

Market economic system

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Read first: [The nature of the economic problem](#), [The role of markets in allocating resources](#)

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What you need to know

By the end of this topic you should be able to:

1. **Say what a market economic system is.** It is an economy where land, capital and firms belong mostly to private individuals and businesses, and where the three big choices (what to make, how to make it, and who gets it) are settled by demand and supply through prices, with the government doing very little.
2. **Weigh up its good and bad sides.** Explain the advantages and the disadvantages of leaving decisions to markets, and back them up with examples of how market systems have worked in real countries.

0455 has no Core/Extended split, so this whole note is for everyone. How prices answer the three questions is covered in the earlier note on markets and resource allocation; what governments do about the weaknesses comes in the notes on market failure and the mixed economic system. This note is about the market system as a whole: what it looks like and how well it works.

Understand it

Who decides, and who owns?

Resources are scarce, so every economy has to answer **what**, **how** and **for whom**. Economic systems differ in two things: **who owns** the land, capital and firms, and **who makes** those three decisions.

	Market economic system	Planned economic system	Mixed economic system
Owners of land, capital and firms	Private people and businesses (the private sector)	The state (the public sector)	Some private, some state
Who settles what, how and for whom	Buyers and sellers, through prices set by demand and supply	Government planners	Prices for most goods, the government for some
What drives producers	Profit	Targets handed down by the state	Profit in private firms; public service in state ones

A pure market system exists only in theory: even the most market-minded country still has courts and police paid for by taxes. So "a market economy" in an exam stem means an economy **near the market end** of the scale, where private firms make most of the output and most prices are free to move.

The parts of a market economic system

Think of the system as five parts working together.

- **Private property.** Households own the factors of production and hire them out to firms: labour for wages, land for rent, capital for interest, enterprise for profit. Firms are owned by private shareholders or sole owners, never by the state.
- **The price mechanism.** Prices carry information. When buyers want more of something, its price rises, which tells firms it has become more profitable to make; when buyers lose interest, the price falls and firms pull resources out. No official directs this.
- **Self-interest.** Owners of firms want the largest profit, households want the most satisfaction their income can buy, and workers want the best-paid jobs they can get. Each acts for themselves, and prices fit the pieces together.
- **Competition.** Many firms chase the same customers. To win sales they have to keep costs down, keep prices attractive and keep improving what they sell, which is why competition is counted as a feature of the system and not just a lucky result.
- **A small state.** The government's job shrinks to protecting property, enforcing contracts and keeping order. It does not tell firms what to make, fix prices, set wages or run businesses.

A quick test for any organisation or policy: **is it privately owned and run for profit, or does it need the state to own, pay for or order it?** If it could exist with no government decision behind it, it fits a market system; if it depends on state ownership, tax money or a government rule, it belongs to a mixed or planned economy. For example, a family-owned chain of petrol stations or a privately owned football club fits; a council-run swimming pool or a government quota on fishing catches does not.

Why markets can work well

Each advantage is a short chain: **what happens** → **why** → **who gains**.

1. **Buyers are in charge (consumer sovereignty).** A firm earns money only when people choose to spend on its product. Make something nobody wants and the firm makes losses, so it must switch or shut. Spending therefore steers production towards what people value.
2. **Resources are used efficiently.** Profit is revenue minus cost, and the owner keeps it, so every cost a firm cuts adds to the owner's income. A café selling 1,000 meals a month at \$8 each, with costs of \$6.50 a meal, makes $\$8,000 - \$6,500 = \$1,500$ profit. Cut waste so a meal costs \$6.00, and profit rises to \$2,000. That reward pushes firms to waste less.
3. **Prices tend to be lower.** Rival firms undercut each other, so a firm that charges well above its rivals loses customers.
4. **More choice and better products.** Firms try to stand out with new designs, new technology and better service, so buyers get variety and rising quality.

5. **Fast adjustment.** When tastes or costs change, prices move at once and firms react within weeks, not after a planning committee meets. Shortages and gluts tend to disappear quickly.
6. **Rewards for effort and risk.** People keep what they earn, so higher pay for scarce skills encourages training and hard work, and the chance of profit encourages people to start new businesses.
7. **Growth and selling abroad.** Efficient, inventive firms raise a country's output and can compete on price and quality in other countries' markets.
8. **Personal freedom.** People choose what to buy, where to work and what business to start. Supporters of markets often value this freedom for its own sake.

These are also the reasons governments give when they **sell state-owned firms to private buyers** (privatisation): private owners chasing profit usually run a business with lower costs than a state department did.

Why markets can let people down

1. **Some goods are never made.** A flood barrier protects every house behind it, whether or not the owner pays. No firm can charge for it, so no firm builds it. These are **public goods**.
2. **Too little of some goods.** Vaccinations and schooling help the whole of society, not just the person who pays, but each buyer only counts their own benefit and their budget, so less is bought than is best. These are **merit goods**.
3. **Too much of others.** Products such as cigarettes harm users and people around them, yet they are profitable, so the market supplies plenty. These are **demerit goods**.
4. **Costs pushed onto others.** A cement works pays for its fuel and workers, but not for the dust that falls on nearby homes. Since that cost is not in its own accounts, it produces more, and pollutes more, than society would choose. These are **external costs**.
5. **Wide gaps between rich and poor.** Goods go to whoever can pay. People with rare skills or wealth earn a lot; people who are old, sick, unskilled or out of work earn little, and nothing in the system narrows the gap. With no state benefits, poverty can be deep.
6. **Monopoly power.** A firm that buys or beats all its rivals can cut output and raise prices, and buyers lose the gains from competition.
7. **Buyers don't always know enough.** A shopper often can't judge the safety of a medicine or the true cost of a loan, so a seller may profit from that gap in knowledge.
8. **Booms, slumps and job losses.** No one coordinates the whole economy, so spending can swing up and down. When demand falls, firms lay workers off, and people who can't easily retrain or move town stay unemployed.
9. **It needs rules to work.** Markets rely on courts that protect property and enforce deals. Where the legal system is weak or corrupt, markets work badly.

Market systems in real countries

- **Hong Kong** has long been held up as one of the most market-led economies: low and simple taxes, almost no tariffs and very few controls on business. It grew into a rich trading and financial centre. Yet the government still owns most land and houses a large share of the population in public housing, so even here the system is partly mixed.
- **The USA** leaves most output to private firms and is home to many of the world's most valuable companies, a sign of the innovation and investment a market system rewards. It also has some of the widest income gaps among rich countries, and because most healthcare is paid through private insurance, families on low pay can struggle to afford it.
- **Chile** moved sharply towards markets from the mid-1970s, selling state firms, cutting tariffs and in 1981 replacing its state pension with private savings accounts. Growth was strong for long periods and poverty fell, but inequality stayed high and led to large protests in 2019.
- **Former planned economies.** Countries in Eastern Europe after 1990, and Vietnam after its reforms began in 1986, let private firms grow and let demand and supply set most prices. Output, choice and incomes generally rose, and so did the gap between rich and poor.

The pattern is the same everywhere: markets bring efficiency, growth and choice, but also inequality and too little of some goods, which is why nearly every government steps in to some degree.

Key facts and formulas

This topic has no formula list in the exam. "Learn it" means you must remember it.

Fact	Status
Market economic system: resources mainly privately owned; what, how and for whom settled by the price mechanism (demand and supply), with little or no government intervention	Learn it
Planned economic system: state owns resources and planners decide; mixed economic system: private and public sectors both allocate resources	Learn it
Features of a market economic system: private ownership, price mechanism, profit motive, competition, consumer sovereignty, a small role for the state	Learn it
Profit = total revenue – total cost; in a market system firms move resources to where expected profit is highest	Learn it
Advantages of a market economic system: consumer sovereignty, efficiency, lower prices, choice and quality, fast adjustment, incentives to work and take risks, growth, freedom	Learn it
Disadvantages of a market economic system: public goods not made, merit goods under-consumed, demerit goods over-consumed, external costs ignored, inequality and poverty, monopoly, poor information, instability and unemployment	Learn it
Anything that needs the state to own, fund or order it is government intervention, so it is not a feature of a market economic system	Learn it

How to do it

We have tagged 22 questions on this topic (2021–2026). Each has exactly one part on this topic: the 20-mark Paper 2 questions spend their other parts on other topics.

Question type	Question parts
Multiple choice (concept)	17
Discuss (8 marks)	4
Explain (4 marks)	1

No Define (2), Identify (2) or Analyse (6) part on this topic has been set yet. A Define part wants the two halves of the definition: private ownership (1) and allocation by the price mechanism (1). An Analyse part would want two or three of the chains in "Understand it", each taken through to a result.

1. Multiple choice (concept) (17 question parts)

1. **Find what the stem wants:** a feature, an advantage or a disadvantage. Look for **not** in bold, which flips the task.
2. **Run each option through the two tests:** is it about private ownership and decisions made by prices? Does it need the government to act? An option that needs the state belongs to a mixed or planned economy.
3. **Check the wording is true for a market system**, not just pleasant-sounding (see the warning on absolute words below).
4. Pick the one option that survives.

Variations you will meet:

- **Features (8 parts).** Some ask what the system looks like, some ask who owns what and how resources are shared out (sometimes as a grid of yes/no or ownership/allocation columns), and some ask what could or could not happen. Use the two tests. Fill a grid column by column: ownership must be private, allocation must be by prices, and state ownership or state allocation must both be "no". An answer describing private and state sectors sharing the work is the mixed economy, not the market one. In a "could **not** happen" question, apply the same two tests and remember that the system's weaknesses (see "Why markets can let people down") **can** happen in it, so an option describing a weakness, such as people buying too few vaccinations, is not the impossible one. For example, "a bus firm adds evening routes after ticket sales rise" passes both tests, while "a ministry decides how many buses each town receives" fails.
- **Advantages (6 parts).** The right option is a real strength from "Why markets can work well": buyers steering production, efficiency and lower costs, prices passing on information, fast adjustment, incentives, or freedom. Some stems ask why a government would move towards a market system, or what a supporter of markets believes; the answer is still one of those strengths. Two traps:
 - **Absolute words.** "Always", "never", "every", "guarantees" and "ensures" rarely fit. A market system does not promise that every worker finds a job or that prices never rise; it just tends to push in a good direction.

- **A true statement that is not a strength.** An option naming one of the weaknesses of markets may be accurate, but it cannot be the advantage.
- **Disadvantages (3 parts).** The right option is a weakness from "Why markets can let people down", for example fewer people being vaccinated than is best for society. Wrong options fall into three kinds: a strength of markets in disguise, a claim that is simply false for a market system, or an action that only a government could take. Check each wrong-looking option against the two tests before ruling it out.

2. Discuss (8 marks) (4 question parts)

Discuss is marked by levels. **Level 3 (6–8)** needs **both sides developed** and some evaluation; one side can be deeper than the other. A one-sided answer, or two thin sides, stays in **Level 2 (3–5)**. A list of points with little explanation is **Level 1 (1–2)**. Aim for **two or three developed points on each side**, then a judgement.

1. **Open with the definition**, which shows you know the system has little government in it.
2. **One side:** two or three points, each a chain: point → reason → result for the economy or for people.
3. **The other side:** two or three points, developed the same way.
4. **Judge:** say which side is stronger **and what it depends on** (how much competition there is, whether there is a working legal system, how equal incomes are to start with, how good the government is).

The four parts set so far fall into three groups. The points below are in our words; build each into a chain.

- **Does the market system benefit an economy, or share out resources in the best way? (2 parts)**
 - **Yes:** spending tells firms what to make, and profit rewards them for doing it, so output follows what people want; competition squeezes costs and prices; differences in pay draw workers towards jobs where they are most needed and reward effort; efficient firms raise growth and win sales abroad.
 - **No:** public goods are left out; merit goods are under-made and demerit goods over-made; firms ignore pollution and other external costs; a monopoly can hold back output to raise its price; workers who cannot move between jobs or places are left unemployed; without courts that protect property, markets do not work smoothly.
- **Is high poverty likely in a market system? (1 part)**
 - *Likely:* when spending falls, firms cut jobs and there is no state benefit to fall back on; incomes follow what people own and their skills, so gaps widen; poorer families buy too little healthcare and schooling, which keeps their children's earnings low; a monopoly can push up prices of essentials.
 - *Not likely:* competition keeps prices of everyday goods low, stretching low incomes further; efficient, growing firms create jobs and bid up wages; fast-growing market economies have pulled many people out of hunger. Make the key distinction: a market country may still have **relative poverty** (some people far below the typical income) while having very little **absolute poverty** (people unable to buy food, water and shelter).
- **Can government action fix the weaknesses of a market system? (1 part)**
 - **Yes:** the state can supply public goods from taxes; make merit goods free or cheaper and tax or ban harmful products; stop monopolies forming or control their prices; tax or limit pollution; give benefits and services to people on low incomes; set a minimum wage or a maximum price.

- **No: government failure:** officials may not have the information to get the size of a tax or subsidy right; decisions can be slow; high taxes can blunt the incentives that make markets work; money can be lost to corruption; a policy can create new problems (a price ceiling can cause shortages).

3. Explain (4 marks) (1 question part)

Marked **point plus explanation**: 1 mark for naming each point and 1 for explaining it, so **two developed points** earn all 4.

1. Name the advantage or disadvantage in a few words (1).
2. Say why a **market** system produces it, through prices, profit or competition (1).

Keep every point about the market system: examiners saw answers lose marks by describing what a government would add, which is the mixed economy. See Example 2 for a full answer.

Worked examples

Example 1

In a country with a market economic system, more people start working from home and fewer travel to offices each day. Which change is most likely to follow, without any government action?

- **A** A state agency transfers office cleaners to jobs in home delivery.
- **B** Prices of office rents fall, and some owners convert offices into flats.
- **C** The government nationalises the largest office-building company.
- **D** Planners set a lower legal maximum rent for office space.

[1]

B (1). Demand for office space falls, so its price (rent) falls; owners can earn more profit from homes, so resources move there by themselves. A and D need planners or the government; C moves a firm into the public sector.

Example 2

Explain two ways a market economic system encourages firms to keep their costs of production low. [4]

The profit motive (1). Profit is what is left from revenue after costs, and in a market system the owner keeps it, so every dollar of waste a firm removes becomes extra income for its owner (1).

Competition between firms (1). Rivals that produce more cheaply can charge lower prices, so a firm with high costs loses customers and makes losses, and it must cut costs to survive (1).

Example 3

Marisol is a small island with a largely market economic system. Most of its income comes from private hotels and tour boat firms. Discuss whether or not a market economic system will protect Marisol's natural environment. [8]

A market economic system is one where resources are owned privately and decisions about what to produce are made by demand and supply, with little government intervention.

Why it might protect the environment. Tourists pay to visit clean beaches and healthy reefs, so a damaged coastline would cut the demand for hotel rooms and boat trips; firms whose profits depend on the scenery have a reason to look after it. Hotels that market themselves as eco-friendly can charge more if visitors value this, so the price mechanism rewards greener firms. Competition also pushes firms to cut waste, and using less fuel and water lowers their costs as well as the harm they do. (*One side, three developed points.*)

Why it might not. Pollution from hotel sewage or boat fuel is an external cost: each firm does not pay for the damage, so it has little reason to limit it, and the clean sea is a shared resource no single firm owns. Each firm may expect others to keep the beach clean while it cuts its own costs, so the reef can be damaged even if all firms would gain from protecting it. Firms aim at profit this season, so they may build more hotels on the coast than the island can sustain. With little government, there may be no rules on waste or building at all. (*Other side, developed with reasons.*)

Judgement. The market will protect parts of the environment that firms can sell to tourists, such as a hotel's own beach, but it is unlikely to protect shared resources like the reef or the water, where damage costs no single firm anything. How well Marisol's environment is protected depends on how much visitors are willing to pay for an unspoiled island and on whether property rights or some basic rules exist. On balance a pure market system is unlikely to be enough on its own.

Both sides are developed and the judgement says what the answer depends on: a Level 3 answer (6–8).

Common mistakes

- **Writing about a mixed or planned economy.** Examiners report every few years that candidates asked about a market system wrote about taxes, state-provided public goods or government rules. Those belong to the mixed economy. In a "benefits of a market system" answer, government action can appear only as what is **missing**.
- **Confusing a market economic system with a competitive market.** A market economic system is a whole economy; a competitive market is one industry with many firms. Answer the one the question names.
- **One strong side, one weak side.** Many Discuss answers were detailed on one side and limited on the other, which caps them in Level 2. Plan both sides before writing.
- **Listing instead of explaining.** "Efficiency, low prices, choice" earns little. Give the reason each time: lower prices **because** firms compete, efficiency **because** owners keep the profit.

- **Falling for absolute wording in multiple choice.** Examiners noted many candidates choosing options that promise a perfect outcome. Markets push in a direction; they do not guarantee results.
- **Thinking market systems are free of pollution or monopoly.** Both are weaknesses of the system, so they can certainly happen in it.
- **A conclusion that only repeats.** "There are advantages and disadvantages" is not a judgement. Say which side wins and what it depends on.

How to get the marks

- **Multiple choice** is 1 mark with no penalty for a wrong answer, so answer every one. Read for **not** in bold.
- **Define** (2 marks) needs both halves: private ownership (1) and allocation by the price mechanism / demand and supply (1).
- **Explain** (4 marks) means name two points (1 each) and say why each happens (1 each). If you write more than two, examiners usually mark only the first few, so put your best two first.
- **Discuss** (8 marks) is levels-marked: the top level needs both sides developed and a judgement that weighs them. Depth on one side is fine as long as the other side is clearly there.
- **Use the terms:** private sector, price mechanism, profit motive, competition, consumer sovereignty, efficiency, public goods, merit goods, demerit goods, external costs, monopoly, inequality, government failure.
- **Use the country in the stem** where it helps (its size, its main industries, its income level), but keep each sentence about the economics.
- **Label parts clearly**, (a) to (d), so the examiner can find each answer.

Quick check

1. Leila runs a bakery in a market economic system. The price of flour doubles. Who decides whether her bread goes up in price?
 - **A** a national price board that sets bread prices
 - **B** Leila, judging what customers will pay and what rival bakers charge
 - **C** the trade union representing bakery workers
 - **D** central planners who allocate flour to bakeries
2. A market economic system has only private, fee-charging clinics. Which outcome is most likely?
 - **A** Clinics have no reason to shorten waiting times.
 - **B** Fees are set below the cost of treatment.
 - **C** People on low incomes visit doctors less often than is good for society.
 - **D** Too many doctors are trained for the jobs available.
3. Which change would move an economy closer to a market economic system?
 - **A** The state buys the country's largest airline.
 - **B** Rent controls end, so landlords set rents by demand and supply.

- **C** A new tax is placed on sugary drinks.
- **D** The legal minimum wage is raised.

4. Define market economic system. **[2]**

5. Explain two reasons why income inequality may widen over time in a market economic system. **[4]**

Answers

1. **B** (1). Prices are set by private sellers responding to demand and competition. A and D need the state; a union bargains over wages, not bread prices.
2. **C** (1). Healthcare is a merit good: people on low incomes buy less of it than is best for society. A is wrong because competing clinics want customers; B is wrong because private firms won't sell below cost for long; D has no link to the market system.
3. **B** (1). Removing a price control lets demand and supply allocate housing. A moves a firm into the public sector; C and D are government intervention.
4. An economic system where resources are owned mainly by private individuals and firms (1), and decisions about what, how and for whom to produce are made by the price mechanism, through demand and supply (1).
5. Rewards depend on what people own (1): those with wealth earn interest, rent and profit on it and can save and invest more, so their income grows faster than that of people with nothing to invest (1). No state support for those out of work (1): in a market system there are few benefits, so people who lose jobs or cannot work fall further behind, and their children may miss out on education that raises future pay (1).

Past questions to try

- [0455/11/O/N/25 Q8](#): which organisations belong in a market economy.
- [0455/12/F/M/24 Q7](#): what a country gains by moving from a mixed to a market economy.
- [0455/11/O/N/23 Q8](#): spotting a disadvantage of a market economy.
- [0455/22/M/J/23 Q2](#): part (d), whether a market economy allocates resources in the best possible way.