

# Mixed economy approach to allocating scarce resources



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The purpose of this report is to discuss the mixed economy approach to the allocation of scarce resources, factors that determine the extent in which an economy is mixed and to conduct an investment appraisal.

Information was derived from the following sources:

Journals

Textbooks

Google searches

## **LIMITATIONS**

Information was derived from secondary sources which may not be 100% accurate and/or maybe biased. The internet provided a vast amount of information which took time to sort through to get information relevant for this report.

## **THE MIXED ECONOMY APPROACH TO THE ALLOCATION OF SCARCE RESOURCES**

An economic system depicts how production, distribution and consumption of goods and services is managed in an economy[CITATION Dan95 | 2057]. The factors of production (Land, Labour, Capital and Entrepreneurship) needed for any economic system to function are limited[CITATION Dan95 | 2057]and as a result the resources must be allocated efficiently to get the optimum benefit.

Maximum economic efficiency is achieved when output is at that point on the production possibility curve which reflects the demand for agricultural produce relative to demand for manufactured goods.

Figure : Economic Problem of Scarcity[CITATION Dan95 I 2057]

[http://www.unc.edu/depts/econ/byrns\\_web/Economicae/scarcity\\_image003.](http://www.unc.edu/depts/econ/byrns_web/Economicae/scarcity_image003.jpg)

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[http://economicsconcepts.com/economic\\_problems.jpg](http://economicsconcepts.com/economic_problems.jpg)

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 below as follows:

## **FREE MARKET ECONOMY – Consumer is King**

In this economic system goods and services are allocated by market price without any intervention from the government[CITATION Dan95 I 2057].

Those who are willing and able to pay the market price for various goods and services get those goods and services[CITATION Dan95 I 2057]. The consumer is king.

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 Dan95 I 2057].

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This represents the summit of capitalism. In reality, a perfectly free market economy is a myth that only exists in the wild where humans do not intervene and where it is the case of survival of the fittest[CITATION Dan95 | 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 Dan95 | 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 Dan95 | 2057].

## **PLANNED ECONOMY – Government Knows Best**

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 by setting production targets. The emphasis is according to the needs rather than on financial ability to pay[CITATION Dan95 | 2057].

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 Dan95 | 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. The planned economy is more of a one-size fits all approach, whereas a free market is a tailored approach according to 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 as a result of inefficiency and falling mail volumes.

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 – Best of Both Worlds**

In reality there are no 100% free market or planned economies. The government will always control some resources for its own use in any economy but will find it impossible to plan everything produced in the economy[CITATION Dan95 I 2057].

The mixed economy is a hybrid of the free market economy and the planned economy. It reflects the fact that both market and government participation is required in the allocation of resources by combining the best of both worlds. It includes both capitalist[CITATION Dan95 I 2057]and socialist economic policies[CITATION Dan95 I 2057]and often arises in societies that seek to balance a wide range of political and economic views[CITATION Dan95 I 2057]. The mixed economic system is used in most countries, but the extent of the influence of the market or government varies from country to country (and also within the country). The UK with the Labour party in government as Prime Minister was more geared to social service provisions whereas David Cameron is more geared towards a higher degree of public-private partnerships.

In Nigeria prior to the return to Democracy in 1999, under the dictatorship of the military, the economy was predominantly planned with a small role for the markets. Fuel was heavily subsidised, but also rationalised, by the government and all utilities were in the hands of the government. Since 1999, the government has shifted the focus towards a free market model following the privatisation of government owned businesses and deregulation of several industries. The government however still plays a significant part in the economy.

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Britain in Victorian times operated a free market system which exploited many poor people who were forced to work long hours for very little money. Since then the system has been replaced by a mixed economy whereby the government has tried to prevent the extremes of poverty (Moynihan & Titley, 1995).

In 1917 the Russian revolution changed the Russian economic system from one where the ruling Tsars exploited a poor nation of farmers to a planned economy. Now Russia and the wider Eastern Bloc of planned economies are turning to the mixed economy. Most planned economies converted to Mixed Economies in the late 20th century. (Moynihan & Titley, 1995)Figure :

#### Historical Economic System Transitions

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 Dan95 | 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 Dan95 | 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 along 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 Dan95 | 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.

## **ECONOMIC OUTPUT (GOODS PRODUCED)**

Goods can be classed as either necessity goods[CITATION Dan95 I 2057]or desirable/consumer goods[CITATION Dan95 I 2057]. In a planned economy, a majority of goods produced are necessity goods as the government deems them necessary for the upkeep of its citizens (i. e. the government feels the scarce resources are better used for necessity goods such as food, water, shelter etc, rather than on luxury items). Totally free market tend to produce more of desirable/consumer goods as this responds to the forces of demand and supply where goods are made only if there is a demand for it.

For example, in the private sector owner-occupied houses are built according to the price people are able and willing to pay for them. In the public-sector

housing is regarded as a social obligation according and built according to the general need[CITATION Dan95 I 2057].

## **PUBLIC SECTOR V PRIVATE SECTOR SPENDING**

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 Dan95 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 Dan95 I 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 Dan95 I 2057].

## **POLITICAL STABILITY**

In times of war the economy is normally geared towards a planned economy as was done in the UK during the Second World War, where resources were used on weapons and food was rationed, to help the country win the war[CITATION Dan95 I 2057]. Post war times saw the UK economy shift towards the free market economy.

## **DEVELOPED OR DEVELOPING COUNTRY**

In developed countries markets tend to determine how most resources are allocated in the economy than in developing countries where governments tend to play a more pivotal role. Developed countries have the social and economical infrastructure[CITATION Dan95 I 2057]in place for the market to function optimally whereas in developing countries the infrastructure they have is inadequate and also suffer from issues such as overpopulation, with few resources to be shared among an ever-growing population[CITATION Dan95 I 2057], where planning is key in tackling than a free market which will let it spiral out of control.

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

## **Income and wealth disparity**

## **Fiscal policy**

## **Monetary policy**

## **Education**

## **Existence of an efficient market**

## **INVESTMENT APPRAISAL**

The machine to be considered at the forecast sales levels below are as follows[CITATION Dan95 | 2057]:

### **700 units**

At 700 units forecast sales, both machines will be rejected as they will result in a loss. The reason for this is that Widget R US (WRU) requires sales of 884 units of widgets to breakeven[CITATION Dan95 | 2057]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 needed for W4E to break-even.

Figure : Break Even Point & Point of Alternation

### **1000 units**

At the forecast sales of 1000 units, WRU will be selected as this will result in a profit as the forecasted sale has a 13% margin of safety while 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 the forecasted sale 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.

At 5000 units forecast sales, WRU will be selected as this is less than the swing point of 5414 units[CITATION Dan95 | 2057]. At this level W4E will be rejected as this is below the swing point making it less profitable than WRU.

### **7000 units**

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

### **9000 units**

W4E 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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