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# The Limits of Markets

## Multiple Choice Answers

1	C	6	B	11	A
2	A	7	B	12	C
3	D	8	B	13	D
4	A	9	A	14	B
5	B	10	B	15	A

## Short Answer Questions

### Question 1

- (a) Public goods are goods which are non-rival and non-excludable, e.g. a lighthouse. Merit goods are goods which have a greater benefit to society as a whole than to the individual, and so tend to be undervalued in price. Merit goods include public transport and health care.
- (b) Public transport is a rival good, since people will take up seats or standing space, preventing others from the use of the good. Public transport is also excludable, since the provider can require that users purchase tickets and exclude those who do not. Public transport would be more properly considered as a merit good.
- (c) A correct answer to this question may include any one of the following:
- Monopolisation may occur when a dominant firm uses its market power to lower prices with the intention of eliminating competition to gain a monopoly position
  - Price discrimination may occur when firms sell the same product in different markets at different prices to maximise their profits
  - Exclusive dealing may occur when firms force their customers to exclude any deals with their competitors, with the aims of depriving their competitors of business
  - Collusion and market sharing arrangements may occur when firms (usually in an oligopoly) decide to set the same selling price to maximise profit and remove the ability for consumers to select products based on price.
- (d) The government may outlaw restrictive trade practices to prevent firms from abusing market power. Firms which engage in restrictive trade practices may be severely fined. This has been achieved by the Trade Practices Act 1974 (Cth). The government has also established the Australian Competition and Consumer Commission (ACCC) as part of its National Competition Policy with the role of monitoring firms. The ACCC must also give approval before any large mergers between companies occurs and will take into account the risk of a loss of competition.

**Question 2**

- (a) A price ceiling
- (b) As the maximum price ( $P_{\max}$ ) set by the government is below the market equilibrium price ( $P_E$ ), demand exceeds supply, resulting in a shortage of supply (or excess of demand) in the market.
- (c) Consumers typically do not demand pharmaceutical drugs based on price, but based on medical need. To ensure that those who need pharmaceuticals are able to afford them at a reasonable price, the government may impose a price ceiling to control the price level.
- (d) Without adequate regulation, firms will be able to exploit their market power and charge higher prices to maximise their profits. This is especially true if the product is demand inelastic, since firms will be able to raise their prices, which will cause a less than proportionate decrease in quantity, raising total revenue.
- (e) The government may directly provide merit goods in the economy, particularly when the market would produce merit goods at a high cost. The government can then lower the price to encourage the use of merit goods in the economy. Examples include hospitals and museums. The government may indirectly increase production of merit goods by providing subsidies to producers, which reduces the cost of production, allowing the producers to increase their output. Examples include private schools and toll roads.

**Question 3**

- (a) Positive externalities are the beneficial unintended consequences of consumption or production which is not reflected in the market-determined price. For example, a firm which benefits from an employee's previous training by another company.
- (b) Absolute poverty describes those individuals on an income which barely provides the essential needs for survival, which is considered to be less than \$US1 per day. Whereas relative poverty refers to those whose living standards are very low in relation to the average population in the economy.
- (c) The government uses a progressive income tax system which taxes higher income earners at a higher rate than lower income earners. The government then uses this tax revenue to fund welfare payments to lower income earners.
- (d) Without the government's economic stabilisation policies, the economy would be susceptible to the significant fluctuations of the business cycle. During times of economic growth, the economy will grow too quickly, with demand outpacing supply, leading to higher prices in the economy – known as inflation. When the economy enters into a recession, incomes will fall, and without government intervention to provide a minimum standard of living (through welfare payments), income levels will fall sharply, causing a severe recession. The recession is likely to be prolonged without government intervention to inject income into the economy and boost economic growth.