The signaling and incentive functions of price in a market economy

Finance, Market

In free Market economy allocation of resources is left to market forces of supply and demand which also can be referred to as price mechanism. And the prices are determined as a result of the interaction of those market forces. Price mechanism enables the market to move to equilibrium, if left to act alone. When demand curve shifts to left due to a non-price factor such as change in tastes, the equilibrium price will increase. Increasing prices is the signal for the producers and shows the willingness and ability of consumers to buy it more.

This will serve as an incentive to producers to allocate their resources more on that specific product since now it is more profitable owing to its increasing prices. However, as the resources for that production is being used up more and more, they will become scarce eventually leading to shift of supply curve to the left which will push the prices up. This case corresponds to a downward movement along the demand curve as the price increase acts as a signal to consumer to lower their consumption.

Evaluate the proposition that government intervention in the market for Tobacco is justified. Tobacco is a demerit good which costs more than what people may be aware of. So if left to the market forces they are overproduced. Actual optimum level of output for tobacco is misled due to its negative externalities of consumption. When the figure is drawn according to the MPB (marginal private cost), the curve will reflect the benefits that are enjoyed only by the consumers of that product. Related article on methods of resource allocation

On the other hand, when we consider the third parties as well and draw the suitable MSB (marginal social cost) curve, it will be below the MPB curve which means that total benefit of tobacco to the whole society is less than its benefit to the private consumers. The distance between those curves will indicate the externalities of consumption. To prevent that type of marketfailurea government intervention could be useful. Government may choose either to impose indirect taxes to tobacco or use advertisements for deterrence.

First one will increase the cost of production shifting the MSC curve to left and the quantity produced will get closer to the optimum quantity. Second method will act on the consumer aiming for a change in their consumption habits which will shift the MPB (marginal private benefit) curve to right, closer to the MSB (marginal social benefit) curve. The optimum quantity of output will be achieved up to an extend depending on that shift. Although the picture depicted until that point might seem very optimistic for the government intervention, there are also many drawbacks of the same action.

First of all an intervention will hamper the natural functioning of the market force by itself. The incentives and signals will be rendered functionless. The vital role of consumers’ choice in allocation of resources will be disregarded mostly. Also extend of the act on consumers or producers is not easy to calculate and hard to hit the expected target to reach the optimality. Therefore the consequences might get out of the government’s control. In addition to these, a substantial decrease in the output of such a huge industry is likely to cause a big trouble in terms of unemployment.

Not only that specific industry of tobacco but also complementary industries will suffer from unemployment. When both the advantageous and disadvantageous are evaluated, government intervention is superior. This is because the main problem with it, unemployment, can be overcome in long run by well-directed policies to create proper jobs and secure a relevancy between the job vacancies and unemployed ones via training. On the other side bearing the drawbacks of having no intervention may not be affordable considering prospective market failure and social corruptions.