cons

Mixed economy



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Chapter 6

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Chapter 7

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Supply-side policy

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