

The Role of Prices 6.3

- **What role do prices play in a free market system?**
- **What advantages do prices offer?**
- **How do prices allow for efficient resource allocation?**

The Role of Prices in a Free Market

- **Prices serve a vital role in a free market economy.**
- **Prices help move land, labor, and capital into the hands of producers, and finished goods in to the hands of buyers.**
- **Prices create efficient resource allocation for producers and a language that both consumers and producers can use.**

Advantages of Prices

Prices provide a language for buyers and sellers.

1. Prices as an Incentive

Prices communicate to both buyers and sellers whether goods or services are scarce or easily available. Prices can encourage or discourage production.

2. Signals

Think of prices as a traffic light. A relatively high price is a green light telling producers to make more. A relatively low price is a red light telling producers to make less.

3. Flexibility

In many markets, prices are much more flexible than production levels. They can be easily increased or decreased to solve problems of excess supply or excess demand.

4. Price System is "Free"

Unlike central planning, a distribution system based on prices costs nothing to administer.



Efficient Resource Allocation

- Resource Allocation
 - A market system, with its fully changing prices, ensures that resources go to the uses that consumers value most highly.
- Market Problems
 - Imperfect competition between firms in a market can affect prices and consumer decisions.
 - Spillover costs, or externalities, are costs of production, such as air and water pollution, that “spill over” onto people who have no control over how much of a good is produced.
 - If buyers and sellers have imperfect information on a product, they may not make the best purchasing or selling decision.

Section 3 Assessment

1. What prompts efficient resource allocation in a well-functioning market system?
 - (a) businesses working to earn a profit
 - (b) government regulation
 - (c) the need for fair allocation of resources
 - (d) the need to buy goods regardless of price
2. How do price changes affect equilibrium?
 - (a) Price changes assist the centrally planned economy.
 - (b) Price changes serve as a tool for distributing goods and services.
 - (c) Price changes limit all markets to people who have the most money.
 - (d) Price changes prevent inflation or deflation from affecting the supply of goods.

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