Functions and Importance of the Price System

The price system coordinates decentralized decisionmaking.
The price system gives signals (information) to buyers and sellers about market conditions (supply and demand).
The price system creates incentives for decisionmakers (producers, consumers, government, foreigners).

The price system answers the three basic economic questions:

1) What should be produced?
The price system creates incentives (prices, profits) for firms to produce what buyers want, and in the quantities that they want. Firms that pay attention to buyers' desires tend to be more profitable than firms which ignore buyers' desires.

2) How should each commodity be produced? (Which resources should be used to produce which commodities?)
Individual producers choose the least expensive methods of production according to input prices, which reflect the resource's scarcity and opportunity cost (value in alternative uses). Resources tend to be allocated where they are most highly valued. The price system encourages producers to use abundant resources (because they are inexpensive) and to economize on the use of scarce resources (because they have higher prices).
THE PRICE SYSTEM ALLOCATES SCARCE RESOURCES.

3) How should the output be distributed? Who gets the commodities produced?
Goods and services are distributed according to freedom of choice, limited by income. The initial distribution of resources determines resource prices and the distribution of income. Do you have many resources, and are they scarce and valuable (property, capital, highly educated and trained labor)? Do you have only a few resources that are relatively abundant, like unskilled labor? The price system rations the available supplies of goods and services among the many demanders. Who gets the goods? Whoever is willing and able to pay the price.
THE PRICE SYSTEM RATIONS SCARCE GOODS AND SERVICES.

Problems with the price system:

1. The price system fails to adequately provide for public goods and services. The government (public sector) may tax citizens and provide these commodities.
2. The price system results in a distribution of income which is very unequal. If we do not like this distribution, we can ask the government to redistribute income according to our normative desires, using taxes and transfer payments.
3. Externalities, like pollution, occur when some of the costs of production are not paid by the producer. The price system may give incorrect information and create incorrect incentives. Government may try to correct this through regulation, taxation, pollution fees, and other measures.
4. Some markets are not competitive (monopoly), and the proper functioning of the price system is based on competition. Government may try to correct this through regulation or antitrust (breaking up monopolies).