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Economics Revision Focus: 2004

AS Economics

Functions of the Price Mechanism

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Revision Focus on the Functions of the Price Mechanism

AS Syllabus Requirements:

How Markets and Prices Allocate Resources

Candidates should understand the **rationing, incentive and signalling functions of prices** in allocating resources and co-ordinating the decisions of buyers and sellers in a market economy.

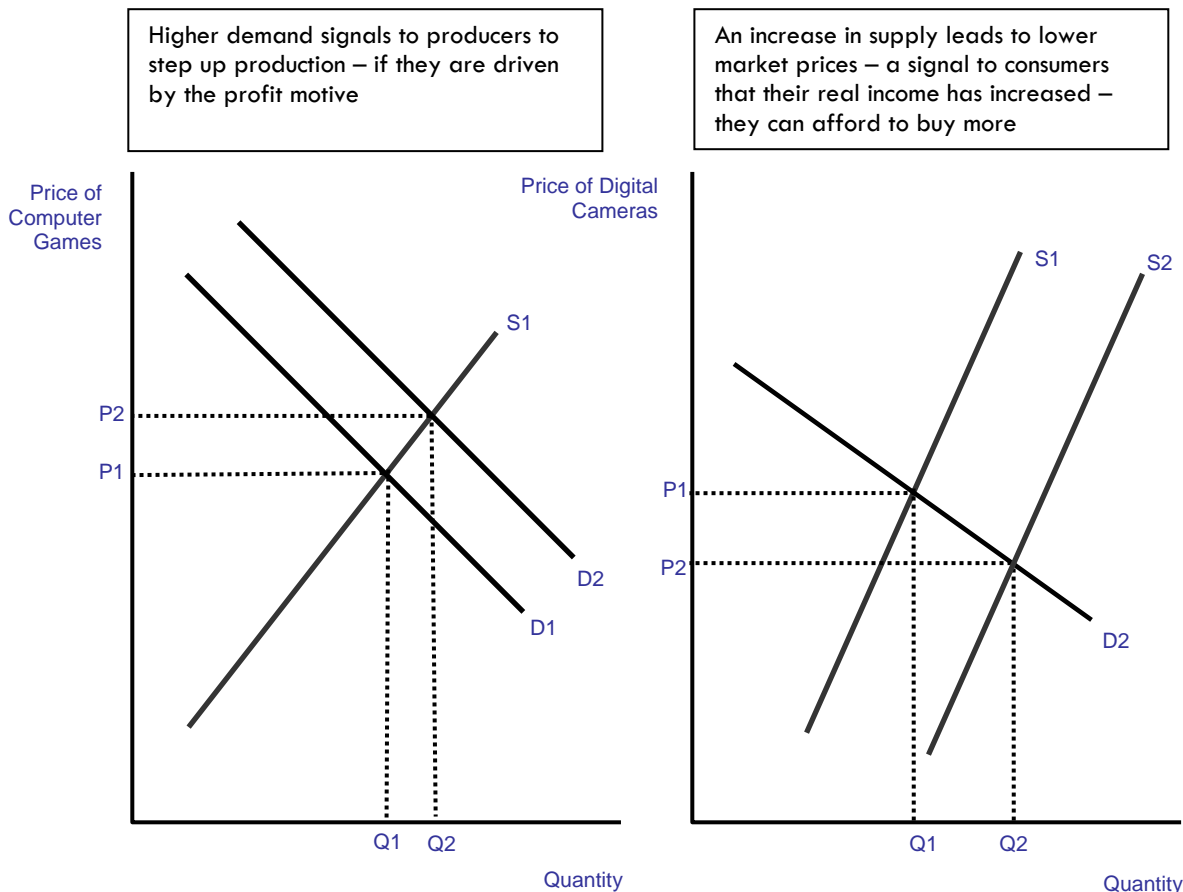
The invisible hand – the workings of the price mechanism

The **price mechanism** is simply the means by which the millions of decisions taken each day by consumers and businesses interact to determine the allocation of scarce resources between competing uses. This is the essence of economics!

The price mechanism plays three important functions in any market-based economy

The signalling function

Prices have a **signalling function**. Prices adjust to demonstrate where resources are required, and where they are not. Prices rise and fall to reflect scarcities and surpluses. If market prices are rising because of stronger demand from consumers, this is a signal to suppliers to expand output to meet the higher demand. Consider the left hand diagram below. The demand for computer games increases. Producers stand to earn higher revenues and profits from selling more games at a higher average price. So an outward shift of demand leads to an expansion along the market supply curve (*ceteris paribus*)



In the second example on the right, an increase in supply causes a fall in the relative prices of digital cameras and prompts an expansion along the market demand curve

The transmission of preferences

Through the signalling function, consumers are able through their **expression of preferences** to send **information to producers** about the **changing nature of our needs and wants**. When demand is strong, higher market prices act as an incentive to raise output (production) because the supplier stands to make a higher profit. When demand is weak market supply contracts.

The rationing function

Prices serve to **ration scarce resources** in situations when demand in a market outstrips supply. When there is a **shortage** of a product, the price is bid up – leaving only those with sufficient willingness and ability to buy with the effective demand necessary to purchase the product. Be it the demand for cup final tickets or the demand for a rare antique the market price acts a rationing device to equate demand with supply.

The growing popularity of **auctions** as a means of allocating resources is worth considering as a means of allocating resources and clearing a market.

Adam Smith and the Invisible Hand

The 18th Century economist Adam Smith – one of the founding fathers of modern economics, described how the invisible or hidden hand of the market operated in a competitive market through the pursuit of self-interest to allocate resources in society's best interest. This remains the central view of all free-market economists, i.e. those who believe in the virtues of a free-market economy with minimal government intervention.



The price mechanism is the only allocative mechanism solving the economic problem in a free market economy. However, most modern economies are **mixed economies**, comprising not only a market sector, but also a non-market sector, where the government uses the planning mechanism to provide goods and services such as police, roads and health.

In a **command economy**, the price mechanism plays little or no active role in the allocation of resources. Instead the main mechanism is state planning – directing resources to where the state thinks there is greatest need. The reality is that state planning has more or less failed as a means of deciding what to produce, how much to produce, how to produce and for whom. The market economy is now the dominant economic system – even though we are increasingly aware of **imperfections in the operation of the market** – i.e. the causes and consequences of market failure.

Prices and incentives

Incentives matter enormously in our study of microeconomics, markets and market failure. For competitive markets to work efficiently all economic agents (i.e. consumers and producers) must respond to **appropriate price signals** in the market.

Market failure occurs when the signalling and incentive function of the price mechanism fails to operate optimally leading to a loss of economic and social welfare. For example, the market may fail to take into account the **external costs and benefits** arising from production and consumption. Consumer preferences for goods and services may be based on **imperfect information** on the costs and benefits of a particular decision to buy and consume a product. Our preferences may also be distorted by the effects of persuasive advertising and marketing to create artificial wants and needs.

Government intervention in the market

Often the incentives that consumers and producers have can be changed by **government intervention** in markets. For example a change in relative prices brought about by the introduction of **government subsidies and taxation**.



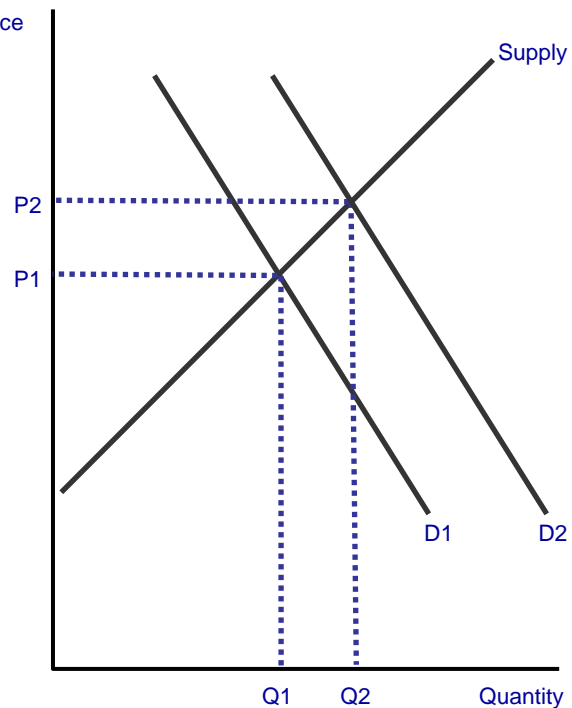
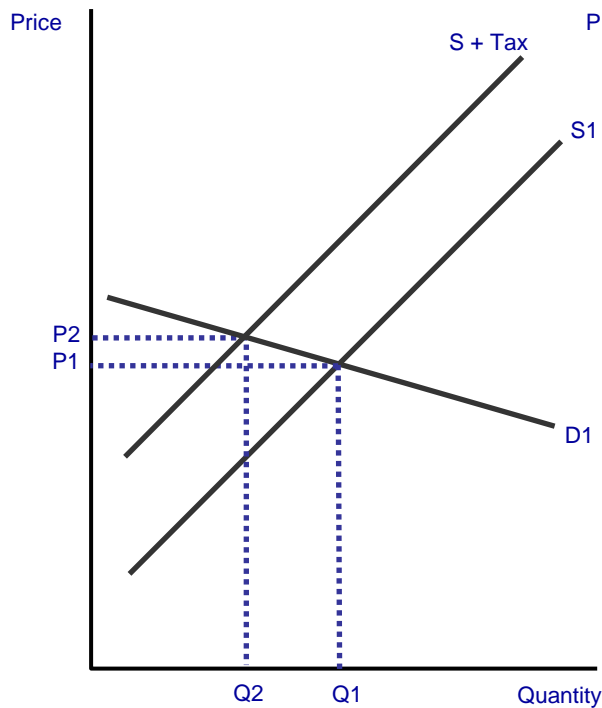
Suppose for example that the government decides to introduce a new tax on aviation fuel in a bid to reduce some of the externalities created by the air transport industry.

1. How will airlines respond?
 - a. Will they pass on the tax to consumers?
 - b. Can they absorb the tax and seek cost-savings elsewhere in their operations?

2. If the tax raises price for air travellers, will they change their behaviour in the market?
3. Is an aviation tax the most effective way of controlling pollution? Or could incentives for producers and behaviour by consumers wanting to travel by air be changed through other more effective and efficient means?

An indirect tax increases the relative price of a product and should cause a contraction of demand. The government is intervening in the market because it wants to change the price signals and incentives of producers and consumers. In this case the justification may be a desire to correct for negative externalities

A government subsidy to consumers to cover some of the costs of buying child care or employing nannies is designed to reduce the relative cost of this and therefore increase demand. The justification could be to encourage more young mothers to actively seek work, expand the labour supply and contribute to the country's productive potential



Agents may not always respond to incentives in the manner in which textbook economics suggests. The **“law of unintended consequences”** encapsulates the idea that government policy interventions can often be misguided or have unintended consequences! See the revision focus article on government failure.