

Economics
Teach Yourself Series
Topic 11: Living Standards (Units 1-4)

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Living Standards

We expect our economy and economic system to satisfy our needs and wants. We also expect the have our economic welfare and economic prosperity to continue to improve. Our economic system, together with assistance from the government should be continually working to improve living standards.

However, we recognise that there are fluctuations in the performance of our economic system – fluctuations in the business cycle – and these fluctuations not only impact upon the achievement of our economic goals but can also impact upon our living standards.

Initial terminology

As it appears in Units 1 - 4

Living standards are the aggregate welfare of people in a country, comprising:

- Material factors
- Non-material factors

Material living standards: measures peoples access to goods and services

Non-material living standards: factors that affect a person's quality of life irrespective of income. Includes things such as: crime rates, public health facilities, pollution levels, stress levels, etc.

Measuring living standards

As it appears in Units 1 - 4

The most common, acceptable measure of living standards is the percentage in real Gross Domestic Product (GDP). Real Gross Domestic Product is measured by the increase in the level of production. This growth expressed as a percentage increase over the period is referred to as “the rate of economic growth”. It is calculated in the following way:

$$\text{Rate of economic growth} = \frac{\frac{\uparrow \text{ real GDP}}{\text{Starting Real GDP}} \times 100}{1}$$

Real GDP (Gross Domestic Product) is the measure of the level of production. It is “real” because any increase in the money value of GDP due to inflation (price increases) has been removed. This is done by “deflating” the money GDP value with an estimate of inflation obtained from a price index.

The figures used in the calculation of GDP are only an estimation of the annual value of an economy's output.

There are limitations to the accuracy of the data as a measure of changes in living standards. This is because of:

1. Excluded production – not all goods and services are included in the calculation because they are too difficult to calculate. The main examples are illegal production as part of the black economy, cash economy production and household or non-market activities.
2. Imputed production – some production must be estimated because it is not sold in the normal way. Examples are government services that are provided free of charge, and farm production produced on the farm
3. Quality changes – GDP does not specifically measure the change in the quality of goods and services.
4. Distribution of the costs and benefits – GDP does not reveal how the growth in the economy is distributed amongst people within the economy.
5. International comparisons – the calculation of GDP is not the same in every country so comparisons are not always valid or statistically accurate.
6. Chain price indexes – the process of removing the effects of inflation relies on the calculation of these indexes which are difficult to calculate accurately.

Another key issue with real GDP as a measure of changes in living standards is that an increase in GDP can be achieved by an increase in working hours at the expense of leisure time and quality of family life.

A better use of real GDP as an indicator of changes in living standards is to calculate real GDP per capita. This is real GDP divided by the population to determine the average amount of goods and services purchased by each person.

This indicator also has some of the same limitations as real GDP. Two alternative measures of living standards are:

1. The Genuine Progress Indicator [GPI]
Measures overall national wellbeing.
Measures production (like GDP) but adds factors such as social costs – crime, problem gambling, pollution, etc.
2. Measuring Australia's Progress [MAP]
ABS attempt to determine if life is getting better using 4 'progress indicators:
 1. Human capital – knowledge, skills and health of all Australians
 2. Social capital – the ways we live and interact as a society
 3. Natural capital – our natural resources, like air and water
 4. Produced and financial capital – machinery, buildings and physical assets

Review Questions

1. The rate of economic growth is likely to increase if
 - A. the terms of trade fall.
 - B. the Australian dollar appreciates.
 - C. interest rates were increased.
 - D. the rate of economic growth amongst our major trading partners increased.
2. Explain how an increase in economic growth can lead to an increase in material living standards in Australia.

3. Apart from GDP, identify one other measure that can be used to indicate changes in living standards.

Full Employment and Living Standards As it appears in Units 1 - 4

Full Employment is a situation in which nearly all persons willing and able to work at the prevailing wage and working conditions are able to find employment.

The problem for an economy is when not all resources – particularly labour – are not employed. This is referred to as unemployment. Unemployment is a situation in which some persons who are actively seeking work and are willing and able to work are unable to find gainful employment.

Causes of unemployment

1. Low levels of consumer confidence and reduced C
2. Low levels of business confidence and higher interest rates
3. Onset of a recession or decreasing economic activity o/s
4. Contractionary macroeconomic government policies

Unemployment & Living standards

Unemployment affects households as well as the overall economy. The effects of unemployment on living standards can be can be broadly categorised into five groups:

1. Changes the distribution of income and wealth and the standard of living – those who are unemployed or become unemployed lose their previous income and if they qualify, must rely on government transfer payments for their income. This will reduce their purchasing power and decrease the amount of goods and services they are able to purchase.

This decline in the ability to purchase goods and services decreases material living standards as the physical quantity of goods and services purchased by those unemployed is less than it was prior to being unemployed.

2. Reduced efficiency in resource allocation and impact upon economic growth – as some resources are now idle, the amount of goods and services able to be produced will decline, lowering the overall level of GDP. This decline in GDP lowers or slows growth and makes GDP per capita fall, lowering overall living standards.
3. Increased burden of taxpayers and government budgetary policy – an increase in the number of people unemployed will mean a greater number of people reliant upon government transfer payments

Solutions to Review Questions

1. Answer: D

Explanation:

Higher growth amongst our trading partners should lead to greater demand for Australian exports (especially mining commodities). As demand increases, producers would respond by increasing production, resulting in a greater volume of goods and services being produced.

2. Living standards are influenced by material and non-material factors. An increase in economic growth means that more goods and services have been produced. Increased production means that the economy generates more income. If this growth occurs at a faster rate than population growth, then the GDP per capita will increase. Economic growth therefore means that households are able to purchase more goods and services than they could before, increasing their material living standards.
3. Other measures include Measuring Australia's Progress (MAP) and the Genuine Progress Indicator (GPI). Both of these measures take into consideration non-economic factors such as life expectancy, educational attainment, social cohesion, crime, divorce rates and social freedoms.
4. Full employment allows people to earn an income that allows them to purchase goods and services to satisfy needs and wants. It allows the government to receive greater tax revenue and therefore increase its spending on services such as health and education.
5. The achievement of full employment generally results in higher production volumes. A person's sense of wellbeing and self-esteem is often intrinsically related to their ability to secure meaningful employment. Full employment therefore gives people a sense of purpose. This might boost non-material living standards.
The achievement of full employment might, however, result in a decrease in some aspects of non-material living standards. If full employment results in greater production levels it could lead to excessive pollution or greater stress to increase productivity in the workplace, then it may be detrimental to one's non-material living standards.
6. A higher rate of unemployment will see a fall in living standards. Unemployed persons will see their income decline and therefore their consumption expenditure. These people may decrease their savings in the short term to maintain their spending patterns but as savings decline they will reduce their spending.
A secondary result may see unemployed persons unable to maintain mortgage repayments and they may be forced out of their homes.
For the economy as a whole, increased unemployment will see a reduction in government tax receipts. This will force the government to reduce its spending on services unless it wishes to move the budget further into deficit. This decrease in spending will also adversely affect living standards as services decline.

7. A rise in inflation will lead to a rise in interest rates leading to a greater percentage of income being spent financing debt. This reduces income available for spending on consumption resulting in less goods and services being purchased by home owners, lowering their living standards

Secondly, inflation reduces the purchasing power of consumers meaning more money is required to purchase less goods and services, reducing living standards.

8. In the event of rising prices, pressures start to build on interest rates. Higher interest rates result in higher loan repayments and less money for the consumption goods and services, thereby reducing living standards.

Increasing inflation leads to increased wage demands, which may be delivered at the expense of the jobs of fellow workers, thereby placing those made unemployed below the poverty line whilst they are out of work and on welfare, thereby reducing their living standards.

Increasing inflation raises export prices, thereby reducing employment in export industries, placing their incomes and immediate living standards at risk.

9. *Answer: D*

Explanation:

A rising \$A makes it very hard for exporters to be competitive. At the same time imports are cheaper under this scenario, increasing pressures on domestic manufacturers. The end result is a decline in living standards.

10. External stability implies strong export growth, which translates into increased domestic production, greater spending and increased employment, the latter improving both household income and general self-esteem.

11. A housing boom will see the demand for houses rise. One effect of this may be a reduction in the availability of properties for rent. This increase in demand will see a rise in rents, leading to consumers spending more of their income on rent and less on other items. Those able to afford to purchase houses for investment will earn income through rent, increasing their overall income. The overall effect is a worsening of the equity in the distribution of income and a decline in living standards for renters as they must reduce consumption in other areas to continue to afford housing.

12. *Answer: B*

Explanation:

An increase in the terms of trade may mean that the price received for our exports and/or the price paid for imports has decreased. An increase in export prices means that a given quantity of some exports will generate greater revenue thereby increasing incomes for those who are connected to the exporting companies either directly or indirectly. A decrease in import prices will also generally mean that households will be able to purchase more goods and services with a given level of income. Both of these situations will mean that access to goods and services increases resulting in higher material living standards.

13. A move from a deficit budget to a surplus budget can be achieved through reducing government spending, increasing government receipts or a combination of both.

Regardless of which method is chosen, a contraction in the economy can occur, leading to a reduction in consumption and investment by the private sector as well as a reduction in services provided by the public sector.

These changes will see a rise in unemployment as spending declines and this will adversely impact upon living standards.

- 14.** An expansionary budget should lead to an increase in Aggregate Demand as either the Government through G1 and G2 or the private sector through C (as a result of tax cuts) increase spending. This growth in the economy can be at the expense of non-material living standards – increased pollution from increased production, increased congestion from increased employees utilizing transport networks to travel to work due to increased employment, reduction in amount of non-renewable resources.
- 15.** The introduction of an emissions trading scheme (ETS), is an example of a government policy that is designed to place a price on carbon and therefore force businesses to take into account the damage and costs they pass onto society. As the costs of production for businesses rise, it results in higher prices and lower levels of AD via lower investment, Consumption and Net Exports (as our international competitiveness falls). This should see a fall in the rates of economic growth. Falling growth creates unemployment leading to a fall in living standards.
- 16. Positive**
Higher levels for skilled immigration can help to alleviate capacity constraints that have been contributed to by skills shortages. Allowing immigrants to fill skilled vacancies helps to reduce inflationary pressure and enables economic growth to be sustained. In this respect, skilled immigration helps to achieve strong and sustainable rates of economic growth, supports incomes, and increases the ability of Australians to purchase goods and services, thereby boosting material living standards.
- Negative**
Higher levels of immigration more generally can contribute to excessive use of the nation's resources, leading to unsustainable development or over-development within certain parts of Australia (particularly city areas). Greater levels of congestion, pollution and resource shortages (such as water) that are associated with excessive population growth more generally can lead to a decrease in non-material living standards.
- 17.** If we don't implement such a scheme then pollution and other such negative externalities will continue. The damage to our environment (and hence tourism industry) will continue and the health risks associated with pollution will continue to grow. This will result in our non-material living standards falling.