**Market Economy and Role of the Government in it**

In this Chapter we will discuss about the market economy and role of the government in a market economy.

**What is a Market Economy?**

A market economy is a system where the laws of [supply](https://www.thebalance.com/aggregate-supply-what-it-is-how-it-works-3306216) and [demand](https://www.thebalance.com/what-is-demand-definition-explanation-effect-3305708) direct the production of goods and services.

Businesses sell their products at the highest price consumers will pay. At the same time, shoppers look for the lowest prices for the goods and services they want. Workers bid their services at the highest possible wages that their skills allow. Employers seek to get the best employees at the lowest possible price.

[Capitalism](https://www.thebalance.com/capitalism-characteristics-examples-pros-cons-3305588) requires a market economy to set prices and distribute goods and services. [Socialism](https://www.thebalance.com/socialism-types-pros-cons-examples-3305592) and [communism](https://www.thebalance.com/communism-characteristics-pros-cons-examples-3305589) need a [command](https://www.thebalance.com/command-economy-characteristics-pros-cons-and-examples-3305585) economy to create a central plan that guides economic decisions. Market economies evolve from [traditional](https://www.thebalance.com/traditional-economy-definition-examples-pros-cons-3305587) economies. Most societies in the modern world have elements of all three types of economies. That makes them [mixed economies](https://www.thebalance.com/mixed-economy-definition-pros-cons-examples-3305594).

### Key Points

* A market economy functions under the laws of supply and demand.
* It is characterized by private ownership, freedom of choice, self-interest, optimized buying and selling platforms, competition, and limited government intervention.
* Competition drives the market economy, optimizing efficiency and innovation.
* Market economies marginalize those that are unable to compete, contributing to income inequality.

## Six Characteristics of a Market Economy

The following six characteristics define a market economy.

1. **Private Property**. Most goods and services are privately-owned. The owners can make legally-binding contracts to buy, sell, or lease their property. Their assets give them the right to [profit](https://www.thebalance.com/what-is-profit-and-how-does-it-work-3305878) from ownership. There are some assets U.S. law excludes. Since 1865, you cannot legally buy and sell human beings.﻿ Federal law prohibits the sale and purchase of human organs in interstate commerce.
2. **Freedom of Choice**. Owners are free to produce, sell, and purchase goods and services in a competitive market. They only have two constraints. First is the price at which they are willing to buy or sell. Second is the amount of [capital](https://www.thebalance.com/what-is-financial-capital-3305825) they have.
3. **Motive of Self-Interest**. Everyone sells their wares to the highest bidder while negotiating the lowest price for their purchases. Although the reason is selfish, it benefits the economy over the long run. This auction system sets prices for goods and services that reflect their market value. It gives an accurate picture of supply and demand at any given moment.
4. **Competition**. The force of competitive pressure keeps prices low. It also ensures that society provides goods and services most efficiently. As soon as demand increases for a particular item, prices rise thanks to the [law of demand](https://www.thebalance.com/law-of-demand-definition-explained-examples-3305707). Competitors see they can enhance their profit by producing it, adding to supply. That lowers prices to a level where only the [best competitors](https://www.thebalancesmb.com/what-s-your-competitive-edge-2890082) remain. This competitive pressure also applies to workers and consumers. Employees vie with each other for the highest-paying jobs. Buyers compete for the best product at the lowest price. There are [three strategies that work to maintain a competitive advantage](https://www.thebalance.com/what-is-competitive-advantage-3-strategies-that-work-3305828).
5. **System of Markets and Prices**. A market economy relies on an [efficient market](https://www.thebalance.com/the-efficient-market-hypothesis-in-simple-terms-2388640) in which to sell goods and services. That's where all buyers and sellers have equal access to the same information. Price changes are pure reflections of the laws of supply and demand. There are [five determinants of demand](https://www.thebalance.com/five-determinants-of-demand-with-examples-and-formula-3305706).
6. **Limited Government**. The role of government is to ensure that the markets are open and working. For example, it is in charge of [national defense](https://www.thebalance.com/u-s-military-budget-components-challenges-growth-3306320) to protect the markets. It also makes sure that everyone has equal access to the markets. The government penalizes [monopolies](https://www.thebalance.com/monopoly-4-reasons-it-s-bad-and-its-history-3305945) that restrict competition. It makes sure no one is manipulating the markets and that everyone has equal access to information.

## Four Advantages of a Market Economy

1. Since a market economy allows the free interplay of supply and demand, it ensures that the most desired goods and services are produced. Consumers are willing to pay the highest price for the things they want the most. Businesses will only create those things that return a profit.
2. Second, goods and services are produced in the most efficient way possible. The most [productive](https://www.thebalance.com/u-s-productivity-what-is-it-how-to-calculate-it-3306227) companies will earn more than less productive ones.
3. Third, it rewards innovation. Creative new products will meet the needs of consumers in better ways that existing goods and services. These cutting-edge technologies will spread to other competitors so they, too, can be more profitable. This illustrates why [Silicon Valley](https://www.thebalance.com/what-is-silicon-valley-3305808) is America's innovative advantage.
4. Fourth, the most successful businesses invest in other top-notch companies. That gives them a leg up and leads to increased quality of production.

## The Disadvantages of a Market Economy

1. The key mechanism of a market economy is competition. As a result, it has no system to care for those who are at an inherent competitive disadvantage. That includes the elderly, children, and people with mental or physical disabilities.
2. Second, the caretakers of those people are at a disadvantage. Their energies and skills go toward caretaking, not competing. Many of these people might become contributors to the economy's overall comparative advantage if they weren't caretakers.
3. That leads to the third disadvantage. The human resources of society may not be optimized. For example, a child who might otherwise discover the cure for cancer might instead work at McDonald's to support her low-income family.
4. Fourth, society reflects the values of the winners in the market economy. A market economy may produce private jets for some while others starve and are homeless. A society based on a pure market economy must decide whether it's in its larger self-interest to care for the vulnerable.

**Role of Government in Market Economy**

The classical economists like Adam Smith, J.S. Say and other advocated the doctrine of laissez faire which means non-intervention of the government in economic matters. Adam Smith introduced the concept of the invisible hand, which refers to the free functioning of the price (market) system in the absence of government intervention.

And, in the 19th century, the western capitalist economics achieved spectacular growth by following the policy of laissez faire. As Paul Samuelson has put it, **“An ideal market economy is one where all goods and services are voluntarily exchanged for money at market prices. Such a system squeezes the maximum benefits out a society’s available resources without government intervention”.**

The doctrine of laissez faire, which means ‘leave us alone’ held that government should interfere as little as possible in economic affairs and leave economic decisions to the interplay of supply and demand in the market place. However, the great depression of 1929 (which lasted for 4 years) shattered the economies of U.S.A. and other western industrialized countries and forced them to partially abandon the doctrine of laissez faire.

And, in 1936, J.M. Keynes suggested in his revolutionary book: The General Theory that the visible hand of the government should replace, at least partly, the invisible hand of the market. Following Keynesian prescrip­tions governments in most countries took on a steadily expanding economic role, regulating monopolies, collecting income taxes and providing social security in the form of unemployment compensation or pension for the old people.

To quote Samuelson again, **“in the real world, no economy actually conforms totally to the idealised world of the smoothly functioning invisible hand. Rather, every market economy suffers from imperfections which lead to such ills as excessive pollution, unemployment and extremes of wealth and poverty”.**

For all these reasons, any government anywhere in the world, whether conservative or liberal, intervenes in economic affairs. In a modern economy like our own, the government has to perform various roles mainly to correct the flaws (defects) of the market mechanism. The military, policy, most schools and colleges, health centres and hospitals and highway and bridge construction are all government activities, research and space exploration require government funding.

Governments may regulate some businesses (such as banking and insurance), while subsidising others (such as agricul­ture and small-scale and cottage industries). And last, but not the least governments tax their citizens and redistribute the revenues to the poor as also the elderly (retired) people.

**Four Main Functions of Government in a Market Economy:**

However, according to Samuelson and other modern economists, govern­ments have four main functions in a market economy — to increase effi­ciency, to provide infrastructure, to promote equity, and to foster macroeconomic stability and growth.

**1. Efficiency:**

First, the government should attempt to correct market failures like monopoly and excessive pollution to ensure efficient function­ing of the economic system. Externalities (or social costs) occur when firms or people impose costs or benefits on others outside the marketplace.

**2. Infrastructure:**

Secondly, the government should provide an inte­grated infrastructure. Infrastructure (or social overhead capital) refers to those activities that enhance, directly or indirectly, output levels or effi­ciency in production.

Essential elements are systems of transportation, power generation, communication and banking, educational and health facilities, and a well-ordered government and political structure. Since the cost of providing these essential services are very high and benefits accrue to numerous diverse groups, such activities are to be financed by the government.

**3. Equity:**

Markets do not necessarily produce a distribution of income that is regarded as socially fair or equitable. As market economy may produce unacceptably high levels of inequality of income and weather. Government programmes to promote equity use taxes and spending to redistribute income toward particular groups.

**4. Economic Growth or Stability:**

Fourthly, governments rely upon taxes, expenditures and monetary regulation to foster macroeconomic growth and stability to reduce unemployment and inflation while encouraging eco­nomic growth.

Macroeconomic policies for stabilisation and economic growth includes fiscal policies (of taxing and spending) along with monetary policies (which affect interest rates and credit conditions). Since the development of macro­economics in the 1930s governments have succeeded in bringing inflation and unemployment under control.

Table 1 presents a framework for classifying the functions of government along a continuum, from activities that will not be undertaken at all without state intervention to activities in which the state plays an activist role in coordinating markets or redistribution assets.

****

Countries with low state capability need to focus first on basic functions: the provision of pure public goods such as property rights, macroeconomic stability, control of infectious diseases, safe water, roads and protection of the destitute. Recent reforms have emphasised economic fundamentals. But social and institutional (including legal) fundamentals are equally impor­tant to avoid social disruption and ensure sustained development.

Going beyond these basic services are the intermediate functions, such as management of externalities (pollution, for example), regulation of mo­nopolies, and the provision of social insurance (pensions, unemployment benefits).

States with strong capability can take on more-activities functions, deal­ing with the problem of missing markets by helping coordination.

Matching role to capability involves not only what the state does but also how it does it. Rethinking the state also means exploring alternative instru­ments, existing or new, that can enhance state effectiveness.

**For example:**

In most modern economies the state’s regulatory role is now broader and more complex than ever before, covering such areas as the environment and the financial sector, as well as more traditional areas such as monopolies.

Although the state still has a central role in ensuring the provision of basic services — education, health, infrastructure — it is not obvious that the state must be the only provider, or a provider at all.

In protecting the vulnerable, countries need to distinguish more clearly between insurance and assistance. Insurance, against cyclical unemploy­ment for example, aims to help smooth households’ income and consump­tion through a market economy’s inevitable ups and downs. Assistance, such as food-for-work programs or bread subsidies, seeks to provide some minimum level of support to the poorest in society.