2005 Assessment Report

VICTORIAN CURRICULUM AND ASSESSMENT AUTHORITY

2005 Economics GA 3: Written examination

GENERAL COMMENTS

It appeared to assessors that the examination was generally well received by students. The results for the multiple-choice were strong, and the great majority of students attempted all questions in Section B, with few leaving any questions blank.

There were a number of outstanding papers. These students had clearly developed a thorough understanding of the current and recent performance of the Australian economy. They were able to use this knowledge to write insightful answers and provide relevant and appropriate examples. This was particularly evident in Questions 1b., 1c., 2 and 3 of Section B.

The move to a question and answer booklet over the past two years has proved to be very successful. It appears to assist students in maintaining focus on the question at hand and assists with time management. The great majority of students seemed to have enough time to complete all questions. Many students made use of the spare pages at the back of the booklet to plan answers and/or as extra space for answers that ran over the lines provided earlier in the booklet. When answering, students may use the blank spaces below the lines provided or the space provided at the end of the booklet. Students should be advised that assessors are happy to read and assess answers that go on beyond the lines provided.

There were a number of concerns noted by assessors about student performance in the examination.

- A number of students appeared to have difficulty with **cause and effect** logic. Students need to read questions carefully, make sure they distinguish between the 'fixed' factor to be affected by the economic 'variable' in the question, and ensure that they answer the actual question being asked. Too many students switched the factors around and consequently did not answer the question appropriately. This was an issue in Section B, Questions 2bii., 2c. and 3d. For example, in Question 2bii. some students wrote about how changes in the Australian balance of payments on current account may have affected the exchange rate, whereas the question actually asked how the changes in the exchange rate since July 2002 may have affected the Australian balance of payments.
- Some students only answered part of the question without following through all the requirements of the question. For example, in Section B Question 1c. many students selected an appropriate example of microeconomic policy and provided a good description of it, including some reference about how it operates, but did not complete the question because they failed to discuss how the policy operates to **increase economic growth**. This also occurred in Section B Question 1d. where students often explained how the factor may affect aggregate demand but did not follow up and talk about how this would affect economic growth.
- Students must be able to provide accurate and meaningful definitions of key economic concepts. There were many opportunities on the examination for students to display their economic literacy and explain a concept. Particularly disappointing were Section B Question 1c., where many students were unable to select two appropriate microeconomic reforms, and Question 3b., where many students had difficulty distinguishing between the different taxes and providing examples.
- There still seems to be some confusion about the difference between demand side and supply side influences. For example, a number of students did not appreciate that Section B Question 1d. was about the influence of demand side factors and instead wrote a discussion about supply side factors.
- Results in Economics can be maximised if students make links and understand relationships between economic objectives, between economic policies and between economic objectives and policies. Too many students made assertions about economic relationships without actually explaining the why and how of the relationship. For example, in Section B Question 1d., when explaining the effect of an increase in the size of the Australian Government's budget surplus, some students simply asserted that this would have a contractionary effect on aggregate demand and economic growth without explaining how and why. Students need to 'step out the discussion'; for example, the government may have taken discretionary decisions to cut government capital expenditures (G2), which would lower government expenditure on the provision of infrastructure, such as the building of new roads and hospitals, and thus slow aggregate demand and economic growth.

SPECIFIC INFORMATION

Section A – Multiple-choice questions

The table below indicates the percentage of students who chose each option. The correct answer is indicated by shading.

Question	% A	% B	% C	% D
1	75	17	2	6
2	10	27	58	5
3	36	19	12	33
4	83	2	13	2
5	87	8	3	3
6	4	70	21	4
7	11	8	53	27
8	18	9	6	67
9	9	71	13	8
10	4	2	77	17
11	8	5	2	85
12	11	15	60	14
13	9	65	12	15
14	5	2	3	90
15	81	6	10	3

Section B – Written responses

Question 1ai.

Marks	0	1	2	Average
%	20	37	43	**1.3**

The majority of students were able to give some pertinent points about the meaning of productive capacity. The best answers clearly explained the notion of the maximum or potential production from a nation's resources and defined the meaning of productive resources/factors of production. A few excellent answers briefly explained how the 'capacity' could be extended, such as by new mineral discoveries or the use of new technology, and that it is a dynamic concept rather than a static one. Other excellent answers used the extension of the production possibilities curve or frontier to explain the concept.

Poorer answers confused productive capacity with the term productivity. A large number of students mentioned the amount produced without linking it to 'resources employed' or explaining that it is the maximum or limit, and so were unable to score full marks. Several students referred to the concept of the 'speed limit' of the economy, which is an interesting analogy but few who used it managed to demonstrate how it tied in with productive capacity. Other poorer answers talked of productive capacity at the firm level rather than at the level of the economy.

Question 1aii.

Marks	0	1	2	Average
%	13	36	50	**1.4**

The best answers here were those that provided a clear explanation and/or example of how one of the listed factors can alter the availability of productive resources (in terms of the quantity or quality) and how this impacts on productive capacity.

Following are examples of how each factor may affect productive capacity.

- An increase in the labour force participation rate suggests that more people are actively seeking work; therefore there is an increase in the quantity of labour resources. Providing more of a productive resource (labour) increases potential production thus increasing productive capacity.
- A slowdown in the rate of technological change, such as through less investment in research and development associated with information and communications technologies, will slow improvements in the quality of capital resources, which slows the rate of growth in productive capacity.

- An increase in government spending on infrastructure, such as increased government expenditure on improved transport and telecommunications networks, would add to the existing supply of resources, notably capital (it may increase the quantity and quality of capital resources), thus increasing productive capacity.

A number of weaknesses were noted in students' responses to this question. Some students confused productivity and productive capacity; for example, some made the erroneous observation that increased participation rates would lead to increased productivity. With reference to the slowdown in the rate of technological change, some weaker answers claimed that this would decrease productive capacity, rather than diminish the rate at which it could expand. Very few students appeared to understand what infrastructure is and those who chose this factor consequently tended to perform poorly.

Question 1b.

Marks	0	1	2	3	4	Average
%	36	22	21	12	9	**1.4**

This question was not well handled by students, although those students who had actively engaged with current economic affairs and had current knowledge of the workings of the Australian economy were able to provide impressive responses. These students structured their answers logically by giving current, relevant examples of capacity constraints in relation to exports and the labour market and by explaining how these capacity constraints are likely to impact on economic growth. Excellent answers made use of the following points.

- As the Australian economy enters its thirteenth and fourteenth years of expansion, it is not surprising that the days of lifting output by reducing cyclical slack are behind us. Australia is now entering a phase where capacity constraints suggest the economy is operating near to productive capacity; that is, available factors of production are being fully utilised. This suggests that future rates of economic growth will be constrained or limited because there is no spare capacity available to meet any increases in demand. This may lead to shortages and subsequently cost pressures.
- In some parts of the resource sector there was a significant volume of investment in the second half of the 1990s (for example, improving the quantity and quality of capital) but a subsequent period of weak commodity prices saw investment decline to very low levels. Hence, the increase in demand in the past two years apparently left some producers without the capacity to take full advantage of the conditions by shipping higher output.
- Other students wrote about the capacity constraints in transport infrastructure, particularly ports and rail, affecting the ability of the economy to meet growth in export demand. Therefore, the future economic growth rate might be slower than it could be.
- In the labour market in the first half of 2005, the rate of unemployment was at its lowest level in over 25 years. A significant proportion of firms reported difficulty in finding suitable staff, and areas of skills shortage have emerged. Thus, a lack of spare capacity in the labour market means the economy is operating near to productive capacity which suggests there will be a slower rate of economic growth into the future.

Question 1c.

Marks	0	1	2	3	4	5	6	Average
%	18	9	12	16	19	16	10	**3.0**

There are a large number of microeconomic reforms that have been used to manage the economy, and students were given the opportunity to discuss any two of these in their answer. While the majority of students were able to select two examples, a number of students seemed to have no idea about the nature and operation of microeconomic reform policy. This was surprising as microeconomic reform policy is a significant Area of Study in Unit 4. Some students even discussed macroeconomic policies instead of microeconomic policies, while others struggled to explain how their chosen reform actually impacts the supply side to increase economic growth. Often, students gave definitions of their chosen reform and stopped there without completing the requirements of the question, which asked how the reforms are used to increase economic growth.

The majority of students selected tariff/trade reforms and labour market reforms as the policies to discuss. Other policies used included the following.

- Capital markets reforms, such as floating the exchange rate, bank interest rate deregulation and licensing foreign banks to operate in Australia.
- Infrastructure services reforms, such as partially deregulating airlines, coastal shipping, telecommunications and the waterfront; improving government utilities, including railways, ports, electricity and water——these were made more efficient and less 'overstaffed' and many were commercialised, corporatised or privatised; and privatising government owned banks and insurance companies.

- Deregulating industry, including stock broking, petrol distribution, eggs, bread and dairy, as well as shopping hours.
- Government services reforms, including competitive tendering and contracting out, performance based funding, the formal definition and costing of community service obligations and user pays pricing.
- Taxation reforms, including capital gains, fringe benefits and dividend imputation introduced in the 1980s. The GST was introduced in 2000, the company tax rate was cut to 30% and there have been a number of cuts to income taxes over recent years.
- The National Competition policy, which was introduced 1995, including an extension to the Trade Practices Act for government businesses and professions, and reforms to public monopolies.

Question 1d.

Marks	0	1	2	3	4	5	6	Average
%	6	7	12	18	24	20	13	**3.6**

This question was generally well handled by students, with the great majority able to identify which factors would increase aggregate demand and economic growth and which ones would slow it. To answer this question successfully, students needed to demonstrate their understanding of economic relationships on the demand side of the economy. It was therefore disappointing to see a number of students ignoring the demand requirement and discussing supply issues instead. Students need to read questions carefully so that they have no doubt as to the purpose of the question.

Factors to increase aggregate demand and economic growth included the following.

- A strong economic recovery overseas: when major overseas trading-partner economies are achieving strong economic growth (such as is currently the case in China), there is likely to be strong growth in the demand for Australian exports, because growing economies want to access more raw materials and goods and services to satisfy the higher levels of demand associated with their growth. Assuming there is spare capacity in Australia, this is likely to result in production increases in export industries in order to meet the higher demand, which would thus increase economic growth
- A reduction in the company tax rate means more profits would be available for firms. This may see firms increase private investment expenditure (I), such as increasing expenditure on business machinery, plant, vehicles and equipment, which will lead to an increase in aggregate demand. An increase in aggregate demand will likely generate an increase in production and economic growth.

Factors to slow aggregate demand and economic growth included the following.

- An increase in the size of the Australian Government's budget surplus may be achieved when taxation revenues rise and/or the size of government payments is reduced. When taxation increases (such as if the marginal rates of income tax are raised) it is likely there will be less personal disposable income. This would likely see a reduction in personal consumption expenditures and thus lower aggregate demand, which would most likely lower production and slow economic growth. If governments reduce the size of their payments by spending less on infrastructure projects, which reduces the size of government expenditure on assets and thus lowers aggregate demand, this also lowers production and slows growth.
- An increase in interest rates means that it costs consumers and business more to service loans, which leaves less cash available to spend. This is likely to lower personal consumption expenditure and private investment expenditure, thus reducing aggregate demand and slowing economic growth.

Question 2a.

Marks	0	1	2	3	4	Average
%	20	11	30	24	15	**2.1**

Again this was a question where students with an understanding about the current performance of the economy were able to excel. Some excellent answers were provided. The majority of students were able to provide at least one circumstance and explain it well. Students seemed to understand much better this year that interest rates are likely to be increased when the Reserve Bank of Australia suspects that factors operating in the economy are a threat/risk to the price stability objective of a two to three per cent price rise annually over the course of the business cycle, as measured by the consumer price index. The sorts of circumstances discussed by students included the following.

- To prevent the possibility of an inflationary breakout as firms bid up wages to compete for scarce skilled-workers, or if there is fear of labour shortages causing a wages breakout.
- To slow growth in household debt, which would see excessive growth in demand.
- If inflation exceeds its target rate or is forecast to exceed its target rate of two to three per cent CPI increases over the course of the business cycle.

- To avoid growing cost pressures impacting negatively on inflation outcomes, including increases in raw material costs and rising oil prices.
- To curb demand pressures such as those from strong global growth, or lower income taxes leading to increasing personal consumption expenditure, or bigger budget deficits.

Question 2bi.

Marks	0	1	2	3	4	Average
%	13	29	19	17	22	**2.1**

Again, students are reminded to read the question carefully and complete all aspects. Many gave an excellent description of the trend for the exchange rate from 2002 but failed to complete the second aspect, which required them to account for that trend.

There were some excellent answers that did account for the trend, with large numbers of students demonstrating a sophisticated understanding of the impact of interest rate differentials between Australia and the US over the period given. These answers talked about how the widening gap between the Australian and US interest rate from July 2002 to May 2004 (due to higher interest rates in Australia) and how this would increase demand for Australian dollars as financial investors seek relatively higher returns, thereby strengthening/appreciating the Australian dollar. The interest rate gap narrowed a bit after May 2004 as the US interest rate increased, thus reducing the demand for the Australian dollar relative to before the US interest rate rise.

Other reasons given by students to account for why the Australian dollar appreciated between July 2002 and May 2004 included favourable movements in Australia's terms of trade and rising commodity prices.

Question 2bii.

Marks	0	1	2	3	4	5	6	Average
%	29	11	13	14	9	11	13	**2.5**

The best answers about the balance of payments on current account described how the strengthening Australian dollar means that exports are relatively dearer and imports are relatively cheap, which may see less demand for exports and increased demand for imports. Thus, all other things being equal, the changes in the exchange rate since July 2002 are likely to increase the size of the balance of payments on current account deficit as imports rise and exports fall. In this part of the question, a number of students wasted time defining the current account deficit and net foreign debt, at the expense of giving a valid explanation.

Many students did not perform as well in the second part of the question, and some students even contradicted their previous answer; for example, writing that the appreciation meant cheaper imports in the first part of the question, but then saying that this would be inflationary in the second part. This lack of understanding of the relationship between appreciation and its effect on inflation was particularly disappointing, given that a similar question appeared on the 2004 paper and students had been reminded in the 2004 Assessment Report about how this relationship actually works. The better answers explained that the strengthening/appreciating Australian dollar is likely to slow the rate of inflation because import prices are relatively lower, which reduces the price of imported consumer goods and services and reduces cost pressures as the price of imported component parts is reduced.

Question 2c.

Marks	0	1	2	3	4	5	6	Average
%	25	16	14	14	11	10	10	**2.4**

There were some very good responses to this question, with high-scoring answers making the following points in relation to the scenario chosen.

- A favourable movement in the terms of trade means that export prices are increasing faster (or falling slower) than import prices, thus strengthening (appreciating) the dollar.
- Falling world commodity prices may suggest a slower world economy, leading to less demand for commodities. As Australia exports a large number of commodities, the likely scenario would see less demand for the Australian dollar and thus lead to depreciation.
- High levels of domestic consumer confidence are likely to lead to more demand, including demand for imports, meaning more demand for foreign currencies and leading to a weakening in the Australian dollar.

Students were often able to accurately articulate how the scenario could impact on the exchange rate, but many did not provide sufficient explanation to show that they understood the reason for the impact. Some students confused the cause

and effect nature of the question and wrote about how changes in the exchange rate would impact on the alternative scenarios given.

Question 3a.

Marks	0	1	2	Average
%	20	43	37	**1.2**

Most students were able to define some pertinent aspect of the objective of equity in personal income distribution. Better answers concisely pointed to several features of this objective, such as: 'equity' refers to 'fairness' rather than 'equality'; the goal relates to a reduction in the size of the gap between higher and lower income earners so that there is a fairer or more even distribution of income between persons, rather than an equal distribution; and/or an aim is to provide access to basic goods and services for all people (such as food, clothing and shelter) so that absolute poverty is avoided.

Question 3b.

Marks	0	1	2	3	4	5	6	Average
%	23	11	14	14	16	12	10	**2.7**

Issues associated with taxation and welfare reform have been on the agenda in Australia in recent years. To engage in debates about these questions, students need to understand the impact that different methods of taxation can have on individuals, businesses and the economy; however, many students seemed to lack this understanding. Too many students did not tackle all parts of the question. A number of students accurately articulated aspects associated with the way taxes are levied in Question 3c., but were unable to apply this knowledge back to part b. Students should be encouraged to cross-reference their answers across the paper to make sure they have applied the same logic in each answer.

Better answers provided concise definitions, appropriate examples and a distinguishing feature, such as the aim of the tax or whether the tax was direct or indirect.

- A progressive taxation system is a system where the proportion of tax paid out of total income increases as income rises. This has the aim of evening out income distribution. An example is personal income tax.
- A regressive taxation system is a system where the proportion of tax paid out of total income decreases as income rises. The tax collected from lower income earners would represent a higher proportion of their income than it would for a higher income earner. This causes the distribution of income to become more uneven. Examples include indirect taxes such as the GST (levied at a flat rate but having a regressive effect).
- A proportional taxation is a tax system where the proportion of tax paid out of total income remains the same, regardless of income level. Known as a flat rate tax and an example would be company tax.

Weaker responses mixed up the different methods and could not provide relevant examples. While most students knew something about progressive taxes, they needed to explain that it is the **rate** of tax that rises as incomes increase, not just that tax rises as income increases. Many thought that the GST is a regressive tax and did not understand the difference between the way the tax is levied and the impact that the tax has. It is the impact of the GST that is regressive.

Question 3c.

Marks	0	1	2	3	4	5	6	Average
%	8	6	8	12	17	23	26	**4.0**

Although this was a higher order question that required a degree of deduction, it was the best answered part of Question 3. Better answers included points such as the following.

- A cut in the top rate of marginal tax: all else being equal, this will raise the post-tax incomes of the richest individuals in the economy and leave less to be transferred to the poorest. This will make the distribution of income between people more unequal.
- An increase in GST: as the GST is a tax that has a regressive effect it is likely that an increase in the GST rate would result in people on lower incomes paying a relatively higher proportion of their income as tax. Hence it would make the distribution of income more unequal.
- Unemployment benefits ceased after six months: unemployed people can currently access unemployment benefits no matter how long they have been unemployed. Therefore, this change would result in greater inequality because unemployment benefits would not be available once the person is unemployed for longer than six months. As unemployment is one of the most important factors that causes inequity, this would make the distribution of income much more unequal.

- Increased government funding for retraining: this would assist long-term unemployed in getting back into work. If fewer people were dependent on welfare payments/unemployment benefits, the income distribution would be fairer. This move would lower unemployment, which would likely see an improvement in the distribution of income.

The option that seemed to challenge students most in this question was the welfare reforms that mean unemployment benefits are ceased after six months. Weaker students failed to realise that the unemployed already receive benefits under the current system, so it was not a situation whereby they would be better off for six months. Many also did not explain the impact on the unemployed after six months. There was great enthusiasm about the 'incentive' to get these people back into work, without considering how they would live if they were unsuccessful in gaining such employment after six months.

Question 3d.

Marks	0	1	2	3	4	5	6	Average
%	28	11	13	15	13	11	9	**2.4**

The broad scope of this question gave students the opportunity to write about an extensive range of economic relationships. However, many students turned the question around by taking two economic objectives and writing how they impact on equity. This was not what the question asked.

Students needed to think about how a more equitable distribution of income is achieved. What sorts of policies would allow this to happen? More equitable distribution requires the implementation of policies that achieve a fairer distribution of income between persons. This could be measured by lowering the Gini coefficient or movement in the Lorenz curve closer to the line of absolute equality. Examples of policies could include the government allocating more on the provision of welfare benefits, or raising marginal income tax rates so that the income tax system is more progressive. Once students set up the scenario they could then consider how the pursuit of these policies to achieve equity may conflict with other objectives.

One conflict could be with efficient resource allocation. In the pursuit of fairer income distribution, the government may implement a policy of further increases in the progressive nature of income taxes by raising marginal rates. This would conflict with economic efficiency (that is, the efficient allocation of resources) because it is likely that higher marginal tax rates would be a disincentive to work harder and earn a higher income. Further, it may be argued that providing higher welfare payments/unemployment benefits (used by redistributing money collected from higher income tax to improve equity) may also discourage the unemployed from moving off welfare to work, again reducing efficiency.

Another conflict could be with price stability. If the government pursues policies such as increasing welfare payments to improve equity, the consequent increase in demand may put upward pressure on prices, particularly if the economy is approaching its productive capacity. Further, increased spending on government services such as education, health, transport and childcare and providing these at subsidised prices and/or spending more on retraining programs for the unemployed may jeopardise the achievement of price stability if it results in increased budget deficits. Budget deficits tend to be expansionary with a consequent increase in demand that may put upward pressure on prices.

Higher income taxes mean that nominal wage demands are increased in compensation. Therefore it is likely that cost pressures may be generated, thus impacting on the achievement of price stability.

Another conflict could be with external stability. If higher company tax rates are used to fund better equity outcomes, then this is likely to reduce business investment and generate cost pressures, leading to fewer exports, a higher current account deficit and a lower Australian dollar.