Economics paper 1 set 4 and marking guide

SECTION A

1. (a) (i) What is meant by scarcity and choice in economics?
Scarcity is the situation in which people has limited resources to satisfy all their desires. Or scarcity occurs when the wants of people exceed available resources.
Choice is the process of selecting or making decision on what is best to produce or consume among the many alternatives.
(ii) Explain how the two are interrelated.
Because scarcity involves working with limited resources to satisfy unlimited wants, **people are often compelled to choose from different alternatives**.

(b) (i) Define income elasticity of demand
Income elasticity of demand refers to the sensitivity of the quantity demanded for a certain good to a change in the **real income** of consumers who buy this good.
(ii) Why may the income elasticity of demand for commodity be negative?
Inferior goods have a negative income elasticity of demand; as consumers' income rises, they buy fewer inferior goods. An inferior good is an economic term that describes a good whose demand drops when people's incomes rise. These are goods that fall out of favour as incomes and the economy improve as consumers begin buying more costly substitutes instead.

(c) Give four characteristics of an economy at drive to maturity stage of economic development
Answer
Drive to maturity is the fourth stage in the stages of development and is characterized by
- → Rate of saving and investment is as high as over 10 -20% of national income
- → Modern production techniques replace old ones leading to production of high quality goods.
- → Economy grows and diversifies.
- → Technological advancement
- → High level of infrastructural development
- → There is considerable decrease in growth rate
- → Emergency of highly skilled industrial labour force
- → Heavy industrialization taking place in the economy

(d) Why is education regarded as both a consumer good and an economic good?

It is regarded as consumer good because

- → Education is an economic good since it satisfies human wants.
- → It helps develop one's mental abilities once attained
- → It has uncertainties such as failing examinations

It is regarded as economic good

- → It is scarce
- → It command price in form of school and other school fees requirements
- → It has an opportunity cost i.e. present levels of consumption is foregone to attain education

(e) (i) What is meant by real income

Real income refers to the measure of the purchasing power of a consumer's money incomes. It is expressed in terms of goods and services that can be acquired out of it. Or real income is how much money an individual or entity makes after accounting for inflation.

(ii) Give two factors that affect real income.

Real incomes are closely linked to market demands (market conditions), since they are an important factor that affects demand. These factors include

- → The general price level of commodities
- → Level of consumer's income
- → Availability of goods and service
- → Levels of taxation
- → Size of monetary/subsistence sector
- → The cost of living
- → General level of production in an economy.
- → Wage Growth.
- → Employment Levels.
- → Interest Rates.

(f) Study the table showing the terms of trade form country X(1976 – 1980) and answer questions that follow

Year	Export price index	Import price index	Terms of trade
1976	100	100	100
1977	142	108	131
1978	120	114	105
1979	128	132	97
1980	154	113	89.5

(i) Calculate the terms of trade for the years 1977- 1980

Terms of trade (TOT) = $\frac{P_E}{P_i} x100\%$

1977: $\frac{142}{108} x\ 100 = 131$ (the rest of the figures are as in the table)

(ii) Did country X experience favourable or unfavourable terms of trade in 1979? Give a reason

The country experienced unfavourable terms of trade because of ratio of a country's average export prices to its average import prices was less than 1 i.e. 0.97

(g)(i)Define the term ad valorem tax

Ad valorem tax is a tax levied on goods (imports) according to their assessed value or is tax where the rate charged is directly related to the value of commodity in question.

(ii) Give two examples of an ad valorem tax in Uganda
- ◊ Value added tax (VAT)
- ◊ Import tax on vehicles and machinery
- ◊ property taxes on real estate

(h)(i) What is meant by a deflationary gap?

A deflationary gap is a situation where aggregate supply exceeds aggregate demand at full employment level. It is called deflationary because it leads to a fall in the price level.

(ii) The ways of closing a deflationary gap.
- ◊ Expansionary monetary policies (extension of credit or loans) directly towards boosting demand so as to match it with supply
- ◊ The central bank can reduce this gap by buying securities.
- ◊ Upward adjustment of wages and salaries
- ◊ decreasing income and corporate taxation
- ◊ Increasing government expenditure so as to increase money in circulation
- ◊ Increase employment opportunities
- ◊ Discourage imports to encourage domestic consumptions

(i) Distinguish between reserve requirement and marginal requirement policies of central bank

Reserve requirement refers to specific proportion of commercial bank deposits held by the central bank not allowed to lent and meant to cover possible withdraws or minimum percentage of deposits that a bank must hold in reserve to comply with regulation requirements

Whereas **margin requirement** refers to the difference between the current value of the security offered for loan (called collateral) and the value of loan granted.

(j)(i) What are parastatal organization?

Parastatal organizations are state enterprises established by acts of Parliament to carry out specific activities on behalf of the government such as NewVision News paper, UNEB

(ii) Give the problems facing parastatal organization or government enterprises
- ◊ Bureaucracy
- ◊ Corruption and embezzlement of funds
- ◊ Political interference
- ◊ Poor management
- ◊ Inadequate funding
- ◊ High production cost
- ◊ Limited skills

SECTION B

2. (a) What is meant by price mechanism?
   Price mechanism is a system of economic organization where economic activities take place with limited government intervention. It is otherwise known as “laissez faire” meaning no

government intervention. It works only in free enterprise or capitalist economy where resources are owned by private individuals and companies which are free to take decisions regarding their utilization.

(b) Explain why price mechanisms may be interfered with

- **Ignorance of customers.** When consumers are ignorant about the goods and services they need to be protected from misleading advertisement.
- **Monopoly.** Consumers may need to be protected from exploitation of monopolists.
- **Income inequality.** If production is left to market price mechanism the poor may not receive basic goods and services
- **Future needs.** Price mechanisms fail to project the future need which call for government planning
- **Profits can at time be a bad guide.** Profits from charcoal can lead to over exploitation of forests.
- **Stability of prices.** Price mechanisms may lead to excessive price fluactuations
- **Mismatch with structural changes.** When there is a need for immediate structural transformation within economy, price mechanisms may be inadequate since they fail to allocate resources to immediate required venture e.g. during the period of war.
- **Unemployment.** Under price mechanism, inefficient firms are forced out of production leading to unemployment.

3. (a) Explain the meaning of the following

(i) Excess capacity of a firm

Excess capacity Occurs when a firm operates at less than optimum level. Excess capacity is measured by the difference between what the firm is producing and what is capable of producing at the lowest possible costs.

(ii) Break-even point of a firm

Break- even point refers to the point where the firm is neither making economic profits nor incurring any loss but only earns normal profit where AC = AR. Or is a point where a form is just able to cover all its costs including opportunity cost of capital.

(b) Why may a firm continue to operate even if it is incurring losses both in short run and long run?

- When it a beginner firm expecting to grow.
- When it has hope of recovering it losses in future
- When the firm is a pilot project or research firm will continue to operate regardless of losses made for the period of study.
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- When the aim is to provide employment opportunities for the people other than profit maximization. In this case, as long as the desirable labour force is employed, such firm don't close down.
- Sales maximization other than profit maximization. The firm continues producing provided the sales are higher.
- When the firm is government owned and their goal is socio-economic welfare of the population.
- When the firm is receiving subsidies from government in which case even though they are incurring losses, their expenditures are met by government
- When a firm is using profits earned from other sources to operate.
- When a firm hopes to change management in order to improve in future.
- When a firm hopes to secure a long term credit

- When a firm fears to lose its popularity/name, losses may be met by the shareholders
- When a firm fears to lose its customers.
- When a firm had accumulated profits and assets in the previous trading period
- When a firm fears to lose its assets
- When a firm fears to lose source of raw materials
- Fear of non-compensable depreciation of capital in case machinery is made redundant.
- It can be a non-government organization that depend on foreign aid or donations.

4. Explain the problems that result over dependence on agriculture. Suggest solutions to the problems

   Problems faced

   - The agriculture sector yield low tax revenue since production is largely subsistence.
   - Agricultural output especially in LDCs is of lower quality this give them low competitive advantages
   - It leads to seasonal unemployment. In LDCs agricultural activities are seasonal mainly during rainy season and farmers are almost unemployed during dry seasons
   - Prices of agricultural output are never stable making it difficult to predict income and consumers expenditure
   - It required a big land which may not be available due to high population growth
   - It has to low marginal productivity. the level output per unit labour usually measured as output per man-hour is very low
   - Inadequate storage facilities
   - It leads to limited level of industrialization. It tends to encourage concentration of agro-based industries instead of capital based industries that lead to fast industrialization
   - Its output is severely affected by season such as drought and floods.
   - It leads to economic dependence especially when a country continues importing most of the manufactured goods.
   - Low outputs
   - May lead to environment degradation
   - Minimum prices may lead to over supply
   - Tariffs on agriculture have led to lower income for food exporters in the developing world and have been a big stumbling block to trade.
   - Land fragmentation

   Solutions to the above problems

   - Flexibility; farmers should be flexible to change from one agricultural system to another in response to market conditions
   - Industrialization through export promotion and import substitution
   - Improvement of infrastructure to ease marketing of agricultural output
   - Irrigation to limit effects of climatic changes
   - Insurance. Individual farms subjected to certain risk should insure against it.
   - Diversification to increase income
   - Price stabilization. Government should stabilize prices through buffer stock and stabilization funds
   - Education and training to encourage and stimulate modern farming techniques
   - Research to produce high yield resistant crops and animals
   - Credit to enable expansion in agricultural production
   - Barter trade can increase on market opportunities.

5. (a) What is meant by underdevelopment

   Underdevelopment refers to the **low level of development characterized by low real per capita income, wide-spread poverty, lower level of literacy, low life expectancy and underutilisation of resources etc.**

   (b) To what extent is under development in the "third world" a result of external factors?

- Brain drainage. Foreign economies often attract skilled man power that are highly required in developing countries
- High prices for petroleum products lead to high foreign exchange expenditure leaving less for development
- The IMF has a great influence on the development programs of LDCs but with limited funding.
- Repatriation of interests by foreign investors limits expansion of the economy
- Liberalization policies encourages dumping to LDCs and suffocates domestic industrial development and overdependence on foreign nations.
- Slave trade robbed Africa of labour force and this could have contributed to underdevelopment
- Limited external market due to protectionism
- Colonial historical exploitation and oppression

However, there are also several internal factors that are responsible for underdevelopment of LDCs

- Under developed infrastructures such as roads, schools railways, etc.
- Political instability discourages investment
- Limited technology
- Low entrepreneur skills
- High population growth rates leading to high dependence rate
- Dependence on low yield agricultural practices
- Rampant corruption
- Low innovations
- Lack of enough domestic market for its produces
- Low level of industrial development leading to unemployment.

6. (a) Define the term collective bargain

   The term collective bargaining refers to the negotiation of employment terms between an employer and a group of workers. Employees are normally represented by labour unions during collective bargaining.

   (b) Under what circumstances are workers justified to demand for wage increase?

- When there is rising cost of living to enable them cope
- When there is increased profitability of the firm to enable them to benefit.
- In case of improved labour productivity. Workers also demand for better wages reward their improved productivity
- In case of exploitation; workers demand for high wages if they feel exploited
- In case of increased work load
- In case the wages are below minimum wages set by the government
- In case of a risky job such as mining
- In case of limited supply of labour and the demand for workers increase
- After training and improved workers skills.

7. (a) Explain the principles of comparative advantages

In economics, comparative advantage refers to the ability of a person or nation to produce a good or service at a lower opportunity cost than another person (or nation).

Given two countries and two commodities in international trade, a country should specialise in production and export of a commodity in which it has the least opportunity cost to the other country. The theory is based on the following assumptions

- That there are only two countries that exist in the country
- The said countries produce only two commodities X and Y.
- There are no transport cost involved
- Factors of production are fully employed

(b) Limitations of the comparative advantage theory

- Relying on comparative advantages can lead to depletion of countries' resources.
- May promote unfair or poor working conditions elsewhere
- May lead to overdependence on other countries
- The theory assumes of only two countries, yet there are many countries in the world.
- It considers only labour costs, yet production involves many other costs such as power, raw materials and transport.
- It assume that countries only produce two commodities but countries trade in many goods and service
- It assumes that there no transport costs yet transport costs affects some advantages of specialization
- It assumes that exchange of goods and services are to be conducted under barter trade arrangements, yet modern trade requires money.
- The theory emphasizes specialization by the countries concerned and overlooks diversification which is currently encouraged
- Factors of production are not equally efficient in all economic activities e.g. labour cannot be shifted from cotton production efficiently to sugar production.
- The existence of the law of diminishing returns is ignored.
- It assumes that there is no government control of production and trade system and yet for economic and political reasons, the government interfere with international trade
- It assumes that the factor of production is always mobile by shifting labour from one producing unit to the other which is not realistic. There are restrictions/barriers to both geographical and occupational mobility between and among countries
- It assumes free trade across boundaries but international trade is limited with barriers like tariffs, foreign exchange control and quotas.
- It has little relevance in developing countries that produce similar goods making exchange impossible
- The law ignores the fact that two countries can incur the same costs in production of a particular commodity making it difficult for a country to identify a product specialize in.
- When a country has absolute cost advantage in production of the two commodities it may difficult to choose what to specialize in.
- Countries today are emphasizing need for self-reliance yet the theory emphasizes specialization and interdependency.
- The law assumes full employment of all resources, which is not always the case.

8. Discuss the role of foreign commercial banks in economic development of your country.

Positive roles

- Provide employment opportunities to local people.
- Provide training and skilling in the banking sector.
- They are sources of government revenue through taxes
- They create competitions and increase efficiency in the banking sector
- Encourage foreign trade and relationships by providing credit
- Encourage capital in flow and foreign investment.
- Tend to increase the level of saving by mobilizing from rural and urban population
- Introduce technology and innovations in the banking sector to compete with international banks in developed world
- Encouraging Right Type of Industries by extending loans to right investments/persons
- Fuller Utilization of Resources. Savings pooled by the banks are utilized to a greater extent for development purposes of various regions in the country. It ensures fuller utilization of resources.
- Channelizing the Funds to Productive Investment. Banks invest the savings mobilized by them for productive purposes.
- Creation of Credit. Banks create credit for the purpose of providing more funds for development projects

Negative roles

- Most of their business activities are usually concentrated in urban areas with no significant benefits in rural areas
- They are usually associated with foreign investor who are associated with excessive capital outflow
- Low employment prospects due to their preference in foreign manpower or capital intensive technologies
- High competitiveness suffocates indigenous banks
- They tend to prefer large deposits
- Lower the multiplier effect in the country since they repatriate their profits and incomes.