Economics paper 2 set 7 and marking guide

1(a)(i) Explain the three theories of inflation

- **Demand pull inflation:** this arises when the demand for goods and services exceeds the supply for commodities available e.g. during Christmas season.
- **Cost push inflation:** is caused by rising costs of production. It occurs where there is an increase in prices of factors inputs which eventually results into higher prices of final products
- **Structural/bottleneck inflation:** this is caused by structural circumstances due to hindrances in the supply system or monetary inflation caused by too much money in the circulation.

(ii) What are costs of stagflation?

- Poor standards of living
- Discourage saving and investment
- Leads to social distress and misery
- Leads to income inequality
- Loss of confidence in the country's currency

(b)(i) Explain the difference between monetary and fiscal policies

Monetary policy is **a set of actions/guidelines to control a nation's overall money supply and achieve economic growth**.

Fiscal policy is **the use of government spending and taxation to influence the economy**.

(ii) Which of the two monetary policies do you think has been more effective in combating inflation Uganda? Give reasons.

Arguments for fiscal policy

- The financial institutions in Uganda are not well developed and at times because of government pressure, these institutions do not perform as per guidelines governing the lending and borrowing policies.
- People's ignorance about the operation of monetary tools i.e. even if the bank interest rates are high, people still borrow from banks.
- The increase in taxation reduces people's disposable income leading to fall in prices of goods.
- Reduction in government expenditure on some sectors has also reduced the money supply and finally leading to low demand for the goods in the economy.

Arguments for monetary policy

- In most developing countries automatic fiscal stabilizers – such as income taxes and transfer programs built into the fiscal system – are too small to have a significant effect on aggregate demand
- Politicians have a problem of overspending of public revenues when they are abundant in good times.
- Fiscal expansions are difficult to reverse for instance if inflation is due high government spending programs during recessions; these may be very difficult to reverse is short run

(c)(i) What is meant by consumer sovereignty?(1mark)

Consumer sovereignty is an economic situation where the desires and needs of consumers control the output of producers. (A customer's desires and need control allocation of resource).
Or
Consumer sovereignty is the idea that **consumers hold the power to influence production decisions, based on what goods and services they purchase**.

(ii) Briefly explain the extent to which consumer sovereignty determines how resources are used in the various sectors of Uganda's economy. (3marks)

Consumer sovereignty is playing an increasing role in resource allocation in both private and public sector.

The private sector allocates resources according to demand for goods and services in other words business establishment are based on products and services demanded by customers

Public sector as well allocates resources according to the demand for such products such as schools, hospitals, etc.

However, to some extent, due to government interference like price control, taxation and nationalization of enterprises, consumer sovereignty is downplayed.

(d)(i) Which reasons classify the market structure of petrol industry in Uganda?

The market structure of Petrol industry in Uganda is oligopoly because

- There are few unequal competing firms in the market
- There is high degree of competitive/persuasive advertising
- The products are highly differentiated e.g. Totalenergies, Shell.
- There is interdependence of firms

(ii) In which way is the price of Saudi Arabia's crude oil related to the prices of bananas in any Kampala market?

When the price of crude oil in Saudi Arabia increases, the cost of fuel in Uganda increases and hence the costs of transporting bananas to the markets around Kampala increase leading to the increase in the prices of bananas.

(e)(i) Clearly differentiate between the "balance of trade" and "balance of payment" of an economy.

Balance of trade (BOT) is the difference between the value of a country's exports and the value of a country's imports for a given period.

Balance of payment is the difference between country's foreign exchange expenditure and its foreign exchange earnings in a given period of time usually a year.

(ii) Why has Uganda's balance of trade continued to worsen despite the strong and persistent external stabilization efforts?

- Increased importation of oil products at very high prices
- Exportation of low value exports such as raw materials
- Low export base due to limited external market
- Increased demand for luxuries such as cars
- Increased demand for capital goods necessary for industrialization
- Falling prices of agricultural products on world market
- Low quality export products
- Trade restriction on Uganda's exports by MDCs

(f)(i) Clearly distinguish between an income and a consumption tax

Income tax refers to a type of tax that governments impose on income generated by businesses and individuals within their jurisdiction. By law, taxpayers must file an income tax return annually to determine their tax obligations.

Consumption tax is an indirect tax on the purchase of a good or service by the consumer in the form of retail sales taxes, excise taxes, tariffs, value-added taxes (VAT) etc.

(ii) Which of the two types of type taxes is ideally a bettertax?

Consumption tax is better than income tax because

- It is less felt by the taxpayer.
- It is cheaper to administer
- It does not discriminate between consumers
- It has wide coverage
- It is flexible i.e. it easily be increased or lowered
- It convenient and difficult to evade

(g)(i) Briefly explain the difference between terms " least developed and under developed in reference to a poor country.

Least developed country refers to a stagnant country with very low levels of income, persistent unemployment characterized by constant poverty, standards of living below international poverty line.

Underdeveloped countries are countries economically better than least developed countries (but still developing) characterized by slow growing GDP, but people affording minimum standards of living.

(ii) Do you think that structural adjustment alone will lead to the "Rostovian take-off" in Uganda?

Structural adjustment alone will not lead to take-off because there is need for

- Increased exploitation of resources

- Increased entrepreneurship skills
- Political stability throughout the country
- Increased saving and investment
- Innovation and invention

(h)(i) What is international trade organization and what is its objectives?

International Trade Organization is the main international body, which was established with the aim of reducing tariffs, promoting the production, exchange and consumption of goods so as to increase international trade

The main objectives of International Trade Organization include

- to set and enforce rules for international trade,
- to provide a forum for negotiating and monitoring further trade liberalization
- to resolve trade disputes,
- to increase the transparency of decision-making processes,
- to cooperate with other major international economic institutions involved in global economic management, and
- to help developing countries benefit fully from the global trading system.

(ii) How does the law of comparative advantage explain the failure of East African countries to establish serious and long lasting regional cooperation?

Because East African countries produce similar commodities hence have very low opportunity cost in similar commodities.

(i)(i) Clearly differentiate between precautionary and transactions motives for money demand.

Precautionary motive for money demand refers to **a desire to hold cash in order to be able to deal effectively with unexpected events that require cash expenditure** such as sickness.

Transactions motive for money demand is a **desire to hold cash in order to conduct cash-based transactions**.

(ii) Relate interest rate and demand for money in an economy.

If interest rate offered by the banks is high people will deposit their money in banks and this reduces their demand for money and the vice versa.

(j)(i) What is meant by the “tax structure” of a country?

Tax structure is the composition or categories a tax(es) according to either the mode of payment which can be direct or indirect or by the percentage (proportions) of income paid in taxes which can be progressive, proportional or regressive and the methods of assessment and administration within a country.

(ii) Clearly distinguish between a tax base and taxable capacity.

The tax base is **the total amount of income, property, assets, consumption, transactions, or other economic activity subject to taxation by a tax authority**.

A broad tax base reduces tax administration costs and allows more revenue to be raised at lower rates.

Taxable Capacity means the maximum capacity of the people of a country to bear the burden of taxation without much hardship or taxable capacity or **taxable capacity** refers to the ability of the tax payer to pay the tax assessed to him and remain with enough disposable income to enable him enjoy his former standard of living.

SECTION B

2(a) Why do some economist argue that an inequitable income distribution may be necessary during the early stages of development? (10 marks)

- **It promotes individual initiative and hard work in bid for the poor to earn a living.**
- **Entrepreneurs require rewards**. Inequality is necessary to encourage entrepreneurs to take risks and set up a new business. Without the prospect of substantial rewards, there would be little incentive to take risks and invest in new business opportunities.
- **Trickledown effect**. If some people gain extra income, then this can 'trickle down' to other people, e.g. if an entrepreneur sets up a business he may become a millionaire, but also will create jobs and provide incomes for other workers. There may be a gap between the highest and lowest earners. But, the lowest earners are still better off than without the entrepreneur.
- **Fairness**. It can be argued that people deserve to keep higher incomes if their skills merit it. If a top footballer gets paid £100,000 a week, this is a reflection that people are willing to pay that kind of money to watch him.
- **Improvement of relationship** such as between employer and employee to promote production
- **Encourages labour mobility**. geographical mobility is search of of an increase in income
- Stimulates government effort to adopt policies that alleviate poverty.
- **Promotes harmony and respect in society**. Poor respect the rich.
- **Promotes creativity and innovativeness in peoples'** struggle to become rich
- **Leads to progressive tax** and ability of the government to obtain taxes for infrastructural development.
- **Provide employment** opportunities when the rich invest

(b) Describe five policy measures for reducing income inequality in Uganda.

- **Adoption of progressive taxation.** High taxes should be imposed on the rich and the income earned from such taxes should be used to subsidize the poor.
- **Land reforms.** Land ownership and use should be changed from individual ownership to communal ownership system so that poor people can have access to productive land and generate income
- Price controls. Government should fix maximum prices to basic goods and services.
- **Setting and maintaining high minimum wages** to increase incomes of the employees.
- If the private market fails to provide enough jobs to achieve full employment, **the government must become the employer of last resort**.
- When growth is below capacity and the job market is slack, **apply fiscal and monetary policies aggressively to achieve full employment**.

- **Modernization of agriculture**. Agricultural sector should modernized to absorb unemployed educated people.
- **Infrastructural development throughout the whole** country to allow everybody to participate in productive activities.
- **Rural electrification schemes** to encourage rural development and curb rural-urban migration.
- **Education reforms** that encourage job makers rather than job seekers.
- **Fight corruption and embezzlement** through anticorruption agencies.
- Formation of credit scheme to provide initial capital to businesses.
- **Level the playing field for union elections** to bolster collective bargaining while avoiding, at the state-level, anti-union, so-called “right-to-work” laws.

3(a) What is the difference between under-employment and disguised unemployment?

Under employment is a situation where the person is working, below the full extent of their abilities, skills, or qualifications.

The common forms of under employment are

- Labour working less time than desired for example a worker works for six hours instead of eight hours a day.
- Being employed in socially undesirable activities e.g. prostitution
- Labour force engaged in last resort or unsuitable jobs for example a teacher working as a gatekeeper due to failure to get where to teach.

Disguised unemployed refers to workers who are left without work, are working in a redundant manner, or are not being utilized to their full potential.

The common forms of disguised employment are:

- Engaged full time but doing unproductive activities due to inactive co-operant factors e.g. a serious man using blunt hoes for digging.
- Where the marginal productivity of labour is zero or negative especially when labour exceeds fixed factor e.g. land
- unutilized workers who are ill or disabled but still able to be productive,
- job seekers who are demoralized by their inability to find work and so stop looking for it

(b) Explain how frictional and structural unemployment arise in developing country like Uganda.

(i) Frictional unemployment in LDCs arise in the following ways

Frictional unemployment is a **voluntary employment that occurs when workers are moving from job to job or when new workers entering the workforce** .

- ignorance of the existing job opportunities due to failure to get in touch with the media
- Poor infrastructure which makes it hard for labour to move from one geographical area to another.
- Labour immobility due to the inadequate skills, which limit the labour force to get new job immediately
- Over specialization which makes it hard for labour to suit any new carrier job
- Bureaucracy in getting a job. This makes is hard for labour to get a new job immediately.

- Poor working conditions which force labour to change jobs.
- Boredom which makes people change place of work
- Conflicts in place of residence that force people to change place of residence and consequently change jobs

How structural unemployment arises

Structural unemployment is a category of unemployment caused by mismatch between the skills possessed by the unemployed population and the jobs available in the market.

- **Change in the structure of the industry** e.g. if the industry changes from use of labour intensive to capital intensive technology. For example automation in printing industry worker on manual printing press become redundant.
- **Change in demand** which forces employers to lay off some workers.
- Exhaustion of some inputs for example exhaustion of a mineral such as copper in Kilembe mine
- **Technological changes** which make the economy to demand for capital intensive then labour intensive technology.
- **Labour immobility** where labour cannot move from a declining industry to growing industry due to lack of adequate skills.
- **Political instability** that lead to closure of industries
- **Poor management** that causes collapse of industries and production units
- **Structural rigidities in economy** such as breakdown of the main transport systems.
- **Government restructuring policy** of reducing on the number of civil servants as it was done in 1990 in Uganda.
- **Seasonal unemployment** especially in agriculture.
- **Company reallocation.** For example, if a region only has one airport and that airport moves to a new area, the employees may become structurally unemployed.

4(a) Explain the terms “Stagnation” and “balance of payment deficit”.

Stagnation is undesirable economic period with no signs of economic progress. It is characterized by static savings, investment, employment, production and GDP growth rate.

Balance of payment deficit is a situation which occurs when the country’s total foreign expenditure is greater than its total foreign exchange earnings.

It can be attributed to

- high marginal propensity to import for countries with high desire to import
- high prices of imports
- a fall in price or demand of major export
- high capital outflow
- inflationary tendencies in an economy

(b) How would a monetary policy solve the problem of balance of payment deficit and economic stagnation

- Use of open market operations. It involves the purchase of securities from the public in order to increase money supply.
- By reducing bank rates to promote borrowing and investment.

- Reduction of special deposits. This enable commercial banks to have more money to lend
- Devaluation of the local currency to promote exports and increase foreign exchange earnings.
- Use of non-selective credit control to enable indiscriminate lending.
- Reduction of liquid reserve ratio/cash ratio to increase ability of commercial banks to lend more.
- Adoption of pump-printing

5(a) What is the cause of persistence of balance of payments problems in Uganda (10marks)

- **Exportation of low cost primary** products leading to low foreign exchange incomes.
- **Importation of expensive** manufactured products leading to high foreign exchange expenditure.
- **Limited variety of exports** to earn foreign exchange
- **Limited markets for exports due to low technology and poor quality products that fail to compete on world market.**
- **Debt servicing** that drain foreign exchange
- **Political instability** that leads to high foreign expenditure on military
- **Over protectionism and discriminatory policies by developed** countries. This limits markets for LDCs.
- **Lack of skilled manpower** in export techniques and export promotions to increase foreign exchange earnings.
- **Unfavourable natural factors like floods, drought, etc**. these lower the volume of agricultural out. This limits export earnings but may also lead foreign exchange expenditure through importation of food.
- **Lack of skilled manpower** leading to foreign exchange expenditure on expatriates.
- **Profit and income repatriation** since large production facilities are owned by foreigners.
- **Existence of a large subsistence sector**, which does not generate enough export volumes.
- **High population growth rate** leads high consumption and high expenditure on imports.

(b) Why is devaluation failing to solve the problem of persistence of balance of payments problems in Uganda?

- Price inelasticity of demand for imports making devaluation to lead to more capital outflow.
- Price inelasticity of demand for exports, i.e. devaluation has little benefits on export volumes
- Rigidities in supply of major commodities that limit elasticity of demand for export..
- Other countries devaluating at a bigger margin nullifying the effects of devaluation and limits countries exports
- It may worsen imported inflation especially when the demand for imports is price inelastic.
- Most of importing countries have alternative cheaper sources of imports other than the devaluating country (Uganda)
- It causes smuggling as nationals will try to earn high value foreign currencies which increase per capita outflow.
- It increases the value of foreign debts because foreign currency becomes expensive.
- It leads to corruption in the civil service as they hoard foreign currencies so that they get higher profits in future when devaluation occurs.
- LDCs tend to have insufficient import substitutes making importation inevitable

6(a) Describe Rostov's stages of economic growth? (10marks)

Rostov divided economic growth process into five stages

(i) The traditional stage
- Dominated by the subsistence sector with limited levels of exchange.
- Primitive technology,
- Agricultural sector engaging in majority of labour force.
- Low labour of production and productivity.
- Limited degree of specialization and exchange
- Work is done in groups (communal society)
- Limited degree of industrialization
- Limited influence of foreign resource force

(ii) Transitional or pre-condition for take-off stage
- There are radical changes in agriculture, industry, infrastructure, foreign trade etc.
- Change in attitude from traditionalism to modernity, science and technology
- Diversification in economy where wide ranges of goods and services produced.
- Increased exploitation of the available natural resource potential.
- Economic transformation. There is remarkable increase in investment (up to 5% of national income)
- More foreign capital resources are increased.
- Better and efficient technologies emerge
- Changes in political systems e.g. society moves from traditionalism, chiefdoms and colonialism to political independence.

(iii) Take-off stage
- The economy experiences a substantial reduction in foreign aid dependence
- The rate of investment of national income increases from 5% to 10%.
- Both domestic and foreign market are likely to expand
- Increase in the real output per capita is likely to occur.
- The economy experiences the development of new technology in the social, institutional and political systems
- Urbanization. There is high growth and development of towns.
- There is increased investment in social capital
- The economy tends to move towards self-sustenance, though this can take place for at least 20 – 30 years
- Significant sectors of the economy start showing up or emerge.
- There is breakthrough in the vicious circle of poverty

(iv) Drive to maturity stage
- Modern and efficient technology is used in production process of economy.
- Use of more professional labour force e.g. accountants, consultants, etc.
- Increase level of research and innovation
- The rate of investment as proportion of national income increases from 10% to 20%.
- The rate of industrialization increases significantly.
- The vicious cycle of poverty is completely broken
- There is some equitable distribution of income among the majority of individuals in society.
- The rate of output society.
- The rate of output increases in the new leading sectors.
- High and increasing levels of exports
- The economy tends to reduce on the level of importation.

(v) High mass consumption
- There is high level of technological maturity in all sectors
- The figure of the GDP are very high
- Favourable balance of payment positions

- High levels of consumption of goods and services especially durable luxury items
- Full utilization of the resource potential
- The economy becomes fully developed in almost all sectors.
- Good terms of trade
- Well-developed ICT systems
- Automation and computerization in most production sectors.
- High standards of living e.g. countries like Japan, USA, Britain, France, Italy, etc. have attained this stage.

(b) With reasons, suggest the Rostovian stage at which Uganda current level of development is.

Uganda is pre-condition for take-off stage because

- There is increased rate of saving and investment needed for development
- The illiteracy rate of the population is declining
- Uganda economy is dualistic in nature
- There is improvement in life expectance
- Potential entrepreneurs are increasing
- There is infrastructural development
- There is adoption of modern and scientific methods of production
- There is increased investment in foreign trade
- There is modernization of agricultural sector
- There is reduced obstacles to economic growth

7(a) Relate small scale industry with "informal" sector (7marks)

- Both are small sized with low output level
- They both require little capital for establishment and maintenance
- Both use local inputs
- They are all scattered all over the country i.e. they are widely dispersed.
- They both produce mainly consumer good
- They are mainly labour intensive
- They all operate in private sector
- They both operate at excess capacity
- They are limited in book keeping and accountability
- There is on job training in both sectors.
- They produce for local market

(b) Explain the difference between technology development and technology transfer (8marks)

Technology development means the overall process of invention and innovation of new modern techniques of production of new high quality goods and services, e.g. the invention of mobile phones to simplify telecommunications.

Technological transfer the movement of new technology from the inventor to a secondary user, usually from developed to developing countries in an attempt to boost their economies.

This can be through exchange of information, technical assistance, direct investment by foreign investor or importation of specialized equipment.

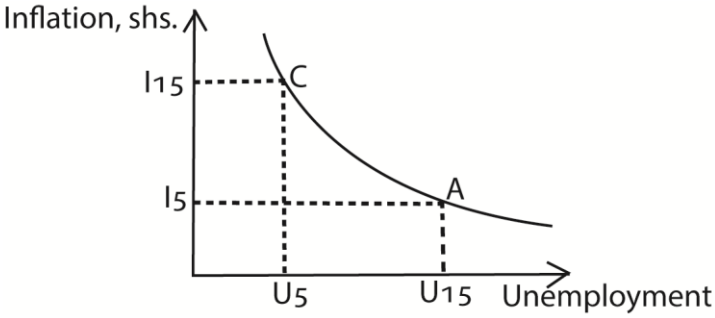
(c) What are the major obstacles to technology transfer from developed to developing countries?

- Inadequate capital to purchase and use the technology
- Insufficient technical and scientific skills to adapt technology
- Limited market
- High level of protectionism making technology inaccessible i.e. multinationals have their interests and they protect it at all costs
- Low level of infrastructural development to absorb new technology
- Inappropriate education system
- the feudal/colonial mind-set that still exist today, i.e. developing country supply the raw materials, and developed country utilise and supply the secondary material;
- Inappropriate technology
- High cost of maintenance of new technology
- Institutional weakness (bureaucracy, nepotism, corruption, legal system,...) and scarcity of entrepreneur factor
- Foreign direct investment is not well oriented to the strategic sectors.
- Weak mechanisms to protect the intellectual property rights (IPR) of the technology developers.

8(a) Explain the theoretical relationship between inflation and unemployment. (10marks)

Theoretically, as inflation rises there is a general tendency of producers to produce more both for export and domestic market in order to cash in on the increasing profit. This leads to more labour demand and reduction of unemployment level. Hence in theory inflation is inversely related to unemployment.

The relationship between inflation and unemployment is shown in the Phillips curve below



In the above curve, point C shows a higher inflation (I_{15}) and low unemployment (U_5) whereas A show a lower inflation (I_5) and higher unemployment (U_{15}).

A higher rate of inflation leads to higher prices which induce investment and high demand for labour.

Restrictive policies to fight to control inflation lead to high rate of unemployment, lowers people's income, leading to low demand for goods and services, reduction in profit causing further unemployment and vice versa.

(b)How does inflation cause unemployment? (10marks)

- High inflations lowers purchasing power leading to reduction in aggregate demand and leads to low productivity in an economy
- It reduces the level of saving and capital accumulation leading to unemployment

- It leads to rural-urban migration which turned into open urban unemployment.
- High interest rate during inflationary period, discourages borrowing and investment resulting in unemployment
- High rate of unemployment lead to low output causing inflation
- Restrictive monetary policies adopted to fight inflation discourage investment leading to unemployment.
- Leads to high government expenditure leaving little funds for investment in infrastructures causing unemployment
- The uncertainty of inflation leads to lower investment and lower economic growth in the long term.
- Inflation leads to a decline in competitiveness and lower export demand, causing unemployment in the export sector (especially in a fixed exchange rate).
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Thank you

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