PEARSON ECONOMICS 11

THE MARKET ECONOMY

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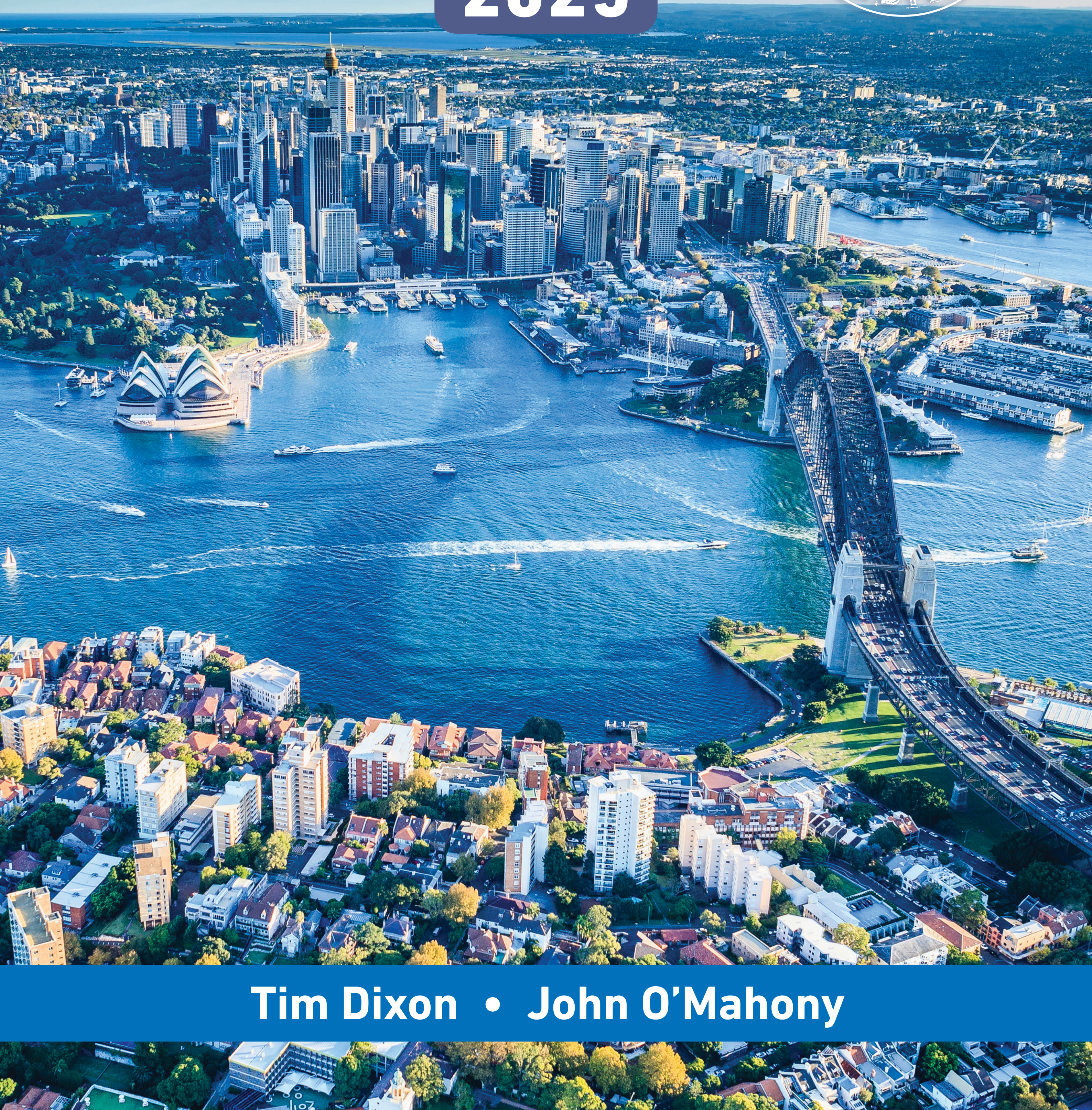

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TOPIC 2

CONSUMERS AND BUSINESS

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Focus

The focus of this topic is an investigation of how consumers and businesses make decisions about the choices they face, recognising that, in a market economy, they are motivated largely by self-interest.

Issues

By the end of Topic 2, you will be able to examine the following economic issues:

- Examine the impact of income on the spending and saving decisions of individuals
- Assess the extent to which consumer sovereignty is achieved in a variety of markets
- Investigate the relative significance of the various sources of incomes in Australia
- Work in groups to investigate the factors leading to change in a particular industry.

Skills

Topic 2 skills questions can ask you to:

- analyse the impact of changes in consumer income levels on the types of production within the economy
- explain the role of firms in solving the economic problem.

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Topic 2

Introduction

Both individuals and businesses within the market economy are driven by self-interest, yet understanding how self-interest affects our economic decisions is no simple matter. We must gain an accurate picture of what individuals and firms believe their self-interest to be, as well as how their interests are affected by the economic conditions around them. Once we do this, we will have a much clearer picture of the actions of individuals and firms in the market economy.

Chapter 4 examines the role of consumers in a market economy who buy goods and services to satisfy their needs and wants. We analyse the role of individual income and age in influencing consumers' decisions to spend and save. Chapter 4 concludes with a discussion of the sources of consumer income.

Chapter 5 examines the role of business in the market economy – how businesses make their production decisions and how businesses contribute to the economy by boosting economic growth and providing individuals with employment and income. We examine the goals of businesses and how firms can maximise their profits. Finally, we consider the impact of investment, technological change and ethical decision making on businesses in a market economy.

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4 Consumers in the Market Economy

4.1 Consumer sovereignty
4.2 Decisions to spend or save
4.3 Factors influencing individual consumer choice
4.4 Sources of consumer income

4.1 Consumer sovereignty

One of the main features of a market economy is that consumers determine what is produced. Consumers will ultimately decide what goods and services will be produced by exercising their freedom to choose what they buy and which wants they will satisfy. Business firms will produce whatever goods and services are in demand. This concept is known as **consumer sovereignty** because consumers determine the answer to the questions of what to produce and how much should be produced. This is also one of the great strengths of the market economy because production is geared to what people want and their wants are satisfied.

Consumer sovereignty is based on consumers sending signals to producers through their demand for goods and services. Where their demand is high relative to supply, prices will rise. Producers will then notice that higher profits can be made by producing those items for which demand is greatest. As a result, they will shift resources into those other forms of production. Consumer sovereignty can therefore determine how resources are allocated in an economy.

Through consumer sovereignty, consumer income levels determine the types of production that occur in an economy. As an economy becomes more prosperous and income levels rise, demand for luxury goods increases, and so does their production. Thus, during periods of economic growth and higher incomes, the production of goods such as sports cars and designer clothing will increase. Similarly, production of these items will fall in an economic downturn.

However, consumer sovereignty is not absolute. In the market economy, there are several aspects of business conduct that can reduce the sovereignty of consumers:

- **Marketing**: Advertising and marketing exert a powerful influence over the spending patterns of consumers and can change consumer tastes and preferences. While some marketing strategies are informative, most strategies place a strong emphasis on understanding their target consumer in order to influence their behaviour. Marketers conduct extensive research into their wants, interests, desires and fears. They then use this information as the basis for both mass marketing (such as television, radio and billboards) and direct marketing (such as targeted social media advertisements, including the use of influencers across Instagram and TikTok, as well as via SMS or email). Consumer sovereignty is diminished by manipulative marketing practices.

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- **Misleading or deceptive conduct**: Consumers can be deceived by false or dishonest claims about a product, leading them to pay for items that do not do what they claim. This is especially common among claims over weight-loss supplements, anti-aging products, investment schemes, baldness treatments and other health products and services.
- **Planned obsolescence**: Firms sometimes produce goods that are designed to wear out quickly or go out of date, in order to encourage consumers to make further purchases in the future. By emphasising the importance of keeping up with the latest technology and most recent products, firms can manipulate people to buy a product more often than they would otherwise. For example, smartphone manufacturers update phone models regularly with new and improved features to encourage new purchases, even if older models continue to function effectively.
- **Anti-competitive behaviour**: Markets where there are only a few sellers can also diminish the ability of consumers to choose what they really want because there are limited product options. For example, businesses may manufacture electronic devices so that only the company's brand of accessories, such as power supply cords and batteries, are compatible. The device could work just as well with cheaper generic brands of accessories, but this can be a strategy to reduce consumer choice and to try to manipulate consumers into purchasing more products from the same business.

Economists debate the extent to which these factors diminish true consumer sovereignty and create a degree of business sovereignty. Some critics argue that a great deal of consumer demand for goods and services is generated by deceptive marketing practices that manipulate people's fears and insecurities. Others argue that these practices are a natural part of the market economy and, despite these patterns of business conduct, consumers still ultimately choose for themselves what they buy.

reviewquestions

1. Explain how consumer sovereignty can influence the production decisions of businesses.
2. Outline THREE examples of business practices you have observed that reduce consumer sovereignty.
3. Explain how government policy can be used to support consumer sovereignty.

4.2 Decisions to spend or save

In overall terms, after consumers have received income and paid their tax, they make a choice to either spend or save the remaining money. This is expressed in the following equation:

$$Y = C + S$$

Where:

Y = Disposable (after tax) income
C = Consumption expenditure
S = Savings

This equation means that, for a specific level of income, any increase in consumption will cause an equal reduction in the level of saving, and similarly, a rise in saving will reduce consumption by the same amount. It also indicates that any change in disposable income will result in a change in the levels of consumption and savings.

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$$\frac{C}{Y} = \text{APC} \qquad \frac{S}{Y} = \text{APS}$$

Where:

APC = Average propensity to consume

APS = Average propensity to save

Average propensity to consume (APC) is the proportion of total income that is spent on consumption.

Average propensity to save (APS) is the proportion of total income that is not spent but is saved for future consumption.

The proportion of an individual's income that is spent on consumption is called the **average propensity to consume** (APC). The proportion of an individual's income that is saved is known as the **average propensity to save** (APS). Because each dollar of an individual's disposable income must be spent or saved, the APC and APS must sum to 1.

Figure 4.1 shows the level of savings for a range of high-, middle- and low-income economies. This includes savings by households, businesses and governments. While economies with higher per capita incomes tend to save a greater proportion of their income, the relationship between income and savings levels is weak at an economy-wide level.

Country	GDP per capita (US$, 2023)	Gross saving (%GNI, 2023)	Country	GDP per capita (US$, 2023)	Gross saving (%GNI, 2023)
Luxembourg	128,259	25	Brazil	10,043	16
Norway	87,962	41	South Africa	6253	14
United States	81,695	18	Indonesia	4940	37
Australia	64,711	26	India	2484	31
Japan	33,834	27	Burundi	199	6

Source: World Bank, World Development Indicators 2024

Figure 4.1 – Income and savings levels, selected countries

A variety of factors influence levels of spending and saving in an economy, including:

- **Income levels and future expectations**: Individuals have greater capacity to save as income levels across an economy rise. Savings levels may be higher in economies with greater inequality in the distribution of income (because those with higher incomes have more capacity to save). If individuals feel uncertain about their future income levels, they are more likely to save.
- **Cultural factors**: Decisions about saving and spending are influenced by individual personality factors (e.g. more cautious versus more easygoing personalities) and by wider cultural values. For example, in some East Asian economies people tend to save more of their income than people in other industrialised economies, and previous generations tended to save more than people today.
- **Confidence and future expectations**: When consumers are worried about the economic outlook, including inflationary expectations and rising cost of living, they are more likely to be cautious and save more. On the other hand, if they are confident about the future, they are more likely to increase their consumption and save less. In some instances, a change in consumer confidence may not be linked to actual changes in economic outlook. For example, recent research from the Reserve Bank of Australia (RBA) identified patterns of consumer spending in relation to a change in government at elections, finding that consumers who voted for the winning party were more optimistic about economic conditions and were more likely to increase their consumption than consumers who voted for the losing party.
- **Life stage and age distribution**: Consumption and savings behaviours change over the course of our lives, reflecting different phases such as young adulthood; starting a family and settling down; late middle age when incomes are generally highest, and then retirement and old age.
- **Government policies**: The government can influence patterns of consumption and savings by making it more attractive to save (such as through lower taxes on superannuation savings) or to spend (such as through the abolition of consumption taxes).

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- **Availability of credit**: Spending is likely to be higher if credit is cheap and is readily available, as this creates a new source of money for expenditure. Further, individuals are less likely to save if they feel confident that they will be able to access credit easily in the future. For example, the CommBank Household Spending Insights (HSI) Index found that interest rate increases over 2022 and 2023 reduced spending growth from around 18 per cent in mid-2022 to just 1.3 per cent a year later.

In overall terms, however, the two most significant factors that influence a consumer's decision to spend or save are their **level of income** and **age**.

Income

As **income** rises, people tend to save a higher proportion of their income; that is, APS rises and APC falls. Consumers on lower incomes spend proportionately more of their disposable income than people on higher incomes. As income rises, people do not need to spend as much of their income on essential items. For example, a person with a disposable income of $400 per week might have to spend it all on basic costs of living, whereas someone receiving $4000 per week might comfortably save half of that income. The consumption function diagram (figure 4.2) shows hypothetical data for the relationship between income and consumption for an individual. As income rises, so too does the level of consumption. However, even without any income, individuals tend to have some positive level of consumption, ($50 per week), which may be financed through credit or existing savings. As income rises from $200 to $300 per week, consumption also rises, from $150 to $200. However, because income rises faster than consumption, the average propensity to consume falls. In the example in figure 4.2, APC falls from 0.75 to 0.67, and APS rises from 0.25 to 0.33 as income rises from $200 to $300.

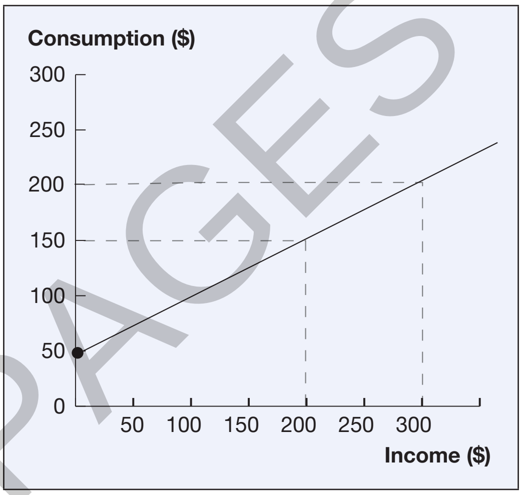

Figure 4.2 – The consumption function

The **consumption function** is a graphical representation of the relationship between income and consumption for an individual or an economy. It is usually upward sloping with a gradient less than one, and with a positive y-intercept.

To complete the story, economists have also developed terminology around the concept of a person's propensity (or tendency) to consume or save for each extra dollar they earn as a result of a change in income.

Marginal propensity to consume (MPC) is the proportion of each extra dollar of earned income that is spent on consumption.

Marginal propensity to save (MPS) is the proportion of each extra dollar of earned income that is not spent, but saved for future consumption.

- The **marginal propensity to consume** (MPC) is the proportion of each extra dollar of income that goes to consumption (and is the slope of the consumption function in figure 4.2).
- The **marginal propensity to save** (MPS) is the proportion of each extra dollar of income that is saved.

$$\text{MPC} = \frac{\text{change in consumption}}{\text{change in income}} \qquad \text{MPS} = \frac{\text{change in saving}}{\text{change in income}}$$

Since each extra dollar of income earned must be either spent or saved, the sum of MPC and MPS for an individual (or household) must always be one. Therefore:

$$\text{MPC} + \text{MPS} = 1$$

In our simple example in figure 4.2, both the MPC and the MPS remained constant when income increased (that is, the consumption function was a straight line with a gradient of 0.67). In reality, as a person's income rises, their marginal propensity to consume tends

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to fall and their marginal propensity to save tends to rise. Therefore, the consumption function tends to become less steep as income rises.

The relationships explained on the previous page also apply to the economy as a whole. In general terms, as a country's national income rises, the overall level of savings in the economy should rise at a faster rate. However, like many economic relationships, this does not always hold true – for example, although the United States is one of the richest nations in the world, its savings level (18 per cent as a percentage of GNI in 2024) is not high by international standards, as the data in figure 4.1 shows.

Age

Age also plays a role in savings and consumption patterns. An individual's income stream and propensity to consume and save are not constant throughout their life. Individuals and households tend to smooth their consumption – if they expect to earn a very high level of income this period and very low or no income in the following period, they are likely to save more income this period so as to have a reasonably constant standard of living in both periods.

Over the course of our lifetime, our consumption and savings behaviour moves through several patterns. When people are young, they tend to receive lower levels of income because they lack skills, experience and education. Therefore, they tend to spend most of their income and save very little – in fact they will often dis-save (or borrow) in order to finance their education. However, once people start working, and especially in middle age, their incomes rise, and they will consume a smaller proportion of their income, as they start saving and accumulating assets for retirement. In retirement, people no longer earn income from their labour, and they consume out of past savings and wealth, or rely on the government's age pension.

This way of looking at a household's consumption behaviour can explain why individuals on higher incomes tend to have a lower average propensity to consume compared with lower-income earners. Individuals who are on higher incomes save more to accumulate wealth and assets for retirement, whereas low-income earners must use a higher proportion of their income just to meet the costs of daily needs such as food and living expenses. Thus, over time, their average propensity to consume initially falls (as their income rises) and then subsequently rises again after retirement.

This theory is known as the life-cycle theory of consumption. Figure 4.3 shows an individual's income, consumption and savings patterns during their lifetime, according to this theory.

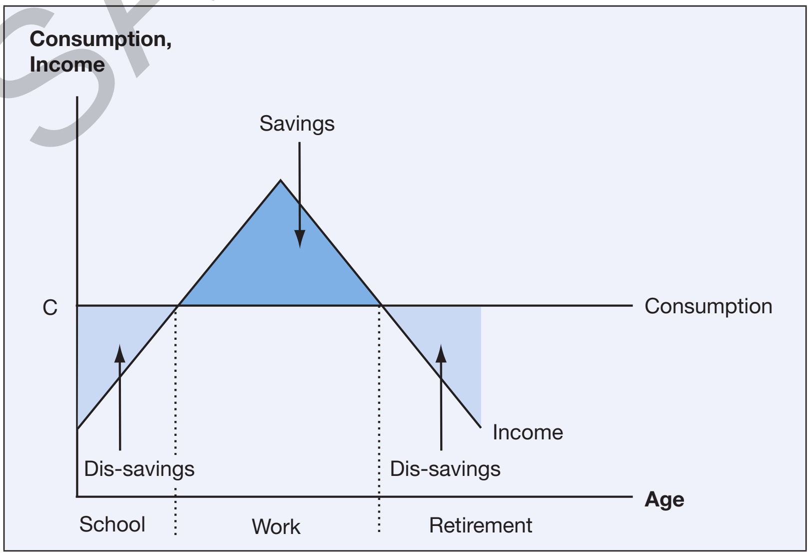

Figure 4.3 – Life-cycle theory of consumption

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1 Distinguish between average propensity to save and marginal propensity to save.

2 Consider a person earning $3000 a week who consumes $2100 of their income. Suppose that when they receive a 20 per cent pay rise, their consumption rises to $2300 a week. Calculate the following:
- their average propensity to consume at their new income level
- their marginal propensity to consume after their increase in income.

Now suppose that this person decides to work part-time so they can complete a part-time university course. Their income falls to $1500 a week. Assuming they have a constant marginal propensity to consume, calculate the following:
- their new level of consumption
- their new level of saving.

3 Explain THREE factors which influence an individual's decision to spend or save.

4 If high-income earners tend to save a larger proportion of their income than lower-income earners, identify which economy's average propensity to consume would be higher – one with a relatively equal distribution of income, or one with a very unequal distribution of income.

4.3 Factors influencing individual consumer choice

Utility is the satisfaction or pleasure that individuals derive from the consumption of goods and services.

Once a consumer has decided how much of their income to spend, they are faced with an almost endless range of ways to spend their money. Economists assume that in their expenditure decisions consumers aim to maximise their **utility**, or well-being. Achieving higher utility means that an individual has satisfied more of their wants, but they are constrained in their ability to increase their utility by their level of income and the market price of goods and services. The demand of each consumer for a particular good or service is known as **individual demand**, whereas the demand of all consumers in the entire economy is known as market demand.

The main factors affecting the consumer's expenditure choices are:

1 The level of income

A person's income level is one of the main influences on an individual's spending pattern. As individuals earn higher incomes, they tend to choose to buy more items and items of higher quality. The range of goods or services that might be purchased by an individual on a salary of $300,000 a year would be quite different from that of a pensioner who is living off an income of $40,000 per year from the age pension and their superannuation. For example, a cruise ship holiday might increase the pensioner's level of utility today, but the pensioner may then not have enough income to continue to satisfy other wants into their future.

Another factor that may influence consumption is house prices. Rising house prices makes people feel wealthier as their assets are now worth more – the so-called "wealth effect" – which makes them more likely to spend money. Recent research shows that a 10 per cent increase in housing wealth in Australia raises the level of consumption by 0.75 per cent in the short term and 1.5 per cent in the long term.

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2 The price of the good or service itself

In considering whether or not to purchase a good, consumers must decide whether or not they are willing to pay the nominated price for the item, given their level of income.

Some goods are considered **necessities** and people will need to buy them regardless of price changes. For example, if the price of basic food increases, people will not reduce their demand for food greatly, because they need it for survival. (Gourmet foods like caviar or oysters, however, are hardly necessary for survival and would be more responsive to price changes.) In contrast, consumers are likely to reduce their demand for luxury items when their prices increase.

3 The price of substitute and complement goods

The quantity of a good demanded at any time will be affected by the prices of other goods. Consumers consider some goods to be close **substitutes**, such as butter and margarine, or rival ridesharing apps (consumers are easily able to substitute one for the other). If the price of margarine rises, consumer demand for butter, which is a substitute, will also tend to increase.

A substitute is a good that consumers may choose to buy in place of another good, such as butter and margarine or rival ridesharing apps.

On the other hand some goods are considered to be **complements**, and consumers tend to purchase them together. Possible examples include iPhones and AirPods, cars and petrol, and surfboards and wet suits. If the price of an iPhone falls, we would expect an increase in consumer demand for iPhones as well as for their complements, AirPods.

A complement is a good that is used in conjunction with another good. For example, petrol would be a complement of cars.

4 Consumer tastes and preferences

Tastes and preferences also influence a consumer's spending decisions. An individual will decide to purchase those goods and services that give them the highest level of utility or personal satisfaction. Generally, we assume that a higher quantity of most goods increases consumer utility. However, some goods and services will give an individual consumer a higher level of satisfaction than others. For example, a consumer who has a preference for fruit juice and who dislikes soft drinks will tend to spend more on juices and consume relatively fewer soft drinks.

Other goods can subtract from consumer satisfaction. For example, if a consumer who dislikes watching sport were to purchase a ticket to the NRL Grand Final, this would reduce their utility (they gain no extra satisfaction for the ticket), and they will probably not value the purchase. Consumer tastes and preferences can be changed by experimentation and learning (a consumer who dislikes watching sport may change their mind after watching a particularly exciting win by a local team).

As **consumer tastes and preferences** change over time, so too will the demand for particular goods. For example, clothing that is coming into fashion will face an increase in demand, while consumer demand for clothing that is going out of fashion will decrease.

Innovation and **technological progress** lead to consumers demanding new and better products at the expense of superseded ones. In 2023, over 60 per cent of Australian households subscribed to at least one video streaming service, while demand for DVDs has almost vanished. Research by Australia Post in 2024 found that 8 in 10 Australians shopped online in 2023, with 5.3 million households making an online purchase once a month, and online sales accounting for 16.8 per cent of total retail spend.

5 Advertising

Advertising can influence individual consumer choice, sometimes even creating demand for a particular good or service where none existed before. People are saturated with advertising all day long, from sponsored content on social media, seeing billboards at bus shelters and railway stations, to television advertisements. In Australia, billions of dollars are spent every year on advertising. Advertising can make demand for goods and services less responsive to price increases by building consumer loyalty to particular brands over time.

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1 Identify TWO pairs of substitute goods and TWO pairs of complement goods.
2 Explain, using examples, how the development of technology influences individual consumer choice.

4.4 Sources of consumer income

Consumers gain their income from a variety of sources. Consumer income mainly comes as a return for resources such as labour, land, capital and entrepreneurial initiative. These resources are also known as the factors of production. Consumer income can also come from the government in the form of social welfare.

Returns to factors of production

Consumer income can be defined as the rewards to the owners of the factors of production. Consumers receive income from the sale of these factors of production. These are:

- **Wages from labour**: This is the main source of income for consumers. It comes in the form of wage or salary payments for labour when consumers participate in the labour market. It also includes non-wage income such as fringe benefits, employer contributions to superannuation, and workers' compensation payments.
- **Rent from land**: Land is a source of income when it is rented. For example, consumers may own an investment property that generates property income.
- **Interest from capital**: Returns from the ownership of capital are a significant source of consumer income. Wealth creates ongoing income through returns from owning capital. For most consumers, their ownership of capital occurs indirectly through superannuation and other investment funds or through the ownership of shares, which earn them dividends each year. They may earn interest on savings held in bank accounts or bonds.
- **Profit from entrepreneurial skills**: Many Australians are involved in operating businesses, especially small businesses. If the business makes a profit, this income is considered a return for their use of entrepreneurial skill.

Social welfare

Social welfare payments are payments made to increase the incomes of individuals or families in need of assistance by the government; for example, unemployment benefits and family allowances.

A significant proportion of household income in Australia is received by way of social security or social welfare, known as transfer payments, as figure 4.4 indicates. This is income collected through taxation and then transferred from governments to individuals. More than a third of government revenue is spent on social welfare payments. Examples of these transfer payments include:

- **Age pension**: For people who are over 67 years of age and retired from working.
- **Parenting payment**: For primary carers of young children, means tested according to income level.
- **Disability support pension**: For people with a permanent physical, intellectual or psychiatric condition that stops them from working.
- **JobSeeker payment**: For people aged between 22 and 67 who are seeking work, but are unable to find it.

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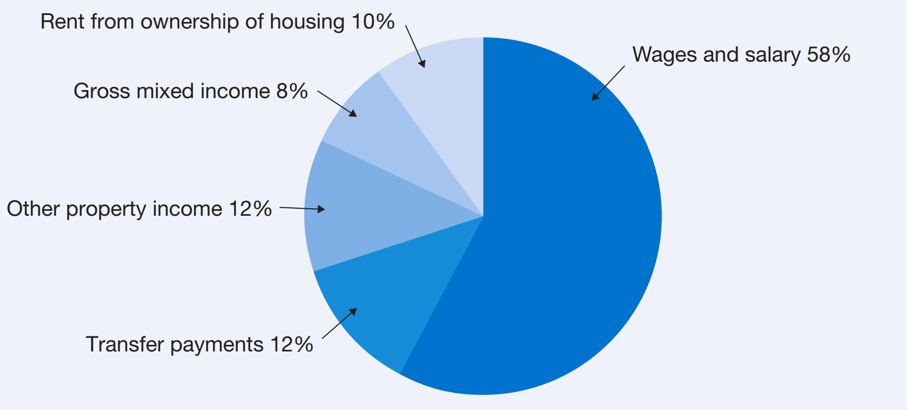
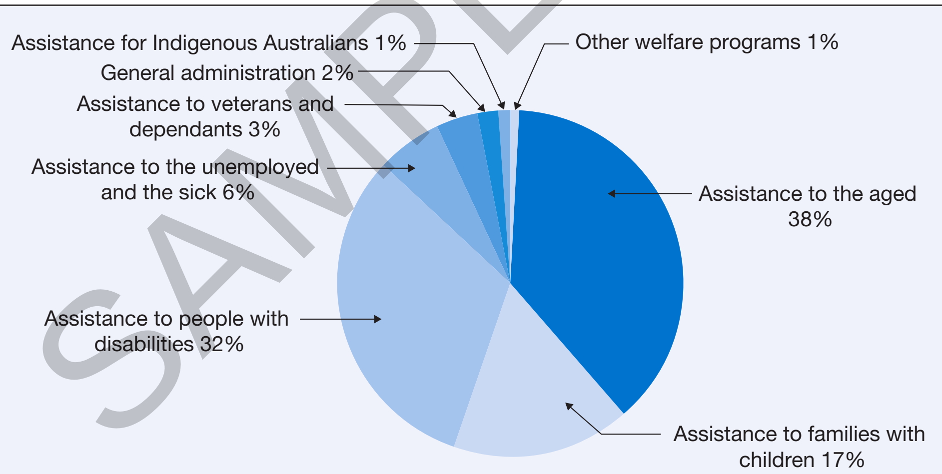


Source: ABS *Australian National Accounts: National Income, Expenditure and Product*, Table 20

Figure 4.4 – Sources of household income, 2023–24

The aim of social welfare is to provide a minimum income safety net, allowing individuals with low incomes to purchase the basic necessities of life. Governments sometimes raise transfer payments in order to increase consumer demand and boost economic growth. For example, in the 2024–25 Budget, the Albanese Government provided a $300 energy bill rebate to every household as part of a package of measures to address rising cost of living pressures.

Figure 4.5 demonstrates that government social welfare spending provides income to a wide range of people in the community. Despite common perceptions that a large percentage of welfare spending goes to unemployed people, in fact they only receive around 6 per cent of the welfare budget. In the 2024–25 Budget, total social security and welfare spending was $265 billion. The largest beneficiaries of this welfare spending are the elderly and people with disabilities. Two of the fastest-growing expenditure items in the Budget are aged care and the National Disability Insurance Scheme.



Source: Budget 2024–25, Budget Paper No. 1, Statement 6, Commonwealth of Australia

Figure 4.5 – Commonwealth social welfare expenditure 2024–25

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1. Identify TWO sources of income for Australians.
2. State the THREE most significant social welfare payments in the Australian economy.

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chapter summary

1 In a market economy, consumers decide what goods and services will be produced by exercising their freedom to choose their purchases. This concept is known as **consumer sovereignty**.

2 Consumer sovereignty can be reduced by certain forms of business behaviour including marketing, misleading or deceptive conduct, planned obsolescence or anti-competitive behaviour.

3 All income in the economy must be saved or consumed. This is shown by the equation: $Y = C + S$.

4 The pattern of consumer **savings** can be influenced by a variety of factors including culture, an individual's personality, expectations, future spending plans, government policies and availability of credit. However, the two most important influences are individuals' income and age.

5 Higher-income earners tend to save proportionally more than lower-income earners – they have a higher **average propensity to save (APS)** and a lower **average propensity to consume (APC)**. As income in the economy increases, the level of both savings and consumption tend to rise, but savings usually rise faster than consumption.

6 The **consumption function** diagram shows the relationship between consumption and income for an individual. The slope of the consumption function gives the **marginal propensity to consume (MPC)**, the proportion of each extra dollar of income that goes to consumption.

7 The **life-cycle theory of consumption** states that consumers save and consume according to their stage of the life cycle, where most of a person's savings occur while they are of working age. Dis-savings occur before work begins and after retirement.

8 **Individual demand** is the demand of each consumer for a particular good or service. Factors influencing individual consumer choice include the level of income, the price of the good itself and the price of substitutes or complements, consumer tastes and preferences, and advertising.

9 **Income** is derived from the sale of the four factors of production: natural resources, labour, capital and enterprise. Their respective returns are rent, wages, interest and profits.

10 The government may provide social welfare to supplement an individual's income or provide a basic standard of living. These are called **social welfare payments**.

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chapter review

1 Discuss what is meant by *consumer sovereignty* and the extent to which this principle operates in our economy.

2 Explain how changing levels of income influence an individual's decision to spend or save.

3 Calculate the average propensity to consume and average propensity to save for the following individuals:
- Libby, who has an annual income of $83,000 and saves $16,000 per year
- Marco, who receives a weekly income of $900 and spends $750 per week

4 Draw a consumption function diagram based on the information in the following table.

Income ($)	0	200	400	600	800
Consumption ($)	200	300	400	500	600

Calculate the marginal propensity to consume and the marginal propensity to save.

5 Explain the effect that age has on an individual's consumption and savings patterns.

6 Consider how savings and consumption patterns might be affected if an economy was to experience an increase in house prices.

7 Distinguish between a *substitute good* and a *complementary good*. Explain how a change in the price of a substitute good might affect the individual demand for an item.

8 Give an example of how changing consumer preferences have influenced demand for a good or service in recent years.

9 Outline the main sources of income for Australian households.

10 Explain what is meant by *social welfare payments* and their importance to Australian households.

Extended response

Explain the factors that influence an individual's demand for goods and services. Discuss the role that advertising and marketing play in influencing consumer demand. Outline government policies that might be used to encourage individuals to increase their savings.

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