

How does a mixed economy deal with scarcity?



An economic system depicts how production, distribution and consumption of goods and services is managed in an economy. The factors of production (Land, Labour, Capital and Entrepreneurship) needed for any economic system to function are limited[CITATION Geo08 I 2057]and as a result the resources must be allocated efficiently and effectively to get the optimum benefit.

The mixed economy is a combination of two economic approaches, the free market economy and the planned economy. Before discussing the mixed economy, the other two approaches will be briefly covered as follows:

FREE MARKET ECONOMY

In this economic system goods and services are allocated by market price without any intervention from the government[CITATION Geo08 I 2057].

Those who are willing and able to pay the market price for various goods and services get those goods and services[CITATION Geo08 I 2057].

Adam Smith, a Scottish moral philosopher and a pioneer of political economics, was of the opinion that if everybody acts from self-interest, spurred on by the profit motive, then the economy will work more efficiently, and more productively, than it would do were economic activity directed instead by some sort of central planner[CITATION Geo08 I 2057].

This represents the summit of capitalism. In reality, a perfectly free market economy is a myth t only exists in the wild where humans do not intervene and where it is the case of survival of the fittest[CITATION Geo08 I 2057].

However, the free market economy often creates problems of selfish interest abandoning and abusing communal resources in society (such as the Tragedy of the commons[CITATION Geo08 I 2057]), creating monopolies and oligopolies, and may relegate the less fortunate to persistent poverty.

Capital flows to where it will get the highest return, this may engender a gap between the rich and the poor. With this in mind, Adam Smith recognised that some government action might be needed, such as to impose antitrust laws, enforce property, and to provide policing and national defence[CITATION Geo08 I 2057].

PLANNED ECONOMY

In a planned economy, resource allocation is determined by a central authority (usually the government) rather than by demand and supply. This is normally practised in socialist countries such as North Korea and Cuba. The central authority determines the quantity of goods and services produced in the economy.

A planned economy, in theory, does not suffer from business cycles, asset bubbles Such as the tech bubble in the late 1990's and housing bubble mid-2000[CITATION Geo08 I 2057].

However, a planned economy lacks the kind of flexibility that is present in a free economy, and because of this, it reacts slower to changes in consumer needs and fluctuating patterns of supply and demand.

Government businesses tend to perform poorly in comparison to private-sector counterparts. Government businesses often enjoy a legally

protected monopoly, and the lack of competition means the firms face little pressure to be efficient.

Royal Mail is a good example of how the government impeded it from taking on sensible business strategies and modernising its operations. It was a legally protected monopoly till 2006 following the full liberalisation of the postal market which opened the door to newer and more efficient competitors, leading to fall in revenue.

Politicians often interfere in important management decisions, making it harder to take unpopular actions on pay, factory closures and job cuts, particularly when there are strong public-sector trade unions and a union-friendly government.

Politically imposed financial constraints may also force public-sector firms to under invest. Although privatisation has not been universally beneficial, on balance it has increased economic efficiency.

MIXED ECONOMY

The mixed economy is a hybrid of the free economy and the planned economy. It reflects the fact that both market and government participation is required in the allocation of resources, as both systems have disadvantages which are corrected by the other. It includes both capitalist and socialist economic policies and often arises in societies that seek to balance a wide range of political and economic views[CITATION Geo08 I 2057]. The mixed economic system is used in most countries, but the extent of the influence of the market or government varies. The UK with Gordon Brown as Prime Minister was more geared to social service provisions

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whereas David Cameron is more geared towards a higher degree of public-private partnerships.

The UK for example is a mixed economy with a majority of decisions made by the market due to the high level of efficiency in responding to the needs of consumers and some by the government. The government provides free health services through the NHS Trust to its citizens, but also employs private consultancy firms who ensure the trust is running efficiently. In a mixed economy, individuals can help guide the economy not only through the choices they make as consumers but through the votes they cast for officials who shape economic policy.

John Maynard Keynes thought it would be beneficial for the government to use fiscal and monetary measures to mitigate the negative impact of economic recessions, depressions and booms[CITATION Geo08 I 2057]. Keynesian economics argues that private sector decisions sometimes lead to inefficient macroeconomic outcomes and therefore advocates active policy responses by the public sector, including monetary policy actions by the central bank and fiscal policy actions by the government to stabilize output over the business cycle. The events of the recession in 2007 saw a resurgence in Keynesian thought. World leaders have used Keynesian economics to justify government stimulus programs for their economies[CITATION Geo08 I 2057].

During the last two decades of the 20th century, many governments committed to the free market pursued policies of liberalisation based on substantial amounts of deregulation hand-in hand with the privatisation of

industries owned by the government. The aim was to decrease the role of government in the economy and to increase competition. Even so, red tape is alive and well. In the United States, with some 60 federal agencies issuing more than 1, 800 rules a year, in 1998 the Code of Federal regulations was more than 130, 000 pages thick. However, not all regulation is necessarily bad. According to estimates by the American Office of Management and Budget, the annual cost of these rules was \$289 billion, but the annual benefits were \$298 billion[CITATION Geo08 I 2057].

FACTORS THAT DETERMINE THE EXTENT TO WHICH AN ECONOMY IS MIXED

In a mixed economy, some of the factors that determine the extent to which a market is geared towards a planned or free market economy are as follows:

POLITICAL IDEOLOGY

In individualist societies, as is the case in most western countries, the economy is normally geared towards a free market economy as self-interest is encouraged in society, with ownership of land and capital in the hands of private individuals. However, in collectivist societies, the economy is geared towards a planned economy where land and capital are collectively owned.

POLITICAL SYSTEM

In countries where a democratic system of government is in place, the economy is geared towards a free market economy. This is the case as the citizens dictate what is best for themselves by way of voting. In socialist

countries the economy is geared towards a planned economy, as the central authority dictates what is best for its citizens.

GOODS PRODUCED

Goods can be classed as either necessity goods[CITATION Geo08 I 2057]or desirable goods[CITATION Geo08 I 2057]. Where a majority of goods produced in an economy are necessity goods the economy tends to be a planned economy as the government deems them necessary for the upkeep of its citizens. Totally free market tend to produce more of desirable goods as this responds to the forces of demand and supply where goods are made only if there is a demand for it.

ECONOMIC OUTPUT

In countries where a majority of the economic output is bought by consumers they tend to be more of a free market economy. In the United States for instance, almost two-thirds of the nation's total economic output goes to individuals for personal use[CITATION Geo08 I 2057]. In planned economy like Cuba a majority of the goods are bought by the government with little being purchased by individuals.

ECONOMIC CYCLE

Depending on prevailing times the goods and services can transit from one end of the spectrum to the other. During economic downturns the government tend to increase their involvement to stimulate the economy from further contraction. The recent recession made the banking sector, in a number of major economies, enter the planned economy spectrum from being at the extreme end of free market economy. The crisis was followed by

the nationalisation of banks, such as Northern Rock, and increase in regulations such as the US federal rules of civil disclosures[CITATION Geo08 | 2057]. In times of booms, regulations are sometimes relaxed to take advantage of it pushing the economy towards a free market economy. Since 1980, regulations were progressively relaxed until they have practically disappeared[CITATION Abo101 | 2057].

LEVEL OF LITERACY

Social factors also play a significant role in determining the extent to which an economy is mixed

Fiscal policy

Monetary policy

Education

Existence of an efficient market

Level of economic development

Scarce resources

INVESTMENT APPRAISAL

The machine to be considered at the forecast sales levels below are as follows:

700 units

Based on 700 units forecast sales, both machines will not be worthwhile as this will result in a loss. The reason for this is that Widget R US (WRU) requires sales of 884 units of widgets to breakeven, the point at which

neither profit or sale is made, while Widget 4 Ever (W4E) requires sales of 1875 units of widgets, both of which are over 700 units.

However, if it is a necessity to meet the forecasted sales, WRU will be the ideal option as it has the closer break-even point of 184 extra units, and will have a lower level of loss, in comparison to 1175 extra units for W4E.

Figure : Break Even Point & Point of Alternation

1000 units

At forecast sales of 1000 units, WRU will be selected as this will result in a profit as the forecasted sale is 13% margin of safety. W4E will be rejected outright, as the forecast sales is 875 units below its breakeven point and as such will result in a loss.

5000 units

At this level of sales, both WRU and W4E will make a profit as forecasted sales is above both breakeven points. To make a choice between WRU and W4E, we need to look at the most profitable of the two at this level.

In order for this to be determined, the swing point must be calculated to know at what level of sales WRU/W4E will be more profitable than the other. The calculated swing point is 5414 units, at this level of sales both WRU and W4E will give the same level of profit. Sales below 5414 units will swing in favour of WRU as is the case in this scenario. WRU will be selected at this forecasted level of sales.

7000 units

At this level, W4E machine will be selected as the sales forecast is above the swing point of 5414 units. This makes W4E the more profitable option.

9000 units

W4E machine will be selected at this level as well as the sales forecast is above the swing point of 5414 units making it more profitable than WRU.

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