UNIT 1

MARKETS IN ACTION

Edexcel IAL Economics | Complete 20-Mark Mastery Guide

What This Document Covers

PART 1 — The Master Story: How Unit 1 Fits Together

Unit 1 is not a list of disconnected topics. It follows a single logical argument about how markets work and when they don't. Understanding this arc is what separates 14-mark answers from 20-mark answers.

1.1 The Unit 1 Argument in Six Steps

SCARCITY & CHOICE	Resources are finite, wants are unlimited. Every economic system exists to solve this problem. Opportunity cost is the foundation — every choice involves a sacrifice.
THE PRICE MECHANISM	In a free market, prices perform three functions: rationing scarce goods among competing wants, signalling producers and consumers where to direct resources, and incentivising output and consumption decisions.
DEMAND & SUPPLY SET PRICE	Consumer utility-maximising behaviour shapes demand. Profit-maximising behaviour shapes supply. PED and PES determine how sensitively each responds. Elasticity governs who bears the burden of taxes and who gains from subsidies.
MARKETS SOMETIMES FAIL	The free price mechanism produces allocatively inefficient outcomes when externalities, public goods, information failure, moral hazard, or speculation exist. Too much or too little is produced relative to the socially optimal level.
GOVERNMENT TRIES TO CORRECT FAILURE	Taxes, subsidies, price controls, regulation, permits, and state provision all attempt to move output toward the social optimum. Each policy instrument has strengths and weaknesses depending on the type of market failure.
GOVERNMENT FAILURE IS POSSIBLE	Intervention that creates a net welfare loss is government failure. The central Unit 1 debate: do the benefits of correcting market failure outweigh the risks of government failure? This is the question every 20-marker is really asking.

PART 2 — Topic Linkage Maps

Each topic in Unit 1 feeds into at least two others. These connections are exactly what examiners reward in 20-mark essays. The chains below show how topics link and why those links matter for your answers.

2.1 Scarcity, Opportunity Cost, and the PPF

These introductory concepts are the foundation for every other topic. Scarcity forces choice; opportunity cost measures what is sacrificed; the PPF makes trade-offs visual. Any move along the PPF incurs an opportunity cost — this is the basis of marginal analysis throughout the unit.

- **LINK:** Scarcity forces a mechanism for allocation. In a free market, that mechanism is price. Any question about the price mechanism traces back to scarcity.
- **LINK:** Capital vs consumer goods on the PPF illustrates the trade-off between present consumption and future growth. Relevant when evaluating supply-side policies (investing now means sacrificing consumption today).
- **LINK:** PPF with unemployed resources (inside the frontier) links to market failure: markets that underproduce due to externalities operate below potential.
- **LINK:** Specialisation and division of labour improve productive efficiency (moving toward the frontier) but create structural unemployment risk if sectors decline.

2.2 Consumer Behaviour, Demand, and Elasticity

The demand curve emerges from diminishing marginal utility — each extra unit yields less satisfaction, so consumers only buy more at lower prices. PED, YED, and XED are not standalone topics; they are multipliers that determine the size and direction of every policy effect.

- **LINK TO MARKET FAILURE:** Irrational consumer behaviour (herding, inertia, framing) leads to information failure — consumers make suboptimal choices. This justifies government information provision.
- **LINK TO POLICY:** PED determines tax incidence: the more inelastic demand is, the more of the tax consumers bear. Low PED also means taxes are less effective at reducing harmful consumption.
- **LINK TO WELFARE:** YED distinguishes normal from inferior goods — relevant in evaluating whether growth reduces or increases consumption of certain goods (e.g. inferior goods are consumed less as income rises).
- **LINK TO COMPETITION:** XED identifies substitutes and complements. High positive XED = close substitutes = more competitive market = less market power for firms. Low XED = less competitive.

2.3 Supply and Price Elasticity of Supply

The supply curve reflects cost conditions and the profit motive. PES captures how responsive output is to price changes — determined by time, spare capacity, perishability, and factor mobility.

- **LINK TO POLICY:** Indirect taxes and subsidies are supply-side interventions — they shift the supply curve. The incidence (who bears the burden) depends on the relative values of PED and PES.
- **LINK TO MARKET FAILURE:** Low PES (agriculture, housing) means prices are highly volatile when demand shifts. This is a market failure justification: price instability harms planning for producers and consumers.
- **LINK TO EVALUATION:** PES increases over time as firms can adjust capacity. Short-run interventions may have different effects than long-run ones — key evaluation point.

2.4 Price Determination and Welfare Surplus

Equilibrium is reached where Qd = Qs. Consumer surplus (CS) is the welfare consumers gain; producer surplus (PS) is the welfare firms gain. Total welfare = CS + PS. Any policy that distorts equilibrium creates a deadweight welfare loss — a triangle of lost potential surplus.

Government Policy	Welfare Effect
Indirect tax on a negative externality	CS falls, PS falls, government revenue rises — but if tax is correctly set, welfare loss from original externality is eliminated
Subsidy on a positive externality	CS rises, PS rises, government cost increases — net welfare gain if subsidy correctly sized
Maximum price below equilibrium	Short-run CS gain for those who buy — but shortage created, allocative inefficiency, potential black markets
Minimum price above equilibrium	PS rises for those who sell — but excess supply created, resources wasted

This welfare analysis framework applies to every 20-marker involving government intervention. Always ask: does the intervention increase or decrease total surplus?

2.5 Market Failure — The Six Types

Market failure is the central pivot of Unit 1. Every type links directly to a policy response, and every policy response links to a potential government failure. Learn the complete triangle: failure type -> policy response -> government failure risk.

Market Failure Type	Why Market Fails	Policy Response
Negative externality (e.g. pollution, congestion)	MSC > MPC at market output — overproduction creates welfare loss triangle	Pigouvian tax, tradeable permits, regulation, extension of property rights
Positive externality (e.g. education, vaccines)	MSB > MPB at market output — underproduction creates welfare loss triangle	Subsidy to producer or consumer, state provision, information campaigns
Public good (e.g. national defence, street lighting)	Non-rival + non-excludable: free-rider problem means private market won't provide	State provision financed by taxation
Asymmetric information (e.g. insurance, healthcare)	One party knows more than the other — adverse selection, moral hazard, suboptimal choices	Regulation, compulsory provision, information disclosure requirements
Moral hazard (e.g. banking, insurance)	Protected agents take excessive risks because costs fall on others	Regulation, monitoring, co-payment requirements, prudential capital requirements
Speculation and market bubbles (e.g. housing, stocks)	Asset prices detach from fundamentals; crash causes systemic welfare loss	Financial regulation, macroprudential policy, transaction taxes

2.6 Government Intervention and Government Failure

Government failure is not just a counterargument — it is a specific economic concept. It occurs when intervention creates a net welfare loss. The causes are predictable and should feature in every evaluation section of your 20-markers.

Five Causes of Government Failure

1. INFORMATION GAPS: Governments cannot perfectly measure external costs or benefits, so taxes/subsidies are mis-set and create new welfare distortions.
2. UNINTENDED CONSEQUENCES: Rent controls reduce supply; minimum wages can increase unemployment; subsidies can distort incentives and cause dependency.
3. REGULATORY CAPTURE: Regulators become too close to the industries they regulate and end up serving producer, not consumer, interests.
4. POLITICAL SHORT-TERMISM: Democratic governments optimise for electoral cycles (typically 4-5 years), not long-run economic efficiency.
5. ADMINISTRATIVE COSTS: Designing, implementing, monitoring, and enforcing intervention consumes resources — these costs can exceed the welfare gain from correction.

PART 3 — Generic Chains of Analysis for 20-Markers

A chain of analysis earns AO3 marks. It must be multi-step, each step causing the next, leading to a welfare conclusion. Learn these five chains — they cover the vast majority of Unit 1 essay questions. Adapt the context, keep the logic.

Chain A — Negative Externality, Welfare Loss, and Correction

CHAIN: Negative Externality

1. Production or consumption creates external costs borne by third parties → 2. MSC > MPC at every output level → 3. Profit-maximising firms produce where MPC = MPB (private optimum), not where MSC = MSB (social optimum) → 4. Market overproduces relative to the social optimum → 5. Welfare loss triangle arises between Q-market and Q-social optimum → 6. Government imposes a Pigouvian tax equal to MEC → 7. Supply curve shifts vertically upward by the tax amount → 8. New equilibrium is closer to social optimum: welfare loss reduced or eliminated

Evaluation Points for Chain A

MEC is very difficult to measure in practice — tax will almost certainly be mis-set, creating a new (smaller) welfare distortion

If PED is price inelastic, tax is a poor behaviour-change tool — revenue rises but quantity barely falls (cigarettes, petrol)

Indirect taxes are regressive — a higher proportion of income falls on low earners, worsening inequality

Carbon leakage: firms may relocate to untaxed jurisdictions — global externality simply moves rather than being eliminated

Alternative: tradeable pollution permits create a market price for pollution and may achieve the same output reduction at lower overall cost

Chain B — Positive Externality, Underproduction, and Subsidy

CHAIN: Positive Externality

1. Consumption or production generates external benefits enjoyed by third parties not party to the transaction → 2. MSB > MPB at every output level → 3. Utility-maximising consumers consume where MPB = MPC (private optimum) → 4. Market underproduces/underconsumes relative to social optimum → 5. Welfare loss triangle arises — potential gains from greater consumption are not realised → 6. Government provides a subsidy equal to MEB to producer or consumer → 7. Supply shifts right (producer subsidy) or demand shifts right (consumer subsidy) → 8. Output rises toward social optimum, welfare loss partially or fully recovered

Evaluation Points for Chain B

Marginal external benefit is inherently difficult to quantify — subsidy may be over or undersized

Opportunity cost: subsidy spending requires taxation or borrowing — displaces other spending

State provision (rather than subsidy) may be needed when private markets completely fail to provide — e.g. vaccines with very high non-excludability

Over time, subsidies can distort incentives, prevent structural adjustment, and create dependency

If the good has irrational consumers (behavioural failures), subsidising price may be insufficient — compulsory provision may be needed

Chain C — Information Failure, Misallocation, and Policy

CHAIN: Information Failure

1. Consumers (or producers) lack information to make optimal decisions — asymmetric information or information gaps → 2. Rational utility-maximising behaviour leads to suboptimal choices given incorrect beliefs → 3. e.g. consumers underestimate future health risks of a harmful product → 4. Demand is higher than socially optimal — overconsumption and welfare loss → 5. Government provides accurate information via public health campaigns or labelling requirements → 6. Consumers now make better-informed decisions — demand shifts toward optimal level → 7. Welfare loss reduced

Evaluation Points for Chain C

Behavioural economics: even with full information, people exhibit present bias, inertia, and social norms — information alone may not change behaviour

Cost of campaigns can be high relative to behaviour change achieved — question of value for money

Structural information asymmetries (e.g. doctor vs patient) cannot be eliminated by information provision alone — regulation may be needed

Risk of nanny-state criticism: individuals may argue they have the right to make their own choices

Stronger nudge interventions (opt-out pension schemes, default healthy menus) may be more effective while preserving freedom of choice

Chain D — Public Good, Free-Rider Problem, and State Provision

CHAIN: Public Good

1. Good is non-rival (one person's consumption does not reduce availability) and non-excludable (no one can be prevented from consuming it) → 2. Private firms cannot charge a market price — anyone can free-ride on others' payment → 3. No profit motive exists for private provision → 4. Market completely fails to provide the good — or drastically underprovides → 5. Government provides the good financed by general taxation — compulsory contribution solves the free-rider problem → 6. Socially optimal level of provision achieved in principle

Evaluation Points for Chain D

Government must estimate the socially optimal level of provision — inherently difficult without a market price signal

State provision without competition risks X-inefficiency and productive inefficiency

Some goods are quasi-public (roads become rival when congested, lighthouses can be made excludable with technology) — justification is weaker

Provision can be contracted to private firms via competitive tendering — preserves some market discipline while ensuring universal access

Political rather than economic factors may determine the scale of provision — government failure risk

Chain E — Government Failure: When Intervention Backfires

CHAIN: Government Failure

1. Government intervenes to correct market failure (e.g. sets a maximum rent below equilibrium price) → 2. Due to information gaps, the price ceiling is set too far below equilibrium → 3. Large excess demand (shortage) results — quantity supplied falls as landlords exit the market → 4. Some consumers who valued housing highly cannot find it — allocated by non-price means (waiting lists, personal connections) → 5. Black markets emerge where housing is traded at prices above the legal ceiling → 6. Long-run: investment in new housing falls as returns are capped — supply worsens over time → 7. Net welfare loss from intervention exceeds original welfare loss from high rents → 8. Government failure: intervention has made the situation worse

Evaluation Points for Chain E

The severity of government failure depends on the quality of information available — better data can improve policy design

Government failure is more likely in complex, dynamic markets (financial, healthcare, housing) than in simpler ones

Political incentives mean governments may persist with failing policies for electoral reasons

However, government failure does not mean laissez-faire is correct — the comparison must be between imperfect intervention and imperfect market, not intervention vs a perfect market

Iterative policy design (trial and error, evaluation, revision) can reduce government failure risk over time

PART 4 — The Universal 20-Mark Essay Structure

The 20-mark question rewards all four AOs. To score in the top band (17-20), you need: precise knowledge, confident application to context, coherent multi-step chains of analysis, and genuine two-sided evaluation with a supported judgement. Here is the structure that achieves this every time.

4.1 The Six-Part Essay Template

INTRO (3-4 lines)	Define 1-2 key terms from the question title. State the argument you will make. Reference the context (industry/sector from the question) if given. Then STOP — move straight to analysis.
POINT 1 — Main analysis (8-10 lines)	State the point. Develop a chain of analysis (3-5 steps minimum). Reference a diagram by describing it precisely. Apply to the specific context. State the welfare effect. Link back to the question's exact wording.
POINT 2 — Second analytical thread (6-8 lines)	Second distinct mechanism or a different group affected. Must be a new chain, not a restatement of Point 1. Apply to context. State welfare effect.
COUNTER-ARGUMENT — Evaluate (6-8 lines)	Challenge the core assumption behind your main argument. Open with: 'However, this analysis assumes... In reality...' Show a different mechanism or outcome. Demonstrate you understand trade-offs.
FURTHER EVALUATION — Conditions (4-6 lines)	Identify the factors that determine which side is stronger: e.g. the size of the externality, the value of PED, the time horizon, the quality of government information. Use 'it depends on...' explicitly.
CONCLUSION (3-4 lines)	Make a decisive, qualified judgement. Weigh both sides and state which argument is stronger and WHY. Acknowledge the counterargument briefly. Never say 'it could go either way' — that is a low-band conclusion.

4.2 Evaluation Phrase Bank

Deploy these openers in your counter-argument and evaluation paragraphs. Each signals to the examiner that you are thinking at AO4 level.

Evaluative Opener	Why It Earns AO4 Marks
"However, this critically depends on the price elasticity of demand for the good..."	Shows outcomes vary with market conditions — not a blanket, context-free argument
"In the short run this argument holds, but in the long run..."	Time horizon awareness — demonstrates dynamic analysis
"This analysis rests on the assumption that the externality can be accurately measured, but..."	Critiquing model assumptions — the highest level of evaluative thinking
"The effectiveness of this policy depends on the magnitude of the market failure relative to the costs of intervention..."	Introduces a proportionality test — shows you can weigh trade-offs

"While a tax corrects the production externality, it creates a distributional problem because..."	Identifies a new trade-off between efficiency and equity — multi-dimensional evaluation
"On balance, I would argue that... is more likely to be effective because... although I accept that..."	Qualified, reasoned judgement — the hallmark of a top-band conclusion

4.3 Describing Diagrams Without Drawing Them

The Diagram Formula for Essay Questions

Step 1 — State what the diagram shows: 'A supply and demand diagram with the supply curve shifted left by the amount of the tax...'

Step 2 — Identify the key change: 'The new equilibrium price rises from P1 to P2, and equilibrium quantity falls from Q1 to Q2...'

Step 3 — Label the welfare areas: 'The consumer burden is the rise in price from P1 to P2. The producer burden is the fall in net price below P1. The deadweight welfare loss is the triangle between Q2 and Q1...'

Step 4 — Link to the argument: 'This welfare loss triangle represents the transactions that no longer occur — the cost of the tax to allocative efficiency...'

CRITICAL: Always state which curve shifts, in which direction, and by how much (if quantified). Always identify price and quantity effects. Always identify consumer surplus, producer surplus, and welfare loss areas.

PART 5 — Question Banks with Argument Skeletons

These are the most common Unit 1 essay question types. For each, a full skeleton is provided — arguments for, arguments against, and a model conclusion direction. These skeletons cover approximately 90% of all likely Unit 1 essay questions.

Q1: 'Evaluate the effectiveness of an indirect tax in correcting a negative externality'

ARGUMENTS FOR

Chain A above applies directly. Tax equal to MEC internalises the externality. New equilibrium approaches social optimum. Welfare loss triangle partially or fully eliminated.

Revenue raised can fund compensation for victims of the externality (e.g. tobacco tax funds NHS) — double dividend.

Market-based: firms choose how to reduce output, finding the least-cost method — more flexible than regulation.

Creates incentives for long-run innovation in cleaner technology.

ARGUMENTS AGAINST / EVALUATION

MEC is extremely difficult to measure — tax will be mis-set, creating a new welfare loss.

If demand is price inelastic (e.g. fuel, cigarettes), the quantity effect is small — mostly revenue-raising, not corrective.

Regressive impact — lower-income households spend proportionally more on these goods — worsens inequality.

Carbon leakage: production moves to untaxed countries — global externality not solved.

CONCLUSION DIRECTION: Tax is the right instrument in theory but requires accurate information to be effective in practice. More effective when combined with regulation and when PED is relatively elastic. The equity problem may require complementary redistribution.

Q2: 'Evaluate government intervention to correct information failure in the healthcare market'

ARGUMENTS FOR

Asymmetric information (doctor knows more than patient): patients cannot assess quality of care — they may under-consume or over-consume healthcare.

Government information provision (public health campaigns, required disclosures) shifts demand toward optimal level.

Regulation (quality standards, professional licensing) corrects asymmetry by ensuring minimum quality — even uninformed consumers are protected.

State provision of healthcare ensures universal access regardless of income or information — prevents adverse selection.

ARGUMENTS AGAINST / EVALUATION

Information provision alone is insufficient given behavioural biases — people ignore health warnings (present bias, optimism bias).

Full state provision removes price signals — patients over-consume healthcare (moral hazard), leading to resource misallocation.

High administrative cost of regulating complex healthcare markets — regulatory capture possible (providers influence their own regulators).

CONCLUSION DIRECTION: Some government intervention is clearly justified given the severity and structural nature of information asymmetry in healthcare. However, the optimal policy mix combines information provision, regulation, and targeted public provision — total state control introduces its own inefficiencies.

Q3: 'To what extent does government intervention in markets always improve welfare?'

YES — Intervention Can Improve Welfare

Where market failure exists, the free market is allocatively inefficient. Intervention moves output toward the social optimum — the welfare loss triangle is recovered.

Redistribution via progressive taxation and transfers corrects the equity failures of free markets — improves social welfare beyond narrow allocative efficiency.

Provision of public goods (which the private market cannot supply at all) generates large welfare gains — defence, street lighting, clean air regulations.

NO — Government Failure Is a Real and Serious Risk

All five causes of government failure apply: information gaps, unintended consequences, regulatory capture, short-termism, and administrative costs.

The relevant comparison is between an imperfect market and an imperfect government — not a perfect government vs a failing market.

In practice, the more complex the market (financial sector, healthcare), the more likely government failure is, due to information problems and political economy pressures.

CONCLUSION DIRECTION: Government intervention improves welfare when the market failure is large, well-evidenced, and the policy instrument closely matches the source of failure. Blanket intervention is not always welfare-improving. The case must be evaluated on a market-by-market basis, weighing the size of the failure against the risk and cost of intervention.

PART 6 — Key Definitions and Quick Reference

A precise definition in your introduction immediately signals AO1 competence. Memorise these and use them exactly.

Term	Precise Definition for 20-Mark Introductions
Market failure	A situation where the free price mechanism fails to allocate resources efficiently, resulting in a level of output that diverges from the socially optimal level
Externality	A cost or benefit imposed on a third party not involved in a transaction, which is not reflected in the private market price
Deadweight welfare loss	The loss of economic welfare (consumer plus producer surplus) that results when market output deviates from the social optimum — represented by a triangle on a S&D diagram
Allocative efficiency	Achieved when resources are allocated such that no reallocation could make someone better off without making someone worse off; occurs where P = MC in a competitive market
Price elasticity of demand	The percentage change in quantity demanded divided by the percentage change in price — a measure of responsiveness
Consumer surplus	The difference between the maximum a consumer is willing to pay and the price actually paid — the area above the price line and below the demand curve
Producer surplus	The difference between the market price received and the minimum price a producer would accept — the area above the supply curve and below the price line
Government failure	A situation where government intervention in a market creates a net welfare loss — the intervention makes the overall outcome worse than the original market failure
Pigouvian tax	An indirect tax set equal to the marginal external cost of production or consumption, designed to internalise the externality and restore allocative efficiency
Asymmetric information	A situation where one party in a transaction has more or better-quality information than the other, potentially leading to adverse selection or moral hazard

Good luck in your exam.