

2016 VCE Economics examination report

General comments

Students responded well to the 2016 Economics examination. Most students answered Section A well. There was a significant number of high-quality responses to questions in Section B. Most students attempted all parts of all questions in both Section A and Section B.

A large percentage of students demonstrated sophisticated knowledge of the current performance and policy settings of the Australian economy, such as in Section B, Questions 3c., 3d. and 3e. Students who were able to correctly apply economic theory to explain current and recent changes in economic performance and policies generally earned the highest marks.

In Section B, it was clear that students had developed a strong understanding of a number of economic relationships, such as between changes in the value of the Australian dollar and the rate of inflation, and how microeconomic reform policy and budgetary policy might be used to influence international competitiveness and external stability.

Areas noted for improvement included the need for students:

- to use the mark allocation and command terms in questions in Section B as a guide to the extent of the response required. For example, a number of students wrote long answers to questions such as Section B, Questions 1a., 2a. and 2c., which were 'outline' questions worth two marks, but did not develop more detailed responses to questions worth four or six marks
- to strengthen understanding related to calculations and the use of data, such as in Section A, Question 5, where a number of students seemed to be confused by the meaning and difference between annualised and quarterly figures
- to enhance understanding of a number of economic relationships, such as in Section A, Question 9, which was about the relationship between the labour force, the labour force participation rate and the unemployment rate, and in Section B, Question 4c., which was about the relationship between budgetary policy and the labour force participation rate
- to spend less time defining key concepts and terms related to the question and more time explicitly and fully answering the specific requirements of the question, such as in Section B, Question 3e.
- to develop clearer understanding of the meaning of the terms of trade and the relationship between the terms of trade and the balance of payments on current account, and the terms of trade and Australia's living standards
- to continue to develop deeper understanding of how perfectly competitive markets allocate resources
- to show they understand how and why governments may intervene in the market to stabilise the level of economic activity
- to understand how budgetary policies including taxation and welfare reform might be used to influence domestic economic goals and the supply side of the economy.

Specific information

This report provides sample answers or an indication of what answers may have included. Unless otherwise stated, these are not intended to be exemplary or complete responses.

The statistics in this report may be subject to rounding resulting in a total more or less than 100 per cent.

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	Comments
1	58	28	6	7	
2	3	93	1	3	
3	1	5	92	1	
4	3	2	88	6	
5	68	9	22	2	This question was not answered well. It appeared that a majority of students did not understand that the data was presented as quarterly data and the question required them to make an annualised calculation – i.e. the increase in quarter 2 times 4, which equalled 4%.
6	5	75	17	2	
7	2	1	14	83	
8	12	1	24	62	
9	53	13	24	9	
10	2	12	4	82	
11	70	5	14	11	
12	19	74	2	5	
13	9	5	81	5	
14	27	9	6	59	If demand and supply change in the same direction (as in this case), the change in the equilibrium output can be determined, but the change in the equilibrium price cannot. If both demand and supply decrease, consumers wish to buy less and firms wish to supply less, so output will fall. However, since consumers place a lower value on each unit, but producers are willing to supply each unit only at higher prices, the effect on price will depend on the relative size of the two changes.
15	7	87	3	4	

Section B – Written responses

Question 1a.

Marks	0	1	2	Average
%	28	34	38	1.1

The majority of students appreciated that there had been an unfavourable movement or declining trend in Australia's terms of trade over the past two years as shown on the graph. However, many

students did not appear to have a clear understanding of what is meant by the terms of trade and as a result were unable to explicitly outline a factor that may have explained why there had been a fall in the prices received for Australia's exports.

A possible response could have been:

The terms of trade measure the prices of exports relative to the prices of imports. Australia's terms of trade have fallen due to the fall in prices received for a number of our commodity exports such as iron ore. During the early 2010s, mining companies in Australia and around the world responded to the higher demand and prices by increasing their productive capacity by investing heavily. As world supply increased there was a surplus of many minerals so world prices fell, including the prices Australia received for its mineral exports, thus leading to a decline in Australia's terms of trade.

Question 1b.

Marks	0	1	2	3	4	Average
%	10	20	21	25	24	2.3

Students who had demonstrated an understanding of the terms of trade in Question 1a. performed well in responding to Question 1b. However, many students believed that an unfavourable movement in the terms of trade meant a fall in the quantity of exports, not understanding that it is about falling prices of exports compared to the prices of imports. Therefore, many students had difficulty analysing the significance of falling export prices for the balance of payments on current account or for living standards.

In general, students were able to make some links to the effect on living standards but struggled to accurately analyse the effect on the balance of payments on current account.

When analysing the effect on the balance of payments on current account, high-scoring students argued in terms of the effects on credits and debits, which assisted in structuring their answer.

A possible response could have been:

Effect on balance of payments on current account – When the terms of trade decline (an unfavourable movement in the terms of trade) each export sold receives a lower price. A given quantity sold therefore will generate less revenue, so the value of exports as recorded in the balance of trade may decrease (this might still occur even if the volume of exports sold increases). When the value of exports falls the balance of trade deteriorates, which means that the overall balance of payments on current account might also become more negative.

Effect on living standards – If each export sold receives less revenue as export prices have fallen and, for example, miners receive less for each tonne of minerals sold, it might mean that some mining projects are no longer profitable. Therefore, mining companies with a high cost of production will be forced to close. As mines close, some people will become unemployed. Their disposable income will therefore fall as they go from receiving a wage and move onto unemployment benefits. Their material living standards will fall because their ability to purchase goods and services will be reduced. Their non-material living standards may also fall because being unemployed can negatively affect self-esteem and lead to increased levels of depression and anxiety.

Question 1c.

Marks	0	1	2	Average
%	21	17	61	1.4

This question was answered well by students. Most students were able to describe this economic relationship correctly.

As this was a question worth two marks, it was not necessary that students describe two relationships – that is, one from the demand side and one from the supply side. Writing more than was required may have meant that some students did not leave sufficient time to answer longer questions.

A possible response could have been:

Depreciation of the Australian dollar (AUD) means that the value of the AUD has reduced relative to other currencies; thus, a depreciation of the AUD means that each AUD purchases less foreign currency in the foreign exchange market. This will make imports more expensive. Australian producers who rely on imported components/intermediate goods or raw materials will be forced to raise their prices to maintain profit margins, and consumers will be forced to pay higher prices for the goods and services they require. This likely results in increased cost-push inflationary pressures and will raise the general level of prices, increasing inflation.

Question 1d.

Marks	0	1	2	3	Average
%	13	14	32	40	2

This question was generally answered satisfactorily by the majority of students. Some students, however, struggled to answer the question fully. Often they would explain the nature and operation of the selected microeconomic reform policy but would not explain clear links to how the policy might improve international competitiveness and external stability.

Students were able to select one microeconomic reform (MER) policy from the list in the study design:

- National Competition Policy
- Labour market reform
- Deregulation of key markets
- Trade liberalisation.

The majority of students selected trade liberalisation as their example of microeconomic reform policy. In selecting this option a possible response could have been:

The Australian Government has continued to undertake trade liberalisation over recent years whereby barriers to trade such as tariffs (taxes on imports), import quotas and subsidies (financial support to Australian producers) are reduced and in some cases removed. This exposes Australian firms to greater competition from overseas producers. This immediately imposes a discipline on them to seek the lowest-cost method of production, and they are likely to seek productivity gains where they create more outputs from their labour, land and capital inputs. The resultant improvements in efficiency and productivity will likely increase the ability and willingness of firms to supply, thus increasing their ability to be more internationally competitive (where they offer lower prices or better quality than their foreign competitors). By lowering prices, the demand for Australian exports might increase, which has a positive impact on the balance of payments on current account deficit (CAD), thus improving external stability. Furthermore, when Australian firms are exposed to increased competition some will close down, resources will be reallocated to areas

of comparative advantage and specialisation will further increase international competitiveness. As export demand increases, the achievement of external stability is promoted. This means that Australia is more likely to be able to meet its international financial obligations and achieve a stable CAD to Gross Domestic Product (GDP) ratio and sustainable net foreign debt.

Question 1e.

Marks	0	1	2	3	Average
%	18	14	28	40	1.9

This question required students to select an example of budgetary policy and explain how this policy might be used to influence Australia's international competitiveness and external stability.

The majority of students were able to select a budgetary policy example. In nearly every case, students explained how the selected policy might improve international competitiveness and external stability, with very few responses explaining how the selected policy might influence international competitiveness and external stability in a negative way.

The majority of students selected increasing government expenditure on improving infrastructure as their example, and high-scoring answers made the following points.

- Increased budgetary (G2) spending allocated to infrastructure projects such as improved transportation, road, rail or port facilities will inevitably have benefits for cost structures in Australia, improve technical efficiencies and therefore the price competitiveness of Australian firms wishing to export goods and services.
- This should flow through to cheaper export prices, given the improved international competitiveness. In so doing this may increase demand for Australian exports, thus improving the trade balance (exports minus imports) and reducing the size of Australia's CAD.
- External stability is therefore improved because the CAD is improved, and the need to borrow to finance the CAD is reduced.

Question 2a.

Marks	0	1	2	Average
%	3	35	62	1.6

This question was well handled by the majority of students. Those who did not score full marks needed to ensure that they outlined the characteristics of a perfectly competitive market rather than simply listing two characteristics.

A possible response could have been:

Perfectly competitive markets have a large number of buyers and sellers who act independently. They are regarded as price takers because they are too small to influence prices in the market, and they accept the prices determined by the interaction of demand and supply.

Perfectly competitive markets have low barriers to entry. The set-up costs for a business are minimal, so if profit-making opportunities increase in an industry, it is easy for new firms to enter the market.

Question 2b.

Marks	0	1	2	3	4	Average
%	5	15	28	34	19	2.5

A number of students struggled to answer this question correctly. While most students agreed that a perfectly competitive market is more likely to allocate resources efficiently when compared to an oligopolistic market, some students were not able to accurately explain how a perfectly competitive market allocates resources. They were also unable to clearly explain how resources are less likely to be allocated efficiently under an oligopolistic market structure. A number of other students appeared to confuse an oligopoly market structure with monopolistic competition. Often answers that scored high marks started with (or included) a definition of efficient allocation, and this definition was used to focus and structure the answer.

A possible response could have been:

Exposure to competition in a perfectly competitive market is much higher compared to an oligopoly (which is characterised by a small number of firms/sellers who have a high market share and where there are often significant barriers to entry). A competitive market is generally seen as the market structure that leads to the most efficient allocation of resources. Many sellers are competing for the customers within the market and so aim to sell their products at a competitive (lowest) price because the products they sell are homogeneous. This forces them to constantly seek productivity improvements. They aim to boost technical efficiency (maximising outputs with the available resources).

This market structure operates more efficiently than an oligopoly (which is characterised by a small number of firms/sellers who have a high market share and where there are often significant barriers to entry). With fewer sellers and difficulties for new firms to enter the market, there is less need for these sellers to allocate resources efficiently as the lack of competition means less price competitiveness among the sellers. Firms are able to produce their product without worrying about new firms entering the market and undercutting prices because they are more efficient. Oligopolistic firms may also concentrate on the development of brand loyalty. Resources could be wasted trying to convince consumers to switch from one brand to another. This may lead to higher prices. Concentrated markets also reduce the level of competitiveness, so there may be less incentive for these firms to seek productivity improvements, which would lower prices for consumers.

Question 2c.

Marks	0	1	2	Average
%	63	14	23	0.6

This proved to be a challenging question for a large number of students. Most students seemed to think that government intervention is because of market failure rather than realising that the question asked about why governments intervene to stabilise the level of economic activity.

A possible response could have been:

One of the government's objectives is to reduce fluctuations in the business cycle, aiming to smooth the rate of economic growth in Australia from year to year, thus avoiding the destabilising effects of excessive rates of inflation or cyclical unemployment. For example, if the economy is showing signs of slipping into recession and private sector demand is 'collapsing', then the government may use budgetary policy in a countercyclical way, increasing government spending to avoid the problems associated with the recession such as increasing levels of cyclical unemployment and deteriorating living standards.

Question 2d.

Marks	0	1	2	3	4	5	6	Average
%	12	12	16	21	21	13	6	2.9

Many students found this question challenging. They struggled to select a market (even though examples were listed in the question) and interpret what was meant by an economic factor or free operation. The highest-scoring answers were ones where students had thought through their choice of a market, and where they were then able to discuss an economic factor influencing the operation of the market and comment on the extent to which the market operated freely.

A wide range of markets was selected, including agricultural markets – examples included fruit and vegetables and dairy; a commodity market – examples included iron ore and coal; or retail market – examples included Uber, mobile phones, supermarkets, cars and housing.

The following are examples of possible responses.

Example 1

The new car market: Ford, Holden and Toyota have recently announced that they will cease production of cars in Australia. Factors affecting this market that have led to the closedown of this market have included the relatively high costs of production (a supply factor) such as the relatively high wages paid to workers in Australian car manufacturing compared to other car manufacturing countries, which has negatively influenced the ability and willingness of producers to produce, so the car industry is largely shutting down. This market could be considered to have an oligopolistic market structure and has tended to operate more freely since the reduction in tariffs over recent years. Now Australia's car tariffs are among the lowest in the world. However, because this industry is considered to be such a significant one in the economy, there have been examples of government intervention in recent times such as when the government tried to shore up Toyota to keep them manufacturing in Australia through provision of grants and/or tax concessions.

Example 2

The housing market has experienced significant growth in Australia in recent years. One economic factor influencing this has been steady population growth, mostly due to immigration, increasing the demand for housing relative to the supply of homes and units.

The housing market is a relatively competitive market where there is generally a large number of buyers and sellers. The government has intervened in the market to some degree, though often to stimulate spending and investment in housing with policies; for example, such as negative gearing and the First Home Owner Grant. These government policies have helped to increase demand for housing and hence pushed up house prices.

Question 3a.

Marks	0	1	2	Average
%	22	38	40	1.2

Issues related to taxation reform and change have been discussed over recent years as part of the Australian Government's budgetary policy. While many students answered this question confidently, a number of students seemed to be unaware of reasons why the Australian Government might need to undertake taxation reform.

Any of the following reasons outlined by students scored marks in answer to this question:

- a need to reduce the disincentives associated with increasing numbers of taxpayers moving into higher marginal income tax brackets (bracket creep) and to ensure greater incentives to work and reduce tax-transfer traps
- issues associated with repairing the budget to reduce budget deficits and a need for increased revenue/raise additional revenue as part of a changed tax mix
- issues associated with an ageing population and managing the increased outlays and reduced revenue that this implies
- a need to reduce the company tax in Australia as the relative higher company tax rates in Australia are acting as a barrier to both improving competitiveness of Australian businesses and the discouragement of foreign investors
- reducing the complexity and red tape, which is a disincentive to business and achieving higher levels of efficiency and productivity.

Question 3b.

Marks	0	1	2	3	4	5	6	Average
%	6	9	14	19	20	18	14	3.5

Students generally answered this question well and appeared to have developed a sound understanding of the way income and company tax policies operate. However, there was some confusion around how they might operate to influence aggregate supply, with a number of students discussing how changes to these taxes might influence aggregate demand, which was not a requirement of the question. Another aspect for improvement is that students need to complete all parts of the question, as a number of students did not respond in terms of the influence on the rate of economic growth.

A possible response could have been:

Personal income tax cuts mean workers have higher disposable incomes as they keep more of their wages and salaries. This might be likely to increase the incentive to work, thereby increasing the supply (quantity) of labour resources available for producers to utilise in their production of goods and services, therefore increasing the ability and willingness of producers to supply, raising levels of aggregate supply. As firms have an increased capacity to increase production this is likely to result in stronger rates of economic growth (the increase in the volume of production from one year to the next).

Company tax cuts mean that firms experience a fall in the cost of production. When company taxes are reduced it reduces the firm's expenses and increases after-tax profits. This is a factor that increases the willingness and ability to supply. The firms may also have increased retained earnings with which they can fund new investment. This new capital and technology may allow existing workers to produce more per hour (an increase in productivity). This expands the firm's productive capacity and therefore their willingness and ability to supply. The firm therefore has an increased ability to respond to higher levels of aggregate demand, which means that the rate of increase in the volume of production from one year to the next can potentially increase (increased rate of economic growth).

Question 3c.

Marks	0	1	2	3	4	Average
%	12	8	21	34	26	2.5

Students demonstrated very good knowledge of discretionary budgetary policies announced in the 2016–17 Budget by identifying an example to write about in answer to this question. The most popular policies selected were increased government infrastructure spending and increased spending on a new youth employment package.

When examining the selected policy's influence, students were generally able to make stronger links between the policy and living standards but struggled to make relevant links to long-term economic prosperity.

A possible response could have been:

The government announced in the 2016–17 Budget that it would invest \$840 million in a youth employment package known as Youth Jobs PaTH. This policy is aimed at reducing the high rates of long-term youth unemployment, which is a form of structural unemployment. The policy targets job seekers under the age of 25 and comprises 3 stages that focus on improving the employability skills of these individuals, providing work experience opportunities to enhance practical skills and a range of financial incentives to both employers and job seekers.

By reducing youth unemployment, the government aims to break the cycle of welfare dependency for this vulnerable group, providing scope for greater numbers to earn a factor income, which provides individuals with higher income than that provided through social welfare and unemployment benefits. This creates a larger number of 'productive' citizens with enhanced skills, who it is hoped will enjoy a higher standard of living as earning a factor income should increase access to goods and services. Reducing numbers of citizens dependent on government welfare and increasing the number of workers with skills will enhance long-term economic prosperity by increasing the quality and quantity of labour resources.

Question 3d.

Marks	0	1	2	Average
%	16	23	61	1.5

This question was answered well by students, who showed good current knowledge related to the nature and purpose of monetary policy operation by the Reserve Bank of Australia (RBA) in 2016.

A possible response could have been:

The RBA has reduced the cash rate twice in 2016 (May and August) by 0.25 % points – i.e. from 2% at start of the year to 1.50% currently. This represents a looser/more expansionary monetary policy stance during 2016 as the RBA aimed to bring about downward pressure on the cost of credit in Australia. This has been motivated by clear signs of extremely low inflationary pressures (the inflation rate remains well within the RBA's target range [2–3% increase in CPI over the business cycle] and growth in labour costs continued to be quite subdued as well), prompting the RBA to adopt a much more accommodative stance to support macroeconomic expansion as the economy is operating below full capacity in order to boost the rate of economic growth and improve employment opportunities.

Question 3e.

Marks	0	1	2	3	4	5	6	Average
%	11	8	12	15	22	19	14	3.4

Students demonstrated very sound knowledge of how current budgetary and monetary policies have operated in the policy mix to influence aggregate demand and the rate of economic growth.

The highest-scoring answers described how budgetary and monetary policies operated to influence aggregate demand and the rate of economic growth, and then made clear reference to whether the policies have operated in a conflicting or compatible manner in the policy mix.

A possible response could have been:

Monetary policy (MP) and budgetary policy (BP) have adopted a somewhat different stance in the policy mix in 2016. MP, in adopting an easier/looser/more expansionary stance during 2016, has aimed to support growth in aggregate demand via the transmission mechanisms of cost of credit and cash flow, hoping to stimulate new borrowing and to provide greater levels of discretionary income for households. Also, those people with variable interest rate mortgages can take advantage of lower repayment commitments to reduce their loan repayments and increase their discretionary spending on goods and services. This may lead to an increase in private consumption expenditure, hence increasing aggregate demand. This increase in demand will be noticed by producers, and they will seek to increase production to meet the higher demand. If production increases by a bigger percentage than the year before, rates of economic growth should increase.

While MP has been focusing on immediate and short-term support of demand and macroeconomic variables (the rate of economic and employment growth), BP has focused on intermediate to longer-term economic prosperity of the nation.

The 2016–17 Budget seeks to strengthen Australia’s fiscal position as the economy transitions from the benefits of the past mining boom to a platform of broader-based growth. The government is standing firm on its goal of achieving a return to budget surplus in the next 5 years, with a projected decline in the budget deficit of \$37 billion in 2016–17 to approximately \$6 billion in 2019–20. Therefore, the 2016–17 Budget is considered to be mildly contractionary when compared to the budget outcome of the previous year. This is because the federal government was injecting a smaller level of funds into the economy, relative to leakages collected from taxation and other revenue sources compared to the previous year. This then could be considered to be in conflict with the MP expansionary stance.

However, BP has also targeted a number of areas where BP initiatives aim to generate employment opportunities, increased demand and economic growth such as initiatives to support new ‘start-up’ businesses, tax incentives for the small business sector, export development initiatives, infrastructure spending and the Youth Jobs PaTH program. These aspects of budgetary policy supporting jobs and growth may be considered to be compatible with MP.

Question 4a.

Marks	0	1	2	Average
%	21	45	34	1.2

Students demonstrated a good understanding of factors generally causing unemployment but were less able to answer the requirements of this question, which asked for a factor that might explain an increase in long-term unemployment. Students appeared not to have a clear understanding of what it means to be long-term unemployed. Students with the highest-scoring answers understood

that long-term unemployment is an example of structural unemployment, where closing industries have left workers with skills not required in new and emerging industries.

A possible response could have been:

This increase in long-term unemployment (being unemployed for more than a year) could be a reflection of the changing structure of the economy (some industries closing down) and/or the changing nature of workplaces (the use of new technologies). For example, the restructuring of the Australian economy currently is seeing the closedown of car manufacturing in Australia. As the structure of the economy changes there is an increase in structural unemployment as existing car manufacturing skills become unnecessary or redundant. These structurally unemployed individuals lack the skills required to gain a new job, and without re-training this has led to more individuals becoming long-term unemployed.

Question 4b.

Marks	0	1	2	3	4	Average
%	3	9	21	36	31	2.8

While this question was answered quite well, some students struggled to make the links between long-term unemployment and equity and living standards, and instead made the links between unemployment and equity and living standards, thereby not explicitly answering the question.

When answering this question, most students found it easier to link long-term unemployment to living standards rather than equity. Students with high-scoring answers gave a definition for equity, and this assisted them in structuring their answer.

A possible response could have been:

The long-term unemployed – i.e. those out of work for over 12 months – receive less income on unemployment benefits relative to those on factor or market incomes. Therefore, less income is distributed to the long-term unemployed, relative to those who are more skilled and able to command higher factor incomes through employment. This will worsen the equity in the distribution of income as the long-term unemployed would have less income than they would have had if and when they were employed.

Due to decreased income and reduced savings, the long-term unemployed suffer from a decline in living standards as they have less access to goods and services (material living standards) and they suffer anxiety, mortgage stress and possible mortgage default due to their decreased income (non-material living standards). Increased rates of depression, social alienation, drug abuse and violence may also reduce the quality of life (non-material living standards).

Question 4c.

Marks	0	1	2	3	4	5	6	Average
%	9	8	13	19	21	17	14	3.4

A number of students were unclear about the labour force participation rate (LFPR) and were therefore unable to select an appropriate policy, tending to think that any policy that would address unemployment would be suitable in increasing the labour force participation rate. Students who appreciated that long-term unemployment was a form of structural unemployment were able to score high marks, understanding that re-training was a way to fight long-term unemployment and structural unemployment.

A possible response could have been:

A budgetary policy to increase the labour force participation rate might be to increase subsidies for child care. This will make it easier for working parents to return to the workforce. These subsidies reduce the cost of child care and will encourage mothers or fathers to return to work as there is an incentive to do so (cheaper child care). Prior to increasing these subsidies, the high cost of child care may have acted as a disincentive for a parent to return to work.

The long-term unemployed often do not have the skills or experience necessary to fill the jobs that are available. A budgetary policy to lower the rate of long-term unemployment could see the government in its budget increase funding for re-training and skills development. Providing access to re-training programs equips long-term unemployed persons with skills currently in demand. This will likely increase their chances of being employed. Programs such as the 2016–17 Youth Jobs PaTH program support the long-term unemployed to learn skills, be provided with an internship placement and provides incentives (wage subsidies) to firms who employ them. These sorts of programs are designed to support persons who are long-term unemployed to join the workforce and become gainfully employed.