

How Economies Operate

2

Multiple Choice

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

Short Answers

Question 1

- Rent on natural resources, wages for labour, interest on capital, profits for enterprise.
- Capital is a broad economic term that refers to assets or manufactured goods that are used in the production of other goods and services. For this reason, capital is often referred to as the 'produced means of production'.
- Entrepreneurs play a vital role in the production process because they are responsible for organising the other factors of production (natural resources, labour and capital) to produce goods and services. Entrepreneurs make the management decisions concerning all aspects of production and private businesses are responsible for most activity in an economy.
- The main limitation associated with income distribution in a market economy is the potential for unfairness or inequity as only persons who contribute to the production process are rewarded with income. This means that those unable to contribute due to illness, age or disability will not receive any income, whilst those in a weak bargaining position (such as low skilled workers) may also be unable to secure a fair return for their labour input.
- The problem of scarcity applies to all resources in an economy. For natural resources such as land, water and fossil fuels, there are limits to the amount available for production as often these resources are often finite and non-renewable. For labour, the supply can be limited by population size, labour market skills, people's willingness to work and the age structure of the population. The supply of capital is limited by the private sector's willingness to invest and the level of national savings in the economy. Finally, the supply of entrepreneurs is limited by the size of the population and the willingness of people to take risks.

Question 2

- (a). A recession is a period of downturn in economic activity that is characterised by falling production, falling incomes and rising unemployment. It is usually measured as two consecutive quarters of negative economic growth.
- (b). An individual's wage can be determined by their skills and experience, with higher skilled and more experienced workers generally enjoying higher wages. Another factor is the industry they work in – more profitable and growing sectors will generally offer higher wages.
- (c). One limitation of a market economy is that it may result in an unequal or inefficient distribution of resources in an economy. The government intervenes to correct for inequitable or unfair outcomes through varying its taxation and expenditure. One way it does this is through taxing higher income earners higher and redistributing the income to lower income earners through social welfare payments.
- (d). During a recession, firms will postpone plans for new investment, lower their production levels and reduce their demand for labour. For individuals, this will result in a rise in unemployment and a fall in incomes and may lead to families relying on social security payments and savings to satisfy basic needs. As individuals lower their consumption, the economy may contract further, increasing unemployment further and reducing living standards. The government is also affected by a recession, as it will experience a decline in its taxation revenue whilst increasing its expenditure on social welfare payments.

Question 3

- (a). The economy was in equilibrium in year 3 because $\text{Savings (35) + Taxation (75) + Imports (35) = Investment (25) + Government spending (75) + Exports (45)}$.
- (b). Taxation would have to be at 100 for the economy to be in equilibrium in year 4. $\text{Investment (25) + Government spending (85) + Exports (25) - Savings (20) - Imports (15) = Taxation (100)}$.
- (c). A high level of savings means that less disposable income is being spent on consumption. Reduced consumption will see firms reduce production and economic activity will fall. Lower production levels will reduce incomes and could further reduce consumption. .
- (d). A recession in China could decrease injections in Australia through a fall in exports. Consumers in China are likely to buy less Australian exports during a recession where there is rising unemployment and falling incomes.
- (e). When total leakages are greater than total injections, there will be a downturn in the level of economic activity in the short term. As economic activity falls however, the size of leakages from the economy should also gradually fall as consumers have less disposable income to save, to pay the government as taxes, or spend on imports. Over time, the level of leakages and injections should level out and the economy will be restored to equilibrium. However, this equilibrium will be at a lower level of income in the circular flow because of the higher level of leakages initially.

Skills Revision – Economic Terms

(In order of appearance of definitions from top to bottom)

- Recession
- Services
- Infrastructure
- Factors of Production
- Gross domestic product
- Business cycle
- Financial institutions
- Investment
- Leakages
- Public Sector
- Injections