

The Limits of Markets

15

Multiple Choice

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

Short Answers

Question 1

- (a). **Non-Excludable:** no individual or organisation can be excluded from consuming the good. For example you cannot stop people watching a public fireworks display.

Non-Rival: the use of a good by one individual does not diminish its use by another individual. For example by watching a fireworks display it does not make it any less spectacular for someone else watching it.

Due to the non-excludable and non-rival characteristics of public goods, they are either underprovided, or not provided at all by the private sector, as firms cannot hope to make a profit from the production and exploitation of such goods. But because public goods are often beneficial for society, the government recognises the importance of intervening to either directly provide for public goods that are not produced at all by the private sector, or to make up for the shortfall in underprovided public goods.

- (b). Electricity is a good provided through infrastructure like an electricity grid. The electricity companies have the capacity to control who uses electricity and is connected to the electricity grid. Those individuals who do not pay for electricity are removed from the grid and cannot access electricity. This makes electricity an excludable good, although it may be a 'publically provided' good, whereas a public good is both non-excludable and non-rival.

Gas is provided to homes through gas pipes and other infrastructure. Like electricity, gas companies regulate the use of gas and who is connected to this gas infrastructure. Gas companies can also exclude consumers from using gas and this makes it an excludable good. Public goods are both non-excludable and non-rival and therefore gas is not a public good.

- (c). **Monopoly** – a situation where there is a single producer of a good or service. The monopoly producer determines both the price and the quantity of goods/services provided in a market. This price is likely to be more expensive than if there were many competitors in the market, and the quantity supplied is often below the equilibrium quantity. Consumers are therefore likely to pay a substantially higher price for goods and services produced by a monopoly producer.

Cartels/Collusion – a situation where producers in a market secretly work together to set prices and quantities for a good or service in the market. For example petrol bowsers such as Shell and Caltex may secretly communicate and intentionally restrict quantities to maintain a higher than equilibrium price. The result is consumers pay one standard price that is likely to be higher than the competitive equilibrium price.

- (d). **Consumer Protection Laws** – the government may make it illegal for firms to collude, establish monopolies, engage in price discrimination or create artificial barriers to entry into markets. The Trade Practices Act 1974 (Cth) ('TPA') and the Fair Trading Act 1987 (NSW) are the main statutes that the government uses to facilitate workable competition in order to make markets contestable. The Australian Competition and Consumer Commission (ACCC) is the main Commonwealth body that enforces the TPA. It is responsible for investigations over suspected anti-competitive conduct as well as issuing penalties and prosecuting firms which breach the TPA.

Removing monopolies from markets – the government may dissolve or sell a current government monopoly, for example Telstra, to increase competition in a market. Alternatively a government may introduce more producers into a market with a pre-existing monopoly to increase competition in that market. The effect will be cheaper goods and services for consumers.

Question 2

- (a). The government at P_{\max} below the equilibrium price P_e , with the effect, has imposed a price ceiling that the prices for pharmaceutical drugs are artificially lowered and cannot increase beyond P_{\max} .
- (b). The impact of the government intervention is that the market is now in disequilibrium. Where the price is below equilibrium, firms will contract their supply of pharmaceutical drugs whilst demand for the pharmaceuticals will increase from consumers. There is likely to be excess demand in the market, and insufficient supply to satisfy the demand.
- (c). Pharmaceuticals are merit goods, and have positive effects on the population. They are also considered to be necessities and for this reason, governments are favourable towards making them affordable for a wider range of people. For example pharmaceuticals used to treat bone conditions like osteoporosis or arthritis are beneficial for old people, however people with these conditions will most likely have low incomes because of the debilitating nature of these conditions. For this reason the government may put a price roof on these pharmaceuticals to artificially lower their price.
- (d). Regulation through competition policy, anti-collusion and anti-cartel laws ensure that firms are competing with each other on price. Without regulation, it is more likely that larger firms with greater market power and market share are then able to artificially impose barriers to entry into their industries to restrict potential competition. This will enable the large firms to charge higher prices than would otherwise be the case with more competitive pressures from other firms. An absence of regulation may also enable firms to engage in collusion and cartels with other firms in the industry, thereby artificially restricting quantities and increasing prices above equilibrium.
- (e). **Subsidies** – governments might subsidise production of merit goods. A subsidy is where a government pays money (either a lump sum or instalments over time) to producers often with conditions attached. Producers are able to spend that money on producing more merit goods, increasing the supply of merit goods in the market. Likewise, this increase in supply of merit goods will lead to cheaper prices, as the good is less scarce.

Government production of the merit good – a government might find it more efficient for them to simply start producing the merit good themselves. The government provides most public goods such as parks, lighthouses, streetlights and hospitals. This increases the supply of merit goods to the market.

Tax concessions – a government may cut taxes on firms that produce a merit good. This makes it more profitable for firms to produce the merit good and encourages greater production of that good.

Question 3

- (a). A business cycle is usually characterised by a boom-bust cycle, where periods of strong economic growth are then followed by periods where the economy contracts. These fluctuations may be rather severe, as demonstrated during the global financial crisis in 2008. Up until then economies worldwide were enjoying sustained rates of strong economic growth, which was then followed by a sudden downturn that continues to persist into 2010-11. Governments therefore respond with macroeconomic policies to stabilise the business cycle in order to moderate the severity of its fluctuations. In other words, the government wants to dampen growth when the cycle is booming, and ease the downturn when the cycle is experiencing a trough in order to ensure smoother, more prolonged economic growth over time.
- (b). The free market distributes income according to the value of each individual's contribution to the production process. Within the free market those with higher skills and more experience are likely receive a higher share of income compared to those with low skill levels who will generate less income. With the forces of supply and demand operating, it may mean that some professional or vocational skills are in much higher demand than others and would therefore receive a proportionately larger share of income.
- (c). **Progressive tax system** – the government implements a progressive tax system, which is characterised by an increasing rate of marginal tax payable as individuals' incomes increase. As of 2010, the marginal tax rate for each extra dollar of income exceeding \$180,000 per year is 45 per cent, whereas someone earning less than \$6,000 per year would pay no tax.
- Transfer Payments** – the income payments given to those under a certain income threshold. Also known as welfare payments, these income payments flow to low-income individuals, students and those unable to work due to illness.
- (d). Absolute poverty is a technical term that refers to individuals earning under US\$1.25 per day. Relative poverty refers to a standard of living that is substantially lower relative to the average for the economy as a whole. It is often defined as a level of income below 30 per cent of average earnings. In a developed, wealthy nation like Australia, instances of absolute poverty are practically non-existent. Relative poverty is more common in Australia than absolute poverty because of the relatively high degree of income inequality in Australia, which means that there are a greater proportion of people whose incomes are substantially lower relative to the Australian economy average.

Skills Revision

An electricity grid	Natural Monopoly
A tennis racquet	Private Good
A prison	Natural Monopoly
An air raid siren	Public Good
An illicit drug	Demerit Good
An aeroplane	Private Good
A pharmaceutical drug	Merit Good
A seaport	Private Good
A private school	Private Good
A domestic airline	Natural Monopoly
A courthouse	Natural Monopoly
A public fireworks display	Public Good
A university	Private Good
An umbrella	Private Good
A televised sports match	Public good