**First Year Economics Revision Booklet**

**ECON 1 – Markets and Market Failure**

Making an early start to your revision is important if you are to ensure that you achieve the best grade possible. .

**Useful revision resources**

There are lots of revision guides out there but two that are particularly good and are available in the library are:

* Those published by Anforme
* Student Unit Guides for published by Philip Allan updates

The Tutor2u website at [www.tutor2u.net](http://www.tutor2u.net) has a wide range of resources available including multiple choice quizzes and revision presentations

Econplusdal and Pajholden have useful online tutorials on key topic areas

The economicshelp website has useful notes on key topic areas

The maths and physics tutor website has past papers for old spec old spec paper 1 is micro, paper 2 macro, paper 3 second year micro, paper 4 second year macro

The AQA website at [www.aqa.org.uk](http://www.aqa.org.uk) has copies of the specification, past papers, mark schemes and examiners reports under the key materials section of the Economics section of the site.

The best way to revise for this paper is to make sure you work on consolidating your subject knowledge and practise your exam technique by working through past paper multiple choice and data response questions. To gain high marks on the paper you will need to demonstrate your ability to analyse and evaluate as well as good subject knowledge.

**Econ 1 – Markets and Market failure**

The underlying principle of this paper is that markets (places where buyers and sellers meet) work through the interaction of demand and supply. They often work well, but sometimes the market mechanism (price) breaks down and leads to an inefficient allocation of resources this is known as market failure. As a result of market failure governments may choose to intervene. Government intervention often goes some way towards addressing the market failure but does not necessarily solve it fully and can sometimes create other problems.

**The starting point**

**Basic economic problem** – infinite wants, finite resources which leads to the need to make choices. In a **free market** it is the **market mechanism (price**) which allocates resources. Prices perform three functions **signalling**, **rationin**g and **incentive** function (remember this as SIR).

The concepts of choice, scarcity and **opportunity cost** can be illustrated on a PPF. Sketch a PPF and label a point inside, a point on the PPF and a point outside the PPF what do these represent?

Now use your PPF to illustrate the concept of opportunity cost

Sketch a demand diagram. Why does it slope top left to bottom right. What does this tell us about the relationship between demand and price?

Sketch a supply diagram. Why does it slope bottom left to top right? What does this tell us about the relationship between supply and price?

Now Sketch a diagram to show an outward and an inward shift of the demand curve

Remember factors other than price shift the demand curve. To help you remember these factors remember **P I T OF POG**. Remember the P stands for price and does not shift the curve but I T OF and POG all do. What does each of the letters stand for?

Now Sketch a diagram to show an outward and an inward shift of the supply curve

Remember factors other than price shift the supply curve. To help you remember these factors remember **P COP OF POG**. Remember that P stands for price and does not shift the curve but COP, OF and POG do. What does each of the letters stand for?

Now put demand and supply together on the same diagram. What do we call the point at which demand and supply meet? (remember it can be known by two names)

If there is a change in a condition of demand or supply this would cause a shift in the demand curve or a supply curve. Draw a diagram to illustrate a market (ie. Demand and supply on the same graph) now shift one of the curves and explain what is happening in the market. You need to explain what caused the curve to shift, what happens at the original price and how a new price is established in the market. How do consumers and producers respond to this new price. Try to make reference to **signalling, rationing** and the **incentive** function of prices (remember this as SIR).

In understanding demand and supply you need to consider how sensitive demand and supply are to changes in variables such as price and income. This is known as elasticity. There are four formulae you need to know

**PED=**

**YED=**

**XED=**

**PES=**

Price elasticities will always be –ve because of the inverse relationship between price and quantity demanded. Look back at your demand diagram.

If a product has a +ve YED then the product is a **normal good**. If it is –ve it is an **inferior good**. What do these two terms mean?

**Cross price elasticity** of demand measures the responsiveness of demand of one product relative to a change in price of another product. If a product has +ve cross price elasticity the two products are substitutes. If a product has –ve cross price elasticity the two products are complements.

**Price elasticity of supply** measures the responsiveness of supply to a change in price. In other words how sensitive supply is to a change in price. The more easily a firm is able to supply product to a market following a change in price the more price elastic the supply will be. Price elasticities of supply will be +ve. If you look back at your supply curve you should be able to work out why.

However, sometimes the interactions of **demand** and **supply** in a market result in a price that is either too high or too low. Can you give an example of when the price determined by a market might be too high or too low?

It is at this point when a **market** is said to be **failing** (i.e. the **market mechanism** is leading to a misallocation of resources) that the government may choose to intervene. There are a number of ways in which they might choose to do so.

1. **Maximum and Minimum** prices (what are these also referred to as?). Sketch two diagrams below one to show a maximum price and the other to show a minimum price. Then explain how they work.

Other methods of government intervention include use of **indirect taxation** and **subsidies**, **pollution permits**, **state provision** and **regulation** to correct market failure. If you remember TRE (taxation, regulation, education) this will help you.

**Market failure** occurs whenever a market leads to a misallocation of resources. You need to be able to demonstrate how **public goods, positive and negative externalities, merit and demerit goods, monopoly and other market imperfections and inequalities in the distribution of income and weatlth are forms of market failure.**

There are four useful diagrams that can be used to illustrate positive and negative externalities (i.e. the divergence between private and social costs and benefits).

If left to the free market merit goods such as healthcare and education would be underconsumed. This can be illustrated using your diagram for **positive externalities in consumption**. On your graph you should indicate the free market provision and the socially optimal level of production. You should also indicate underconsumption and underprovision.

Begin by drawing a diagram that shows the free market position i.e. MPB and MPC. Remember the benefit curve looks like a demand curve. If left to the free market merit goods would be underprovided and underconsumed. You now need to add another benefit curve to show where in the best interests of society merit goods should be provided. Label this curve MSB.

If left to the free market demerit goods such alcohol and cigarettes would be over provided and overconsumed. This can be illustrated using your diagram for **negative externalities in consumption**. On your diagram you should indicate the free market provision and the socially optimal level of production. You should also indicate underconsumption and underprovision.

Begin by drawing a diagram that shows the free market position i.e. MPB and MPC. . If left to the free market demerit goods would be overprovided and overconsumed. You now need to add another cost benefit curve to show where in the best interests of society demerit goods should be provided. Label this curve MSB.

Now draw your diagrams for positive and negative externalities in production. Once you have drawn your diagrams check them by looking at the tutor2u 4 key diagrams presentation.

Other forms of **market failure** that you must be able to talk about include

**Monopoly** (make sure you can define what a monopoly is and explain how it can lead to a misallocation of resources)

**Public Goods** (make sure you can define and identify the characteristics of non-excludabiliy, non-rivalry and make reference to the free rider problem)

**Government intervention**

Explain the main types of intervention that can be used to tackle market failure (you should include reference to taxation, regulation and education, ensure that you include any diagrams)

**Government failure** occurs when the government’s intervention in the economy leads to a continued **misallocation of resources**. Government intervention in a market to correct market failure may also result in an improvement in economic welfare but create further problems e.g.unintended consequences.

There are a number of reasons for this. What are they?

**Other useful ECON1 concepts**

**Factors of Production**. There are four of them what are they?

**Economies and Diseconomies of scale**. Economies of scale defined as output increases average unit costs of production decrease. There are five main types of economy of scale what are they? Diseconomies of scale defined as output increases average unit costs of production continue to increase. There are two of them what are they?

Draw a diagram to illustrate economies and diseconomies of scale.

What do **specialisation** and the **division of labour** refer to?

**Normative and positive statements**. Which one is a value judgement and which one can be tested?

**Composite demand**

**Derived demand**

**Joint supply**

**Joint demand**