What is a free market economy?

By Mike Moffatt, ThoughtCo. on 09.05.19
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Paying money for goods, including food items, is an example of economic exchange. Photo courtesy: Pxhere, in the Public Domain

At its most basic, a free market economy is one that is governed strictly by the forces of supply and demand with no governmental influence. In practice, however, nearly all legal market economies must contend with some form of regulation.

Definition

Economists describe a market economy as one where goods and services are exchanged at will and by mutual agreement. Buying vegetables for a set price from a grower at a farm stand is one example of economic exchange. Paying someone an hourly wage to run errands for you is another example of an exchange.

A pure market economy has no barriers to economic exchange: you can sell anything to anyone else for any price. In reality, this form of economics is rare. Sales taxes, tariffs on imports and

exports and legal prohibitions —such as the age restriction on liquor consumption — are all impediments to a truly free market exchange.

In general, capitalist economies, which most democracies like the United States adhere to, are the freest because ownership is in the hands of individuals rather than the state. Socialist economies, where the government may own some but not all the means of production (such as the nation's freight and passenger rail lines), can also be considered market economies as long as market consumption is not heavily regulated. Communist governments, which control the means of production, are not considered market economies because the government dictates supply and demand.

Characteristics

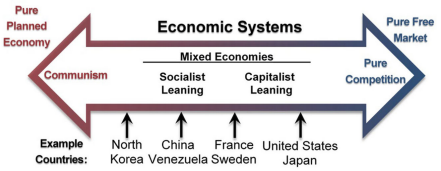


Image 1. This diagram shows a scale of economic systems from pure planned economies to pure free market economies. Includes example countries. Photo by: Brian Craig/Wikimedia

A market economy has several key qualities.

— ***Private ownership of resources.*** *Individuals, not the government, own or control the means of production, distribution and exchange of goods, as well as the labor supply.*

— ***Thriving financial markets.*** *Commerce requires capital. Financial institutions, such as banks and brokerages, exist in order to supply individuals with the means to acquire goods and services. These markets profit by charging interest or fees on transactions.*

— ***Freedom to participate.*** *Production and consumption of goods and services is voluntary. Individuals are free to acquire, consume or produce as much or as little as their own needs require.*

Pros And Cons

There's a reason why most of the world's most advanced nations adhere to a market-based economy. Despite their many flaws, these markets function better than other economic models. Here are some characteristic advantages and drawbacks:

— ***Competition leads to innovation.*** *As producers work to satisfy consumer demand, they also look for ways to gain an advantage over their competitors. This can occur by making the production process more efficient, such as robots on an assembly line that relieve workers of the most monotonous or dangerous tasks. It can also occur when a new technical innovation leads to new markets, much as when the television radically transformed how people consumed entertainment.*

— ***Profit is encouraged.*** *Companies that excel in a sector will profit as their share of the market expands. Some of those profits benefit individuals or investors, while other capital is channeled back into the business to seed future growth. As markets expand, producers, consumers and workers all benefit.*

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*— **Bigger is often better.** In economies of scale, large companies with easy access to large pools of capital and labor often enjoy an advantage over small producers that don't have the resources to compete. This condition can result in a producer driving rivals out of business by undercutting them on price or by controlling the supply of scarce resources, resulting in a market monopoly.*

*— **There are no guarantees.** Unless a government chooses to intervene through market regulations or social welfare programs, its citizens have no promise of financial success in a market economy. Such pure laissez-faire economics is uncommon, though the degree of political and public support for such governmental intervention varies from nation to nation.*

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