

# Chapter 6: Prices Section 3

Prentice Hall

# ECONOMICS

PEARSON

In Partnership With  
THE WALL STREET JOURNAL  
CLASSROOM EDITION

# Objectives

1. **Identify** the many roles that prices play in a free market.
2. **List** the advantages of a price-based system.
3. **Explain** how a price-based system leads to a wider choice of goods and more efficient allocation of resources.
4. **Describe** the relationship between prices and the profit incentive.



# Key Terms

- **supply shock:** a sudden shortage of a good
- **rationing:** a system of allocating scarce goods and services using criteria other than price
- **black market:** a market in which goods are sold illegally, without regard for government controls on price quantity



# Introduction

- What roles do prices play in a free market economy?
  - In a free market economy, prices are used to distribute goods and resources throughout the economy.
  - Prices play other roles, including:
    - Serving as a language for buyers and sellers
    - Serving as an incentive for producers
    - Serving as a signal of economic conditions



# Price as an Incentive

- Prices provide a standard of measure of value throughout the world.
  - Prices act as a signal that tells producers and consumers how to adjust.
  - Prices tell buyers and sellers whether goods are in short supply or readily available.
  - The price system is flexible and free, and it allows for a wide diversity of goods and services.



# Prices as a Signal

- Prices can act as a signal to both producers and consumers:
  - A high price tells producers that a product is in demand and they should make more.
  - A low price indicates to producers that a good is being overproduced.
  - A high price tells consumers to think about their purchases more carefully.
  - A low price indicates to consumers to buy more of the product.



# Flexibility of Prices

- Prices are flexible, which means they can be increased to solve problems of shortage and decreased to solve problems of surplus.
- Raising prices is one of the quickest ways to solve a shortage. It reduces quantity demanded and only people who have enough money will be able to pay the higher prices. This will cause the market to settle at a new equilibrium.



# Free Market v. Command

- Free market systems based on prices cost nothing to administer.
- Central planning, on the other hand, requires a number of people to decide how resources are distributed, such as in the former Soviet Union.
- Unlike central planning, free market pricing is based on decisions made by consumers and suppliers.





# Consumer Choices

- In a free market economy, prices help consumers choose among similar products and allow producers to target their customers with the products the customers want most.
- In a command economy, production is restricted to a few varieties of each product. As a result, there are fewer consumer choices.



# Rationing & the Black Market

- In a command economy, or in a free market economy during wartime, shortages are common.
- One response to shortages is rationing.
  - Since the government cannot track all of the goods passing through the economy, people sometimes conduct business on the illegal black market in order to bypass rationing.



# Rationing During WWII

- During World War II, the federal government used rationing to control shortages.
  - Each family was given tickets for such items as butter, sugar, or shoes. If you used up your allotment, you could not legally buy these items again until new tickets were issued.



## HOW TO SHOP WITH WAR RATION BOOK TWO

... to Buy Canned, Bottled and Frozen Fruits and Vegetables; Dried Fruits, Juices and all Canned Soups

- 1. USE THIS RATION BOOK.** You may use one or all of your family's ration books when you shop. You may not shop with lower ration stamps.
- 2. USE BLUE STAMPS ONLY.** All blue point stamps marked A, B, and C are good during the first ration period. They add up to 48 points for each member of the family.
- 3. THE NUMBERS SHOW POINTS.** You will not be able to get "change" in point stamps, so save your low-color stamps for buying low-point foods.
- 4. LOOK AT THE POINT VALUES before you buy.** Points have nothing to do with prices or quality. Point values will be the same in all stores.
- 5. GIVE THE STAMPS TO YOUR GROCER.** Turn out stamps in the presence of your grocer—or test them out in the presence of the delivery boy.
- 6. FRESH FRUITS AND VEGETABLES are not rationed.** Use them instead of rationed foods whenever possible. Try out recipes that make your rations go further.

**YOUR POINT ALLOWANCE MUST LAST FOR THE FULL RATION PERIOD**  
**Plan How Many Points You Will Use Each Time Before You Shop**

**BUY EARLY IN THE WEEK** Foods are going to our fighting men. They come first! Your ration gives you your fair share of the foods that are left.

**BUY EARLY IN THE DAY**



# Efficient Resource Allocation

- The free market system allows for efficient resource allocation, which means that the factors of production will be used for their most valuable purposes.
- Efficient resource allocation works with the profit incentive. Producers will use the resources available to them to ensure the greatest amount of profit.

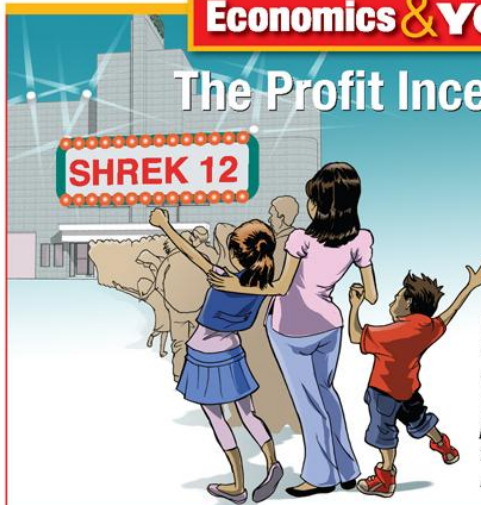


# The Profit Incentive

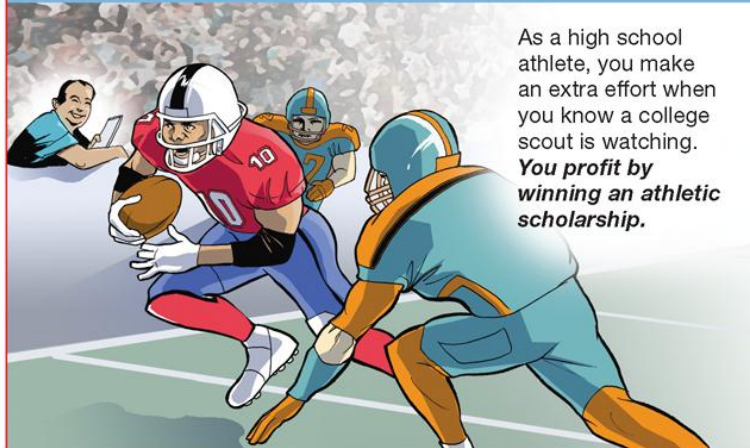
- In *The Wealth of Nations*, Adam Smith wrote that businesses do best when they provide what people need.
- Financial rewards motivate people. **How have you provided or benefited from the profit incentive?**

**Economics & YOU**

## The Profit Incentive



Movie producers are quick to create sequels of highly profitable films. **Your ticket purchase provides an incentive for the producer to make a sequel.**



As a high school athlete, you make an extra effort when you know a college scout is watching. **You profit by winning an athletic scholarship.**



# Market Problems

- Checkpoint: Under what circumstances may the free market system fail to allocate resources efficiently?
  - Imperfect Competition
    - Can affect prices, which in turn affect consumer decisions
  - Negative Externalities
    - Side effects of production, which include unintended costs
  - Imperfect Information
    - Prevents a market from operating smoothly



# Review

- Now that you have learned what roles prices play in a free market economy, go back and answer the Chapter Essential Question.
  - What is the right price?

