

Student Name:



2023 VCE ECONOMICS UNITS 3 and 4

Practice Examination - B

Solutions

Structure of book

| <i>Section</i> | <i>Number of questions to be answered</i> | <i>Number of marks</i> |
|----------------|---|------------------------|
| A | 15 | 15 |
| B | 3 | 65 |
| | TOTAL: | 80 |

- Students are permitted to bring into the SAC room: pens, pencils, highlighters, erasers, sharpeners, rulers and one scientific calculator.
- Students are NOT permitted to bring into the SAC room: blank sheets of paper and/or white out liquid/tape.

Materials supplied

- Question and Answer Book of 22 pages.

Instructions

- Write your name and your teacher's name in the space provided on the front page of this Question and Answer Book.
- Answer all questions in the spaces provided.

Students are not permitted to bring mobile phones and/or any other unauthorized electronic devices into the SAC room.

Section A – Multiple Choice Questions

Question 1

Which one of the following may cause the unemployment rate to rise?

- A. free TAFE courses to address the issue of skills shortages.
- B. opening more universities across Australia
- C. an increase in the labour force participation rate**
- D. delivering favourable Terms of Trade over two consecutive years

Question 2

During the summer months, it is likely that in a purely competitive market the price of ski equipment would

- A. increase and the quantity of ski equipment sold would increase.
- B. decrease and the quantity of ski equipment sold would decrease.**
- C. increase and the quantity of ski equipment sold would decrease.
- D. decrease and the quantity of ski equipment sold would increase.

Question 3

Based on the assumptions given **below**, which of the following statements would be most correct in relation to the value of the Australian dollar (AUD)?

- i. The global economy is getting weaker.
 - ii. Domestic spending is getting stronger.
 - iii. Australia delivers a large trade deficit; imports exceed exports.
-
- A. The value of the Australian dollar is likely to decrease as the weakening global economy reduces demand for the currency, making it less attractive to investors.
 - B. The value of the Australian dollar is likely to increase as stronger domestic spending indicates a robust economy, attracting foreign investors and driving up demand for the currency.
 - C. The value of the Australian dollar is likely to decrease as the large trade deficit, where imports exceed exports, puts pressure on the currency's value, making it less desirable for international trade.
 - D. The value of the Australian dollar is difficult to determine despite the given assumptions, as the interplay between the weakening global economy, stronger domestic spending, and large trade deficit may create a balancing effect on the currency's value.**

Question 4

What is the impact of an economic expansion on government revenues and expenditure?

- A. Both progressive taxation receipts and unemployment benefit payments increase.
- B. Both progressive taxation receipts and unemployment benefit payments decrease.
- C. Progressive taxation receipts decrease, and unemployment benefit payments increase.
- D. Progressive taxation receipts increase, and unemployment benefit payments decrease.**

Question 5

| Quarter | CPI |
|----------------|-----|
| March 2022 | 110 |
| June 2022 | 111 |
| September 2022 | 112 |
| December 2022 | 115 |
| March 2023 | 118 |
| June 2023 | 120 |

Consider the above data showing the Consumer Price Index (CPI) for a number of quarters in a hypothetical economy. The inflation rate for the year ended June 2023 is

- A. 9.1 %
- B. 8.1%**
- C. 4.3%
- D. 1.7%

Question 6

Which of the following is an example of an opportunity cost of choosing to invest in renewable energy infrastructure instead of expanding traditional coal-fired power plants, as part of a recent government initiative in Australia?

- A. Decreased reliance on fossil fuels and reduced carbon emissions.
- B. Potential job losses in the coal mining industry.**
- C. Increased investment in research and development of clean energy technologies.
- D. Higher electricity prices for consumers due to the initial costs of renewable energy infrastructure.

Question 7

Despite the movement towards renewable energy, Australia still relies heavily on coal - which many see as a source of energy that is polluting and a major contributor to climate change. This might result in:

- A. A decrease in dynamic efficiency
- B. A decrease in intertemporal efficiency**
- C. A decrease in allocative efficiency
- D. An increase in technical efficiency

Question 8

The most likely effect of an increase in commodity prices would be:

- A. a favourable movement in Australia's terms of trade and a depreciation of the Australian dollar.
- B. a favourable movement in Australia's terms of trade and an appreciation of the Australian dollar.**
- C. an unfavourable movement in Australia's terms of trade and a depreciation of the Australian dollar.
- D. an unfavourable movement in Australia's terms of trade and an appreciation of the Australian dollar.

Question 9

Which of the following options accurately describes the situation when Australia's foreign equity assets surpass its foreign equity liabilities?

- A. Australia has made lower investments overseas compared to the investments made by foreigners in Australia.
- B. Australia has made higher investments overseas compared to the investments made by foreigners in Australia.**
- C. The Australian Government has increased its overseas borrowings to finance budget deficits.
- D. The Australian Government has reduced its overseas borrowings to finance budget deficits.

Question 10

The opportunity cost of producing 40 units of capital goods at point D is :



- A. 100 consumer goods
- B. 70 consumer goods
- C. 40 consumer goods
- D. 30 consumer goods**

Question 11

If an economy produces its most wanted goods but uses outdated production methods, it is:

- A. achieving productive efficiency, but not allocative efficiency.
- B. achieving allocative efficiency, but not productive efficiency.
- C. achieving both productive and allocative efficiency.
- D. achieving neither productive nor allocative efficiency**

Question 12

If the supply of a product decreases and the demand for that product simultaneously increases, then equilibrium:

- A. price must rise, but equilibrium quantity may rise, fall, or remain unchanged.**
- B. price must rise and equilibrium quantity must fall.
- C. price and equilibrium quantity must both increase.
- D. price and equilibrium quantity must both decline.

Question 13

A hypothetical economy has moved from a Current Account Deficit to a Current Account Surplus.

Which of the following is most likely to explain this?

- A. A decrease in net savings and depreciation of the currency
- B. A decrease in the price of imports and depreciation of the currency**
- C. An increase in export prices and an increase in debt servicing costs
- D. An increase in business investment and a decrease in portfolio investment

Question 14

Migrant workers in Australia often send money back to their families overseas.

How is this recorded in Australia's Current Account?

- A. Primary Income debit
- B. Primary Income credit**
- C. Secondary Income debit
- D. Secondary Income credit

Question 15

What is the most likely impact of a rise in the level of Australia's interest rates relative to overseas interest rates?

- A. An increase in foreign investment in Australia and a depreciation of the AUD
- B. An increase in foreign investment in Australia and an appreciation of the AUD**
- C. A decrease in foreign investment in Australia and a depreciation of the AUD
- D. A decrease in foreign investment in Australia and an appreciation of the AUD

Section B – Written Responses

Question 1 (13 marks)

Australia's financial books are on track to record a far higher than expected budget surplus of around \$19 billion, Department of Finance figures show.

... "The fact that we've turned a \$78 billion deficit that was forecast under the Liberal National Party government just over a year ago into a surplus that's in excess of \$4 billion is a positive thing," Mr Albanese said. "I believe that Australian families will look at the federal budget and say it is good that we have a government that is putting in place responsible budget management in order to put that downward pressure on inflation." But Opposition leader Peter Dutton says the federal government cannot "credibly take credit" for what could be the largest budget surplus ever delivered.

Source:

<https://www.sbs.com.au/news/article/what-the-19-billion-budget-surplus-could-buy/wy7ynbf0y>

- a. Distinguish between a budget deficit and a budget surplus.

3 marks

Marking guide:

1 mark for a clear point of difference / distinguishing feature

1 mark for a clear understanding of a budget deficit, including what the distinguishing feature looks like in the context of a budget deficit.

1 mark for a clear understanding of a budget surplus, including what the distinguishing feature looks like in the context of a budget surplus.

Sample response:

A key distinguishing feature between the two budget outcomes is the impact they have on the economy. A budget deficit is a situation where government expenditure, such as spending on health and welfare payments, is greater than government revenues such as personal income tax receipts. This means injections into the economy are greater than leakages, stimulating levels of economic activity. Whereas, a budget surplus is a situation where government revenues exceed government expenditure, and this tends to restrict levels of economic activity.

Other possible points of difference include what stance they align with or alternatively the impact they might have on levels of government debt.

- b. Outline two ways that the government can utilise the budget surplus mentioned in the article above.

4 marks

Marking guide:

1 mark for identifying a use and providing a brief outline.

2 marks for identifying a use and providing a detailed outline. **X 2**

Sample response:

A budget surplus results from government revenue exceeding government expenditure, and the excess can be used in several ways. The first use would be for the government to utilise the additional funds available to pay down government of public debt, which currently stands at approximately \$500 billion. This would assist in reducing the interest that government have to

pay on the debt, freeing up funds for the provision of essential goods and services, as well as stabilising levels of government debt protecting the nations AAA credit rating. Another use, would be to reinvest the excess funds into the nation's Future Fund, further allowing the government to invest in Australia's future generations with a particularly focus on providing for unfunded superannuation liabilities in the future that will place real pressure on the government's finances due to the nation's ageing population.

- c. Explain how one automatic and one discretionary stabiliser might have led to a higher-than-predicted budget surplus over the last 12 months. 6 marks

Marking guide:

1 mark for displaying an understanding of automatic stabilisers (usually provided through the accurate use of a definition)

1 mark for displaying a general understanding of the link between automatic stabilisers and the budget outcome.

1 mark for explanation of how one automatic stabiliser (e.g., personal income tax or corporate tax or welfare payments in the form of JobSeeker) will contribute to the budget surplus (assessor encouraged to look through the lens of the contemporary environment)

1 mark for displaying an understanding of discretionary stabilisers (usually provided through the accurate use of a definition)

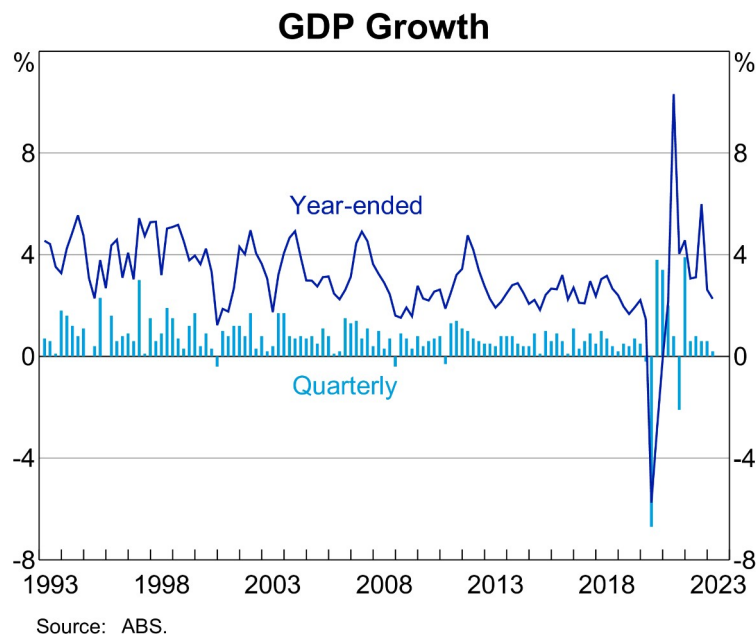
1 mark for displaying a general understanding of the link between discretionary stabilisers and the budget outcome.

1 mark for explanation of how one discretionary stabiliser, which must provide detail of an actual policy, and how this will contribute to the budget surplus (assessor encouraged to look through the lens of the contemporary environment)

Sample response:

The Federal Budget is made up on a cyclical component (resulting from automatic stabilisers) and a structural component (resulting from discretionary stabilisers) as the government endeavours to stabilise the fluctuations in the business cycle. An automatic stabiliser is a component of the Federal Budget such as income tax receipts or welfare payments, that are automatically activated through changes in the business cycle, and therefore influenced by changes in economic activity. For example, over the last 12 months unemployment has remained low due to strong levels of economic activity and shortages of labour in the labour market, this has resulted in strong personal income tax receipts by the Federal government boosting revenues, increasing the budget surplus to an amount that is larger than expected. A discretionary stabiliser is a component of the Federal Budget that is the result of a deliberate change made by the treasurer, Dr Jim Chalmers, that will impact revenues or expenditure or both, of the government. For example, in the October 2022 Budget the government announced the creation of a special "spending audit branch" to be created in the Finance Department that would investigate unnecessary spending by government. Over the last 12 months this initiative has identified and reduced spending on infrastructure projects deemed unnecessary, the savings have contributed to a larger than expected budget surplus with downward pressure exerted on government expenditure.

Question 2 (7 marks)



Source: RBA Chart pack: Released on 5 July 2023 (data updated to 29 June 2023)

- a. In reference to the trend in the GDP Growth Graph above, assess the extent to which the Australian government has achieved its domestic macroeconomic goal of strong and sustainable economic growth over the last two years. 3 marks

Marking guide:

1 mark for a reference to the **trend**

1 mark for defining the goal of strong and sustainable economic growth.

2 marks for a high-level logical assessment (must include reference to both strong and sustainable)

Sample response:

Over the last two years, economic growth initially rose well above 4%, however, the overall trend has been downward, with growth now sitting below 3%. As a result, the goal of strong economic growth has not been achieved, as the current rate is not consistent with strong employment growth and the achievement of full employment which would indicate that whilst unemployment is low currently it will increase into the future. Early in the two-year period, the upward trend will have contributed to inflationary pressures negatively impacting on the sustainability of the growth, however, the recent downward trend has seen those pressures ease.

- b. Analyse how one aggregate supply policy might have complemented aggregate demand policies in promoting non-inflationary economic growth over the last two years.

4 marks

Marking guide:

1 mark for identifying and providing the nature of an aggregate supply policy (this can include skilled migration)

1 mark for providing a basic analysis of how the policy will have operated to impact on the productive capacity and supply side of the economy.

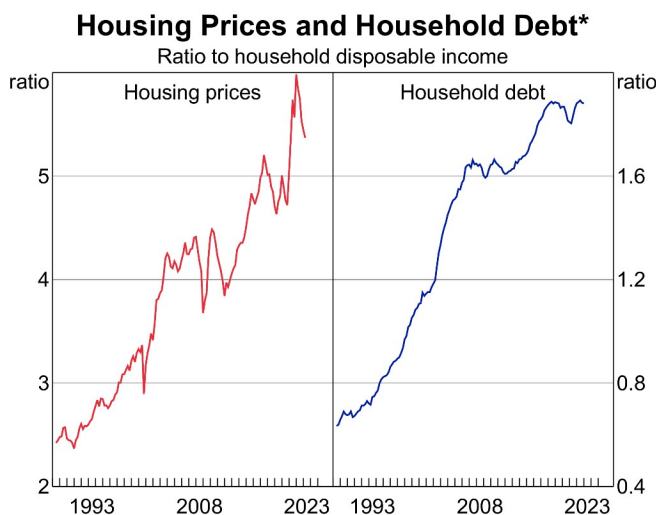
1 mark for provided added detail in the analysis of the operation of the policy.

1 mark for linking the operation of the policy to reducing demand inflationary pressures by increasing the gap between economic activity and the productive capacity of the economy and reducing capacity constraints in the economy, whilst achieving strong economic growth.

Sample response:

The recent re-opening of borders after CoVid and the increase in the net overseas migration by the Federal Government will lead to an increase in the number of skilled migrants coming to Australia boosting the availability of quality labour resources and addressing the current labour shortages that exist in the labour market. By addressing the capacity constraint that exist, particularly in the form of skill shortages, this will boost the productive capacity of the economy and producers' ability to increase the in the volume of production whilst at the same time reduce cost inflationary pressures through reducing upward pressure on a key cost of production wages allowing producers to offer lower prices without having to reduce their profits. In addition, the boost to the productive capacity of the economy enables a greater absorption of any increase in aggregate demand without creating demand inflationary pressures as the capacity utilisation reduces. Both contributing to an increase in strong economic growth that creates jobs, however, without creating inflationary pressures due to rising costs or reduced spare capacity in the Australian economy.

Question 3 (22 marks)



* Household disposable income is after tax, before the deduction of interest payments, and includes income of unincorporated enterprises.

Sources: ABS; CoreLogic; RBA. Released on 5 July 2023 (data updated to 29 June 2023)

- a. Explain how one demand and one supply factor might have caused the change in housing prices over the last two years.

5 marks

Marking guide:

1 mark for identifying and providing a basic explanation of a micro-economic demand side factor.

1 mark for providing detail to the explanation.

1 mark for identifying and providing a basic explanation of a micro-economic supply side factor.

1 mark for providing detail to the explanation.

1 mark for the link of both to the price of houses.

Sample response:

Over the last two years, the housing market has experienced a decline in prices, and this can be attributed to both demand and supply factors.

One demand factor that might have caused the decreasing trend in house prices is the steady increase in interest rates. When interest rates rise, it becomes more expensive for individuals to borrow money to finance the purchase of their homes. As a result, potential homebuyers may be discouraged from entering the housing market or need to settle for smaller and more affordable properties. Higher interest rates lead to increased borrowing costs for mortgages, making monthly mortgage payments less affordable for many buyers. The decrease in housing demand caused by higher interest rates can result in reduced competition among buyers, leading to a decline in overall demand for housing. As demand weakens, sellers may have to lower their asking prices to attract buyers and close sales. Consequently, this decrease in demand can contribute to the downward pressure on housing prices over the last two years.

One supply factor that might have caused house prices to fall could be improvements in global factors, such as easing of shortages in supplies needed for construction has started reducing the pressure on the cost of construction. In addition to a decrease in demand for housing reduction in the cost of construction might have caused a decline in house prices.

- b. Explain whether the supply of a house is likely to be price elastic or price inelastic.

3 marks

Marking guide:

1 mark for a demonstrating an understanding of price elasticity of supply.

1 mark for explain what factor(s) might influence the level of elasticity including a display of understanding of what is meant by elastic and inelastic.

1 mark for the link between elastic and the level of elasticity in the housing market.

Sample response:

The price elasticity of supply measures the responsiveness of the quantity supplied in a market to changes in price. There are several factors that influence producers' ability to respond to price changes including the production period in the market as this dictate whether producers can easily increase their production levels or supply when the price in that market changes. If

the production period is short, then producers can easily increase the quantity supplied even when there is a small change in price making supply elastic, however, if the production period is long then it does not matter what happens to the price, the quantity supplied will not change making supply inelastic. As it takes an extended period to build a house, this would lead to the supply of houses being inelastic, as construction companies cannot increase the quantity of houses supplied quickly, when prices change.

- c. Considering the monetary policy stance over the last 12 months, explain how the monetary policy decision may have influenced the housing market. Draw and label a demand and supply diagram to illustrate your explanation. 4 marks

Marking guide:

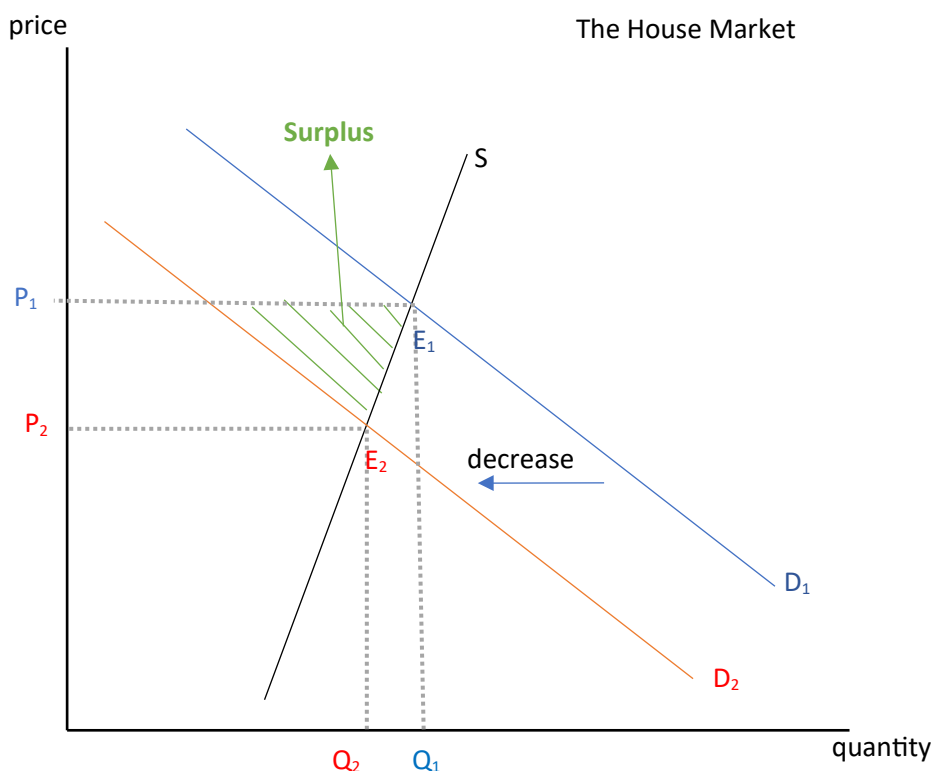
1 mark for correctly labelling the x and y axis correctly including Price, P_1 to P_2 , Quantity Q_1 to Q_2
 1 mark for correctly drawing and labelling the demand and supply curves, including reference to D_1 to D_2 , S , E_1 to E_2 along with dotted lines to the axis.

1 mark for a basic explanation of how the increase in interest rates influences the market with forces of supply and demand interacting.

1 mark for provided the detail in the explanation, for example, including references to how a surplus in the housing market would form, leading to downward pressure on prices to clear the market.

Sample response:

Over the last 12 months, the RBA has increased the cash rate on 12 occasions which has been passed onto the market by the banks in full, increasing interest rates. This increase in the interest rate will have reduced the demand for houses, shifting the demand curve to the left (D_1 to D_2), as borrowing to purchase a house has increased significantly reducing the affordability of buying a new house. In the event, the price of houses remained the same a surplus will form in the market placing downward pressure on the price of houses, to clear the excess stock in the market. This will cause supply to contract along the supply curve, as a new equilibrium will have formed at E_2 , with a lower price (P_2) and quantity (Q_2).



- d. Using one monetary policy transmission mechanism, explain the impact of recent monetary policy decisions on Australia's living standards and the achievement of strong and sustainable economic growth. 4 marks

Marking guide:

- 1 mark for explanation of what the transmission mechanism is.
- 1 mark for explanation of how the transmission mechanism operates to impact on AD.
- 1 mark for the link to living standards.
- 1 mark for the link to strong and sustainable economic growth

Sample response:

The recent increase in cash rate and resulting increase in market interest rates offered by the commercial banks. As a result, aggregate demand will be impacted via the cash flow transmission mechanism, as households with variable rate mortgages experience a significant increase in the interest rate on their loans, and this proportion of the housing loan market will grow as an increasing number come off fixed rate arrangements and revert to a variable rate. This leads to a larger proportion of household disposable incomes being required to service household's mortgages, leaving less for discretionary spending, and resulting in a decrease in private consumption expenditure, as consumers choose to eat at home instead of going out, and continue to wear old clothing instead of buying new clothing. This places downward pressure on aggregate demand, leading to producers reducing the level of production to avoid developing a surplus in inventory which reduces levels of economic activity, pushing economic growth below the 3 to 3.5% range that is consistent with employment growth, however, making it more sustainable due to less depletion of natural resources and degradation of the natural environment. The larger proportion of income required to pay the mortgage, reduces households access to goods and services, reducing their material living standards, and the reduction in economic activity increases the unemployment rate further reducing households access to goods and services, and potential creating financial stresses for consumers reducing their non-material living standards.

- e. Considering the RBA's monetary policy stance over the last 12 months, discuss one strength and one weakness of monetary policy influencing one domestic macroeconomic goal and Australian living standards. 6 marks

Marking guide:

- 1 mark for explain the current monetary policy stance.
- 1 mark for defining the selected goal.
- 1 mark for identifying a strength and discussing the detail of the strength.
- 1 mark for discussion of how the strength enhances the goal and Australia's living standards.
- 1 mark for identifying a weakness and discussing the detail of the weakness.
- 1 mark for discussion of how weakness constrains or restricts the achievement of the goal and Australia's living standards.

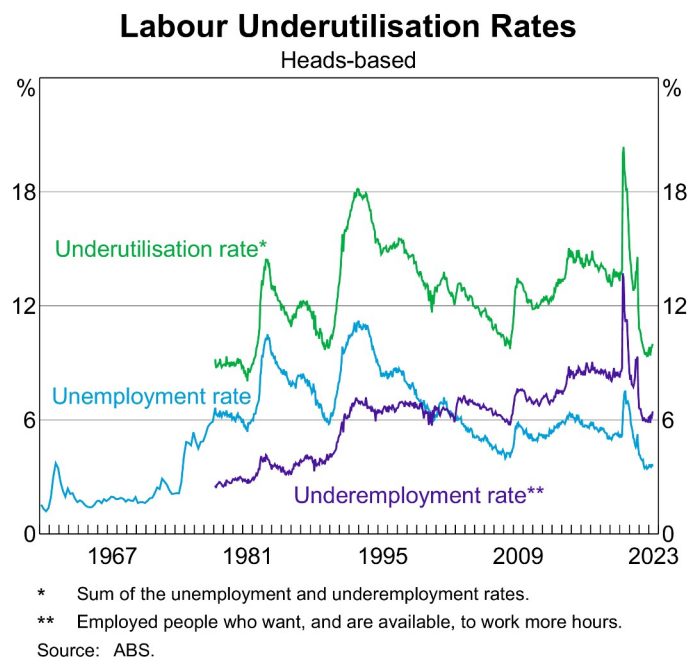
Sample response:

Over the last 12 months, the RBA has tightened monetary policy by increasing the cash rate 12 times, and as a result they have adopted a contractionary or restrictive stance as the cash rate has increased above the rate of monetary policy neutrality of 3.5% in an effort to place downward pressure on aggregate demand and achieve the goal of low and stable inflation, that is a headline inflation of 2 to 3% over the medium term.

One strength of Monetary Policy is what is referred to as the implementation lag. The RBA meet monthly, 11 times a year, analysing various economic indicators to determine levels of national spending and confidence, labour market conditions, international developments, underlying inflation and also to consider the impact on the economy of budgetary policy. Meeting on a regular basis ensures that any tightening or loosening in monetary policy will be very responsive to current economic conditions and enable monetary policy settings to be adjusted to control aggregate demand and the flow on impacts to demand inflationary pressures in the economy. By enhancing the ability to control inflation, this will reduce any negative impacts on living standards such as the erosion of consumers purchasing power or job losses that might result in the event the Australian economy experiences a decline in its international competitiveness.

A weakness of monetary policy is the impact lag, whilst the RBA meets monthly, it is generally accepted that any change in the cash rate takes approximately 18 months to have an effect on the economy as adjustments to spending are delayed with consumers going through extended loan approval processes to borrow money. As a result, by the time the adjustment to the cash rate impacts the economy it could act pro-cyclically, and in the current climate this could be when the economy has already entered a downturn which will further reduce aggregate demand potentially creating a deflationary environment with inflation becoming negative. The lower levels of aggregate demand will flow to low production levels, fewer jobs and a reduction in living standards restricting monetary policy's ability to have a positive impact on living standards and the achievement of the goal.

Question 4 (9 marks)



- a. Distinguish between the terms unemployment and underemployment. 3 marks

Marking guide:

1 mark for a clear point of difference / distinguishing feature

1 mark for a clear understanding of unemployment, including what the distinguishing feature looks like in the context of unemployment.

1 mark for a clear understanding of underemployment, including what the distinguishing feature looks like in the context of underemployment.

Sample response:

The key points of difference between the two terms is what is included in the concepts. Unemployment refers to a situation where there are individuals without jobs, however, they are actively seeking employment and, in a position, to commence work should they be offered a job. Whereas underemployment refers to a situation where there are individuals who are employed as they are receiving a level of remuneration for working 1 or more hours a week, however they would like more hours of work.

- b. In reference to the graph above, assess the extent to which Australia's goal of full employment has been achieved over the last two years.

3 marks

Marking guide:

1 mark for a clear reference to the graph.

1 mark for defining the goal of full employment.

1 mark for the assessment, a straight yes or no analysis should not be awarded the mark, it must be “the extent to which”.

Sample response:

The goal of full employment is the level of unemployment that exists when the government’s economic growth goal is achieved and where cyclical unemployment is non-existent, generally accepted to be 4 to 4.5% non-accelerating inflationary rate of unemployment (N.A.I.R.U.). Over the last two years the unemployment rate has progressed below 4%, where is currently sits at 3.6%. This is a positive development for workers, however, in the context of the goal it has prevented the government from achieving its goal as the rate has led to labour shortages, creating inflationary pressures in the economy meaning that it is not at a NAIRU.

- c. Outline one aggregate demand or one aggregate supply factor that might have contributed to the above trend in Australia’s unemployment rate over the last two years. 3 marks

Marking guide:

1 mark for the outline of the AD factor (must be accurate to contemporary)

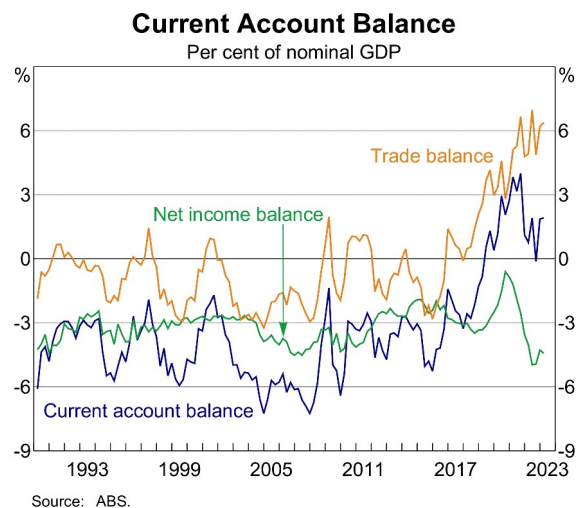
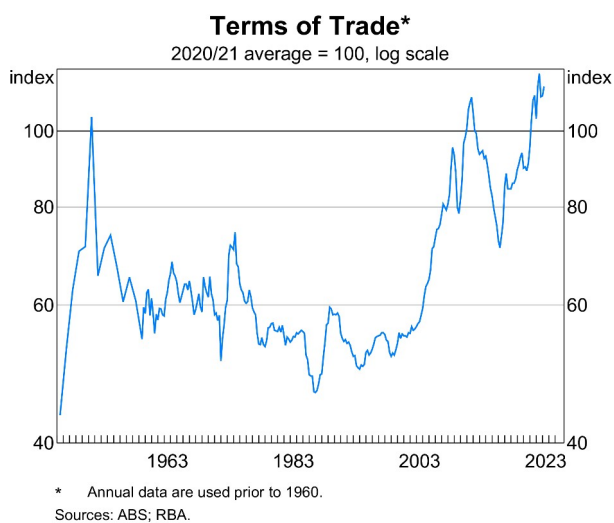
1 mark for the outline of the AS factor (must be accurate to contemporary)

1 mark for the link to the unemployment rate

Sample response:

One aggregate demand factor that might have contributed to the downward trend of unemployment is rebounds in levels of economic growth in the economies of our major trading partners, leading to an increase in demand for Australian exports boosting aggregate demand. One aggregate supply factor that might have contributed to the downward trend of unemployment is increase in access to skill labour with the borders reopening after the worse of the CoVid pandemic. The increase in aggregate demand will have producers responding by increasing production, boosting economic activity, and increasing derived demand for labour reducing unemployment and the increased in aggregate supply will have resulted in producers being more willing to increase production, again increasing the need for workers. Both reducing the unemployment rate.

Question 5 (8 marks)



- a. In reference to the graphs above, explain the relationship between the trends in Australia's terms of trade and the current account balance over the last two years. 4 marks

Marking guide:

- 1 mark for referencing the graphs.
- 1 mark for explaining the terms of trade.
- 1 mark for explain the current account.
- 1 mark for the link between the two

Sample response:

The Terms of Trade is a measure that compares export prices relative to import prices. The Current Account is a record or summary of transactions between Australia and the rest of the world that are current in nature and is made up of four subaccounts. The Balance of Goods and Services, Net Services, Net Primary Income and Net Secondary Income. Funds flowing into Australia are recorded as a credit to one of these subaccounts and funds flow out of Australia are recorded as a debit. The Terms of Trade graph indicates there has been a favourable movement ToT, and in the context of the Australian economy this is due to a rise in commodity prices, key exports. This will have resulted in an increase in credits to the Balance of Merchandise Trade sub account in the Current Account, contributing to a trade surplus and the Current Account Surplus as evidenced by the respective lines in the graph relating to the Current Account Balance.

- b. Analyse how the trend in Australia's terms of trade might affect Australia's domestic macroeconomic goal of low inflation, and Australia's living standards. 4 marks

Marking guide:

- 1 mark for correctly identifying the trend in the terms of trade as upward or favourable.
- 1 mark for explaining how the trend impacts on the Australian economy via national income.
- 1 mark for the link to the goal of low inflation

1 mark for the link to living standards via the consequences of high inflation.

Sample response:

The favourable movement in the Terms of Trade is the result of rising commodity prices in the form of iron ore, coal and natural gas. This is likely to have contributed to an increase in national income, in the form of disposable income and corporate profits in the Australian economy, particularly in the mining sector. As a result, households will have increased spending on discretionary items such as eating out and new clothing boosting levels of private consumption expenditure and also an increase in spending on capital equipment by producers funded by retained profits, boosting private investment expenditure. Both contributing to an increase in aggregate demand, with producers responding by increasing levels of production, boosting economic activity and moving the economy closer to its productive capacity, creating demand inflationary pressures and moving the headline inflation rate above the 2-3% rate over the medium term that is low and stable inflation. This will erode household purchasing power, reducing their access to goods and services, reducing material living standards.

Question 6 (6 marks)

A packet of 25 cigarettes will cost nearly \$50 after Labor announced the excise on tobacco products would be increased by 5 per cent a year over the next three years.

Source:

<https://www.afr.com/politics/federal/smokers-hit-with-3-3b-tobacco-tax-increase-20230502-p5d4vb>

- a. In relation to the concept of market failure, explain why the Australian government has increased the excise tax on cigarettes. 3 marks

Marking guide:

1 mark for the link to a type of market failure, including reference to the inefficient allocation of resources.

1 mark for reference to government intervention in market failure

1 mark for explanation how the intervention corrects the market failure or inefficient allocation of resources.

Sample response:

Smoking is considered to be an example of a market failure in the form of a negative externality in consumption. Left up to an unregulated market, individuals will over-allocate resources toward the consumption of cigarettes that impose a social cost on a third party in the form of passive smoking. The government intervention in the market by imposing an excise duty to incentivise a change in behaviour by imposing a cost on the origins of the negative externality. The government increases the excise duty in order to encourage smokers to quit smoking, ultimately addressing the over-allocation of resources to the activity, addressing the inefficient allocation of resources that is the market failure.

...the way tobacco products were taxed may be linked with higher e-cigarette use among young people, “We found that higher tobacco taxes were associated with higher levels of youth vaping,” Dr Chan said. This could suggest that young people in countries with a higher tobacco tax might be substituting traditional cigarettes with e-cigarettes.

Source <https://shorturl.at/fmCLZ>

- b. With reference to the information given above, analyse how the government intervention in the tobacco products market resulted in the inefficient allocation of resources. 3 marks

Marking guide:

1 mark for a reference to the information

1 mark for analysis on the intervention of the government.

1 mark for the link to the inefficiency / unintended consequence

Sample response:

Dr Chan has identified that “higher tobacco taxes were associated with higher levels of your vaping”, which is an unintended consequence of the government. Governments

around the world have been using indirect taxes to influence a change in behaviour amongst their citizens, with a view to reducing the instances of smoking and the associated negative impact such as passive smoker by their parties and the negative health impact of smoking. Whilst the action has reduced the amount of smoking amongst the younger members of the population, the availability of untaxed e-cigarettes has led to the youth turning to them as substitutes rather than avoiding smoking altogether creating an inefficient allocation of resources due to the negative health effects that are emerging from e-cigarette use.