The Role of Private Organizations. It is an interesting feature of market economies that many economic interactions between people take place in organizations—firms, families, charitable organizations—rather than in markets. Some economic interactions that take place in an organization also take place in a market. For example, many large firms employ lawyers as part of their permanent staff. Other firms simply purchase the services of such lawyers in the market; if the firm wants to sue someone or is being sued by someone, it hires an outside lawyer to represent it.

Economic interactions in firms differ from those in the market. Staff lawyers inside large firms are usually paid annual salaries that do not depend directly on the number of hours worked or their success in the lawsuits. In contrast, outside lawyers are paid an hourly fee and a contingency fee based on the number of hours worked and how successful they are.

Incentives within an organization are as important as incentives in markets. If the lawyers on a firm's legal staff get to keep some of the damages the firm wins in a lawsuit, they will have more incentive to do a good job. Some firms even try to create marketlike competition between departments or workers in order to give more incentives.

Why do some economic interactions occur in markets and others in organizations? Ronald Coase of the University of Chicago won the Nobel Prize for showing that organizations such as firms are created to reduce market *transaction costs*, the costs of buying and selling, which include finding a buyer or a seller and reaching agreement on a price. When market transaction costs are high, we see more transactions taking place within organizations. For example, a firm might have a legal staff rather than outside lawyers because searching for a good lawyer every time there is a lawsuit is too costly. In a crisis, a good lawyer may not be available.

The Price System

The previous discussion indicates that in market economies, freely determined prices are essential for determining what is produced, how, and for whom. For this reason, a market economy is said to use *the price system* to solve these problems. In this section, we show that prices do a surprising amount of work: (1) Prices serve as *signals* about what should be produced and consumed when there are changes in tastes or changes in technology, (2) prices provide *incentives* to people to alter their production or consumption, and (3) prices affect the *distribution of income*, or who gets what in the economy.

Let's use an example. Suppose that there is a sudden new trend for college students to ride bicycles more and drive cars less. How do prices help people in the economy decide what to do in response to this new trend?

Signals. First, consider how the information about the change in tastes is signaled to the producers of bicycles and cars. As students buy more bicycles, the price of bicycles rises. A higher price will signal that it is more profitable for firms to produce more bicycles. In addition, some bicycle components, like lightweight metal, will also increase in price. Increased lightweight metal prices signal that production of lightweight metal should increase. As the price of metal rises, wages for metalworkers may increase. Thus, prices are a signal all the way from the consumer to the metalworkers that more bicycles should be produced. This is what is meant by the expression "prices are a signal."

It is important to note that no single individual knows the information that is transmitted by prices. Any economy is characterized by limited information, where people cannot know the exact reasons why prices for certain goods rise or fall. Hence, it is rather amazing that prices can signal this information.