

How Economies Differ

3

Multiple Choice

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|--------|---------|---------|
| 1. (A) | 6. (D) | 11. (C) |
| 2. (C) | 7. (B) | 12. (D) |
| 3. (A) | 8. (B) | 13. (A) |
| 4. (C) | 9. (C) | 14. (C) |
| 5. (D) | 10. (B) | 15. (A) |

Short Answers

Question 1

- Factor markets are markets for the factors of production, which are natural resources, labour, capital and enterprise.
- Competition plays a vital role in ensuring that the price mechanism (i.e. the interaction between supply and demand to determine prices) can effectively operate. With a large number of buyers and sellers, it means that no one buyer or seller has the power to influence prices on their own.
- In a market economy, prices are determined by the interaction between the forces of supply and demand, a process referred to as the price mechanism. If demand is greater than supply, it will put upward pressure on prices but if supply is greater than demand, it will put downward pressure on prices. Prices will change whenever either demand or supply changes. For example, a rainy day might see the price for umbrellas increase as consumer demand increases but stores have limited stock.
- A centrally planned economy is characterised by government control over economic decisions, with limited scope for individuals to influence the economy. Central planning will normally involve public ownership of factors of production, with the government playing the central role in allocating resources as it determines. A market economy on the other hand, is characterised by economic decisions being made by private individuals and private firms, both of whom are motivated by self interest. Market economies have little or no government intervention, and rely upon the price mechanism to allocate factors of production.

Question 2

- (a). A government may intervene in the economy to reduce income inequality and unfairness in an economy that would otherwise allocate more resources and income to those who controlled the factors of production. The government may also intervene to provide for socially beneficial goods (merit goods) such as education and infrastructure, which may otherwise be underprovided by the private sector.
- (b). A progressive tax system is one where higher income earners pay a higher share of their income as taxation compared to lower income earners. The government can redistribute the income received tax to lower income earners via social welfare payments. Social welfare payments also ensure that those that did not contribute to the production process, such as the elderly and the unemployed, are not left without income, thereby reducing income inequality.
- (c). The government can influence what is produced in an economy by providing subsidies or lower taxes to firms to encourage the production of particular goods or services such as food or properties for rent. The government may also influence production by providing some goods and services itself, such as roads and schools.

The main argument for government intervention in the economy is that through the tax and social welfare systems, it is able to reduce income and social inequality that is caused by the market and provide a better quality of life for the least fortunate in society. Government intervention also means greater production of goods and services with community-wide or social benefits such as education, health care and transport infrastructure. On the other hand, too much government intervention may distort economic outcomes and create inefficiency. The government is not as capable as the price mechanism in responding to consumer and producer signals, and is therefore less efficient in allocating resources. Public ownership of factors of production may also stifle innovation, growth, and other outcomes achieved by firms pursuing maximum profits.

Question 3

- (a). GDP per capita is preferred over GDP in comparing income levels between economies as it takes into consideration population size. By looking at how much income each individual earns on average, rather than the total output of an economy, GDP per capita gives a more accurate indication of individual income levels.
- (b). Australia's quality of life rank, as measured by its HDI ranking, is significantly higher than that of the United States', despite the fact that Australia's GDP per capita, when adjusted for purchasing power parity, is lower than the United States'. This may be explained by the US producing greater output per person than Australia, but Australia having better levels of health and education on average compared with the US.
- (c). Australia is a mixed market economy that operates under a combination of both market forces and government intervention. The government intervenes to ensure economic stability by smoothing fluctuations in the economic cycle through its fiscal and monetary policies. The government also plays a vital role in reducing income inequality through its progressive tax system and social welfare payments. Finally, the government plays an important role in providing for merit goods such as education and infrastructure, as well as limiting the production of harmful goods and services through imposing taxes and restricting quantities.
- (d). Australia has had a relatively poor record of overall environmental quality and resource usage. Although Australia has an exceptionally diverse environment and a large concentration of natural resources, it has not performed well in preserving its biodiversity or promoting sustainable resource usage when compared to some other high income countries such as Sweden and Denmark. Australia is also one of the highest emitters of carbon dioxide per capita in the developed world, ranking only behind the United States. Australia has also continued to remain reliant on non-renewable energy sources such as coal and other fossil fuels for its energy needs.