

# Merits and demerits of market economy and elasticity of demand



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Discuss some of the merits and demerits of market economy. Over the last two decades, the planned economies have introduced some elements of the market mechanism into their economics system. Evaluate some of the success and failures of these developments.

**Definition:**

Market economy is the system of allocating resources based only on the interaction of market forces like supply and demand. A true market economy is free of governmental influence, collusion and the other external inferences.

A Market economy has seven major features as follows:

People purchase what they want, but just if they can afford it.

Therefore, money becomes essential for life.

In order to get money, people are forced to do anything and to sell anything.

The main goal for all production and investments are to have maximum profit than having social needs satisfied.

Other people (as in slavery and feudalism) no longer exercise discipline over those who produce the wealth of society but by money and the conditions of work that one must accept in order to earn money.

Sharing of limited goods happen through money (based on who has more than the others do) rather than through coupons (according to work harder or longer or has a greater need for the good).

While everyone is paid for, what they do and not to keep from trying to get rich, people get a sense that everyone gets what he reserves economically, in general, rich and poor both are responsible for their destinies.

Market economy has some significant advantages and disadvantages and there is no matter that the society is developed or underdeveloped. There are some important advantages as follows:

Between different companies, competition leads to increase competence, as companies do whatever that is needed (containing fire workers) in order to have lower costs.

Most of the people work hard (the important threat of losing job for someone could be the greater motivator).

There is more innovation as firms look for new products to sell and cheaper ways to do their work;

When there is a new opportunity to earn profit, the foreign investments are attracted.

The power, cost, and size of the state bureaucracy are reduced equally as various activities, which are typically connected with the public sector that are taken over by private ventures.

The rapid production or at least those who are involved in making those things that people want to buy by money at home or abroad, cause to increase development.

Too many people rapidly purchase the technical and social skills and necessary knowledge to do in this new economy.

A wide variety of different consumer goods is very available for those people who have money to buy.

Large parts of the society take on a bright, merry and colorful air as everyone busies himself trying to sell something to someone else.

In addition, there are important disadvantages just as follows:

The priority of distorted investment as wealth is directed into what people get as greater profit and what they really need and want.

The more profit from the employer when is the worst exploitation of workers that the longer, faster, and harder people work.

The overproduction of goods while workers are never paid enough, when they are in their role of consumers, to buy them back (in the age of computerization, robotization, and automation, the gap between what they produce and what is their lower wages amount, which allows them to consume has increased extremely).

The capacity of industrial, which is unused ( the verdict of a large percentage of machinery of all kinds that are idle, is the huge amount of unsold goods when many needs are dissatisfied).

Growing rate of unemployment (no machines could make profit for owner when raw materials are accessible but could not satisfy those people that cannot afford for what could be made for them).

Growing social and economic inequality (in this circumstances the poor get poorer and rich get richer and we have the deeper gap in social classes).

With this kind of gap between rich and poor, egalitarian social relations become unfeasible (those people who are rich and have too much money think that they are better than everyone else, when the poor people feel hatred toward them).

Those people who have the most money still exercise to earn and make more and more.

Increasing the corruption in all society's sectors because of increasing the power of those people who have more money in order to bribe officials to whom have not, at a harsh disadvantage.

Increasing crimes in all kinds of economic because of those people who are trying to make money illegally when legal is not accessible.

Reducing social benefits and welfare (while such benefits are financed at least in part by taxes, expanded benefits usually means reduced profits for the rich; in addition, any social security net makes workers less scared of losing their works and accordingly less enthusiastic to do anything to keep them);

Worsening ecological degradation (while any attempt to improve the quality of the air and water need costs for the owners of industry and consequently reduce the profits, so we cannot live in our natural home).

With all this, misunderstand will occur by different social classes about the arising the new social relationship and powers through the performances of a market economy as an usual occurrence with a life and will of their own (for example, money get approximately power, which stands above people and guide their lives, rather than a vehicle into those people through their estranged relations with their productive activity. consequently, the market itself keep the basic human nature than any other possibilities. As a result, people get discourage of their ability or having different qualitatively future. In short, what Marx called “ ideological thinking” becomes general).

The same market experiences expand a set of anti-social manners and feelings (people become self-centered, worried only about themselves. “ Me first”, “ anything for money”, “ winning in competition no matter what the human costs” become what drives them in all areas of life. They also become very nervous and economically insecure, frightened of losing their work, their home, their sale, etc.; and they concern about money all the time. In this circumstances, emotions as well as ideas of collaboration and mutual concern are critically weakened, where they don't vanish altogether, for in a market economy it is against one's personal interest to collaborate with others);

It will be become very difficult for any government to give the people the right picture of the country's problems when people's thinks and emotions

are affected by their life in a market economy (it is more caused to illusion people with the growth rate of economy. By depending on “ favorable market psychology”, the government could not be honest with its own people or even the rest of the world on what is exactly happening in the country).

In conclusion, the market economy leads to periodic economic crisis, where all of the disadvantages expand in a way that all of the advantages above will be completely dried. The growth rate of economy will be stopped, fewer things are going to be made, development of productions will be slowed down, investment will drop off, etc.

**Q2. Explain the concept of elasticity of demand and discuss the factors that determine elasticity of demand. Distinguish between price elasticity, income elasticity and cross elasticity of demand and evaluate on their importance especially to businessmen.**

### **Elasticity of demand**

**The reaction of demand for a service or good in order to decrease or increase in the price. Usually, when the price drops dramatically, the sale will increase and vice versa. As a general rule, appliances, cars, confectionary and other non-essentials show elasticity of demand while most necessities (food, medicine, basic clothing) show inelasticity of demand (do not sell importantly more or less with changes in price).**

**Companies are very interested to know about the reaction of demand but not only to change the price, they also need to know the reaction of demand to change in other determinants like the prices of replacement or complementary goods and customer's income. They will interested to know about the income elasticity of demand – the reactivates of demand in any changes in consumer's incomes; also the cross-price elasticity of demand- the reactivates of demand for their goods to a change in the price of another (whether a complement or replacement).**

### **Price Elasticity of Demand**

Price elasticity of demand is explained as the measure of responsiveness in the quantity demanded for a product because of changing in price of the same good. It is a kind of determinant of how consumers response to a change in price. In the other hand, it is a kind of percentages changing in



quantity demanded by the percentages change in price of the same product.

In the study of economic and business, the price elasticity of demand is rather a computing of the sensitivity of quantity demanded to changes in price. It computes the relationship as the ratio of changes percentage between quantities demanded a commodity and changes in its price.

In the other words, when we can say that the demand for the good is very inelastic if the consumers can and will pay almost any range of prices for the commodity, and very elastic if consumers just can only pay a certain price or a limited range of prices for the products. Inelastic demand means the a producer increase prices without any damages in demand for its goods, and elastic demand means consumers are price sensitivity when the good is sold and they could not afford it again if the price will increase.

As an good example of a commodity, which has inelastic features is drinking water that people will definitely pay anything for that (whether high or low with relative equivalent demanded).

In the other word, some products like sugar has elastic feature because of switching the consumers, as a result of increasing in price, to the substitutions.

In order to compute the coefficients of price elasticity, the below formula is used for a given product just as follow:

Ed =

## Value

### Meaning

$$E_d = 0$$

Completely inelastic demand: by changing the price, quantity will not change. i. e., food and housing.

$$E_d < 1$$

Inelastic demand: Not very responsive to change in price . i. e., electricity, cigarettes.

$$E_d = 1$$

Unit (or unitary) elastic demand: The percentage change in quantity demanded is equal to the percentage change in price. i. e., gasoline, recreation.

$$E_d > 1$$

Elastic demand: Any percentages of changing in price, exactly affect to the percentages in quantity demand. Meaning that consumers are price sensitive. i. e., air travel, movies, and restaurant meals.

$$E_d = \infty$$

Completely elastic demand: Quantity demanded is completely affected in changing in price. A very small increasing in price will affect to disappear the demand. i. e., soft drink from two campus machines located side by side.

## **Perfectly Elastic Demand Curve Perfectly Inelastic Demand Curve**

Falling in price normally affect in the quantity demanded by consumers.

When the changing in quantity demanded is less than changing in price, so the demand for a product is inelastic. While there is no replacement product for the exist one, so the goods and services are inelastic. As an good example, demand for antibiotic will be definitely inelastic when it alone can destroy an specific infection. In this situation, the patient will pay whatever is needed to purchase the enough amount of drug in order to kill the infection.

## **Applications of Price Elasticity of Demand**

The price elasticity of demand can be applied in a wide variety of problems when someone needs to know the expected change in quantity demanded or revenue given a considered changing in price.

As an example, a state automobile registration authority considers a price hike in personalized “vanity” license plates. The current price is \$40 per year and the registration office in thinking about the increasing price to \$45 per year in order to increase the revenue. It is suppose that the registration office knows that the price elasticity of demand from \$40 to \$45 is 1.3.

The elasticity is greater than one in the range of the price, so it is known that an increasing in price would decrease the revenue, which is collected by the automobile registration authority, therefore the hike’s price would be unwise.

## **Factors Influencing the Price Elasticity of Demand**

The price elasticity of demand for a special demand curve is affected by the following factors:

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Availability of substitutes: the greater the elasticity is because of the greater number of replacement of products.

Degree of necessity or luxury: magnificence products tend to have greater elasticity than requirements. Some of the products at first do not have a higher degree of requirement and they are habit forming and can become “ necessities” to some consumers.

Proportion of income required by the item: commodities need a larger portion of the consumer’s income, which is lead to have a greater elasticity.

Time period considered: over the long run, elasticity tends to be greater because consumers can adjust their buying behaviour in changing the price, when they have more time.

Permanent or temporary price change: different kind of responses could be appeared in just one-day sale, than a permanent price decrease in the same scale.

Price points: decreasing the price from \$5. 00 to \$4. 99 may result in greater increase in quantity demanded than decreasing it from \$5. 99 to \$5. 98.

### **Income elasticity of demand (YD,, D)**

How sensitive is the demand for a product to a change in the real incomes of consumers? In order to compute it, we use elasticity of demand. Since the value of income elasticity tell something about the nature of a product and how it is perceived by consumers, so the result is very significant. It also

influences the amount of changes in economic growth level and pattern of demand for goods and services.

Income elasticity of demand measures the reaction of the good's demand in changing the people's income for demanding goods and services. It is computed as the percentage of the changes range in demand to the changes range in income. As an good example, if, in response to a 10% increase in income, the demand of a good increased by 20%, the income elasticity of demand would be  $20\%/10\% = 2$ .

Bellow is the formula of computing the coefficient income elasticity of demand:

The most important determinant of income elasticity of demand is the rage of good requirements; also, another determinant is the level of consumer's income.

As we can see in the developed country, the percentages of demand for luxury products is developed very quickly because of increasing the people's income, while the demand for basic and primary products like bread increase just a little bit. Consequently, things like cars and abroad holiday have a very high elasticity of demand, while something like potatoes and bus journeys have a low elasticity of demand.

When income increase, some of goods will be decreased. When people have high income and earn more, so the switch from cheep margarine to the better quality of that or butter. Some different usual products and goods have a positive elasticity of demand, whereas cheaper goods have a

negative income elasticity of demand (as mentioned earlier, any increasing in income lead to decreasing in demand).

A negative income elasticity of demand is related with inferior goods; any increasing in income will lead to a descend in the demand and may lead to switch to more luxurious replacements.

Inferior good's demand falls as consumer income increases.

A positive income elasticity of demand is related to normal goods, and a rises in income will lead to increase in demand. It is the necessity good, if income elasticity of demand for a good is less than 1. In the other hand, if the elasticity of demand is greater than 1, so it is a superior or luxury product.

While the income is not related to a change in the demand of a good, so a zero income elasticity or inelasticity demand appears. These would be sticky goods.

Product

Share of budget

(% of household income)

Price elasticity of demand

Income elasticity of demand

All Foods

15. 1

n/a

0. 2

Fruit juices

0. 19

-0. 55

0. 45

Tea

0. 19

-0. 37

-0. 02

Instant coffee

0. 17

-0. 45

0. 16

Margarine

0. 03

n/a

-0.37

Source: DEFRA [www.defra.gov.uk](http://www.defra.gov.uk)

For most types of goods, the income elasticity of demand is low- infrequently negative (e. g. margarine) and equally the own price elasticity of demand for foodstuffs is inelastic as well. In the other hand, the demand for these kinds of products among consumers is not a big matter and they are not price sensitive.

When the income of the whole countries rises, the demand for import will respectively change also. For determining how responsive the demand for goods is, in order to change in total income, the perception of income elasticity of demand can be used. The demand for many main goods has an income elasticity of demand coefficient of less than one. As incomes increase the demand for many of the goods such as coffee will increase (while demand for some may even decrease) but by a proportionately smaller quantity. If your allowance increases by 50% it is unlikely that you are going to increase your consumption of coffee by the same percentage! Sales will be slowly growing and sluggish.

## **Cross elasticity of demand**

The cross elasticity of demand and cross price elasticity of demand calculates the responsiveness of the demand of a good to a change in the price of another good. By replacing two goods with each other, we should expect to see that consumers are likely to acquire more of one good while

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the price of this replacement increases. In the same way, when two goods are complementary with each other, we should expect to see that a price rise in one of them is just because of the demanding for these two goods to fall.

Changing in the percentage of demand for the first good, which arise in response to percentage change in the second good's price, could be calculated. For instance, if, in response to a 10% increase in the price of fuel, the demand of new cars that are fuel inefficient decreased by 20%, the cross elasticity of demand would be  $\hat{\Delta}^{20\%} / 10\% = \hat{\Delta}^2$ .

Here is the formulas in order to calculate the coefficient cross elasticity of demand:

Or

Two goods that complement each other show a negative cross elasticity of demand: as the price of good Y rises, the demand for good X falls.

Form the above example, these two goods, cars and fuel, are each other complementary; which is, one of them is used with another one. In this case the cross elasticity of demand will be negative, as increasing the price of fuel, so the demand would be decreased. In the case of perfect complements, the cross elasticity of demand is negative perpetuity.

The cross elasticity of demand will be positive, when the goods are substitutes, therefore while the price of one of them goes up then demand of the other one will increase. For illustration, in response to an increase in the price of carbonated soft drinks, the demand for non-carbonated soft drinks  
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will rise. In the case of perfect substitutes, the cross elasticity of demand is equal to perpetuity.

The cross elasticity of demand will be equal to zero, when the two goods are independent; as the price of one of them change, there will not be any changes in demand for the other goods.

The most important determinant of cross elasticity of demand is the nearness of the complement or substitute. The bigger one will have effect on the first good of changing in price in substitute or complement, and therefore the greater one will be the cross elasticity (positive or negative). Another determinant is time period, elasticity tend to be greater over the long run.

Companies hope to understand the cross elasticity for their good when considering the influence on the demand for their product of a change in the price of a competitor's good (complementary or substitute's goods).

**Q5. Would it be desirable to have zero unemployment? What would be the benefits and costs of increasing the rate of unemployment? What policies would you advocate to reduce unemployment?**

### **Having zero unemployment and the benefits**

Cyclical Unemployment is explained as taking place “ when the unemployment rate moves in the opposite direction as the GDP growth rate. So when GDP growth is small (or negative) unemployment is high.” When the economy goes into recession and workers are fired, we have cyclical unemployment

Frictional Unemployment: The Economics Glossary explains frictional unemployment as “unemployment that comes from people moving between jobs, careers, and locations.” If a person gives up his work as an economics researcher to attempt and find a work in the music industry, we would consider this frictional unemployment.

Structural Unemployment: The glossary explains structural unemployment as “unemployment that comes from there being an absence of demand for the workers that are available”. Structural unemployment is frequently due to technological change. If by introduction of DVD players, the sale of VCRs fall, so many people who produce VCRs will be out of work.

By looking at these three types of unemployment, we can understand that why it is good to have some unemployment.

Most of the people quarrel that while cyclical unemployment is the by-product of a weak economy, it is unavoidably a bad thing, although some have disputed that recessions are good for the economy. The latter is not a position I hold, so I am willing to accept that usually speaking, a zero level of cyclical unemployment is likely to be useful.

What about frictional unemployment? Now refer to that person who gives up his job as an economic research to follow his dreams in the music industry. He quit his job that did not like to try a career at the music industry, even though it caused him to be unemployed for a short while. Alternatively, consider the case of a person who is tired of living in Flint and decides to make it big in Hollywood and who arrives in Tinsel town without a work. A

great deal of frictional unemployment comes from people pursuing their <https://assignbuster.com/merits-and-demerits-of-market-economy-and-elasticity-of-demand/>

dreams. This is definitely a positive kind of unemployment, although we would hope for these individuals' benefits, which they do not continue unemployed for too long.

In conclusion, structural unemployment. When the car became ordinary, it cost many buggy producers their jobs. At the same time, most would dispute that the automobile, on net, was a positive expansion. The only way we could ever remove all structural unemployment is by removing all technological development.

### **The cost of increasing unemployment rate**

By breaking these three kinds of unemployment into cyclical unemployment, frictional unemployment, and structural unemployment, we see that an unemployment rate of 0% is not a positive thing. The only positive rate of unemployment is the price we pay for technological development and for people pursuing their dreams.

The social costs of unemployment to people as individuals, to their families, and to the community as a whole, are as follows:

#### **INDIVIDUALS**

Poverty, lack of spending money

Frustration, despair

Young people without full-time work experience

Social disillusionment

Ill health

Reduced life span

Mental illness

Increasing suicide rate

Drug abuse, crime

## **FAMILIES**

Increased family breakup

Homelessness

Domestic violence

## **COMMUNITY**

Higher and rising crime rates

Brutalization of lifestyle

### **Lost Income:**

(1) Loss of income tax from those now unemployed.

(2) Loss of National Insurance contributions, which would have been received from both employees and employers.

(3) Loss of Value Added Tax as the unemployed reduce their spending.

Increased Expenditure

(4) Increased cost of Unemployment Benefit (Among developed countries, the British rate of benefit appears to be one of the lowest).

(5) Increased cost of Social Security support payments.

(6) Increased costs for Health Service, Police and Prisons.

Note that perseverant lack of consideration and care and towards its members leads to a view of society as being hostile and unrewarding. We now see this happening and see its effects.

To the society, the social cost of unemployment is the whole cost to the society and the total of the items are listed here.

Prices used to be based on the method of 'cost plus reasonable mark-up', and unhindered competition was meant to ensure that the mark-up was reasonable. Prices are now based on what people can be chased to pay for what they can purchase. The mark-up can be massive, when producing in a low wage country and then selling in a high wage country.

Manfred Davidmann pointed this out in 1996, also saying that imports are priced in the amount of what market will bear, or only under. The huge profit margins then cause that production move from high-wage to low-wage countries. The result is a lowering of standard of living in high-wage countries to that in low-wage countries, instead of an increasing of standard of living in low-wage countries to that in high wage countries.

The huge additional profits, which consequence from transferring operations abroad then do not effect from doing a better job, or from providing better, or more desirable, or more efficiently produced, goods or services.

It is an accepted standard of economics, which the social costs of an enterprise's operations have to be paid by the enterprise, expressed by the maxim 'The polluter pays'. In the other hand, the social costs of unemployment have to be paid by the enterprise, which caused the unemployment.

To the extent to which an enterprise fails to allow for, and pay, the social costs of its operations, to that extent are its profits derived from passing its operating costs to the society, is it making profits at the cost of the society, is it developing the society and its members.

The unemployment people and some of that paid by the community; nonetheless, pay the social costs of unemployment.

In this way, the owner and directors make profit from the unemployment and the home country is the cause of the lower standard of living . in continues, they will continue to make profit from increasing unemployment and its results is as long as they are not forced to pay the social cost. In short, until they have permission to pass this part of their operating costs to the community.

## **Policies to reduce unemployment**

In the long period, effectual policies to reduce the total level of unemployment need to encourage.

An improvement in the employability of the labor supply – thus the unemployment people have the right skills to pick up the accessible job opportunities. Policies should concentrate on developing the occupational mobility of labor.

An improvement in the incentives for people to search and then accept paid work – this may need some improvements of the tax and benefits system.

A sustained period of economic growth so that new jobs are being created – this needs that total demand is adequately high for businesses to be looking to develop their workforces.

Improving skills and reducing occupational immobility- Policies should supply the unemployed with the skills they require to find re-employment and progress in the incentives to find job. The consequences of workers being occupationally immobile, is structural unemployment-developments in education and training will raise the human capital of these workers, and hence give them a better chance of taking the new jobs that become accessible in the economy.

Reflecting Aggregate Demand- The government can also use macro-economic policies to increase the level of total demand. These policies might involve lower interest rates or lower direct taxes. It might also encourage foreign investment into the economy from foreign multinational firms. In the diagram below, we see an increase in aggregate demand leading to growth of aggregate supply. Because of the increasing in demand for output, the demand for labor at each wage rate will grow – leading to an increase in total employment.

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No kind of increasing in demand and production has to meet by using more labor. Each year we expect to see an increase in labor productivity (more output per worker employed) and, businesses may decide to raise production by making superior use of capital inputs (machinery and technology).

Benefit and Tax Reforms – falling in the real value of unemployment benefits might raise the incentive to take a job – predominantly if the actual worth of unemployment benefits is well below the national minimum wage rate.

Targeted measures are designed to help the long-term unemployed find re-employment (including the Government’s “ Welfare to Work Schemes”)

Employment Subsidies – Government subsidies for those companies, which take on the long-term unemployed, will make an incentive for companies to raise the size of their workforce.

Economic Growth and Unemployment – A growing economy makes jobs for people entering the labor market for the first time. Moreover, it provides for unemployed people, who are looking for the job, the opportunity for employment .

I do not agree that we can just have less unemployment if we are eager to accept higher inflation, because when inflation rises, prices raise, so demand decreases. Consumers have some problems to survive because of the high price, so obviously workers ask for a pay raise, companies cannot afford to do, subsequently they outsource. They move to a country, which has a low minimum wage such as China or India. Logically, Unemployment increases when Inflation does.

**Q8. What are the constraints normally countries face in achieving a sustainable economic growth. What are the merits and demerits of attempting to achieve a faster growth rate in this country?**

At first, the meaning of Economic Growth Rate and how it can be formulate and calculate should be explained. In second part we will discussed about what is Malaysia's ranking among of the other country in Economic Growth Rate. How we can increase this rate and what is advantages and disadvantages of increasing economic growth rate in this country.

Economic growth is an increase in activity in an economy. It is often computed as the rate of change of gross domestic product (GDP). Economic growth refers only to the quantity of goods and services produced; it does not say anything about the way of producing. Economic deve