## Economics paper 1 set 10 and marking guide

1(a) Mention four problems associated with "Laissez faire" system of economic organization

- Consumer's ignorance/exploitation
- Misallocation of resources
- Instability in economy
- Limited initiative to provide public goods
- Unemployment
- Income inequality
- Existence of monopolies
- Over exploitation of resources
- Inadequacy to match with structural changes

(b) Differentiate between commercial rent and economic rent (2marks)

Commercial rent is the payment for hiring/using a durable asset or property.

**Economic rent** is the additional reward/payment over and above what is required to keep a factor of production in its present use or it a reward over its transfer earning.

(ii) Given that a factor of production receives a transfer earning of Ug. Shs. 100,000 and its economic rent is twice its transfer earning. Calculate the factor's actual earning. (2marks)

Actual earning = transfer earning + economic rent

= 100,000 + 2(100,000) = Ug. Shs. 300,000

(c)

| Country | GNP (millions) | Population (million people) |
|---|---|---|
| A | 1,200 | 20 |
| B | 750 | 15 |

(i) Calculate the per capita income of country A and B. (2marks)

Per capita income = $\frac{GNP}{total\ population}$

Per capita income of A = $\frac{1200m}{20m} = 60$

Per capita income of B = $\frac{750m}{15m} = 50$

(ii) Give two reasons why high income per capita may not necessarily imply standard of living

- When leisure is forgone due to over working
- When the quality of the product is poor
- Tastes and preference change
- Uneven distribution of income
- Inaccurate estimation of population

(d) State any four merits/advantages of technological transfer in the development process.

- Creation of employment
- Production of better quality products
- Increased foreign exchange earning
- Increased profitability/efficiency
- Development of skills
- Socio-cultural transformation
- Facilitates exploitation of resources
- Improvement of infrastructure

(e) (i) Define the term “localization of industries”.

**Localization of industries** refers to concentration of industries in particular area such as industrial area or region such as capital city

(ii) State any three problems which result from localization of industries

- Pollution and noise
- Rural urban migration
- Traffic congestion
- Undeveloped rural area
- Demand pull inflation due to shortage of output
- Sanitation problems
- Increased pressure on existing infrastructure

(f)(i) What is meant by demand for labour?(1mark)

Labour demand is defined as **the amount of labour that employers seek to hire during a given time period at a particular wage rate**

(ii) Mention any three factors which determine the demand for labour in an economy (3marks)

- The degree of sustainability of labour
- Elasticity of demand of labour
- The number of productive firms
- Non-pecuniary reward
- The prevailing economic climate
- The level of productivity of worker
- Levels of skill
- Demand for output of labour
- Levels of motivation of labour

(g)(i) Distinguish between cyclical and seasonal unemployment

**Cyclical unemployment** is a temporary type unemployment that occurs due shortage in aggregate demand, during depression or recession phase of a trade cycle.

An example of cyclical unemployment is massive unemployment due to covid-19

**Seasonal unemployment** is a form of unemployment that occurs when people are unemployed at particular times of the year when demand for labour is lower than usual For example during winter, in some places people remain completely unemployed with no production; secondly, the demand for teachers reduces during holidays

(ii) Give any two factors that give rise to cyclical unemployment

- Decrease in income
- Fall in investment
- Decline in prices
- Reduction in government expenditure
- Reduction in exports

(h) (i) What is meant by balance of payment (1marks)

**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) State any three causes of disequilibrium in the balance of payment.

- Political instability and high military expenditure
- High capital outflow by foreign investors
- High population growth rate
- Trade restrictions by the rich industrialized countries
- High degree of competition in foreign markets.

(i)(i) Define the term “flexible exchange rate system” (1mark)

**Flexible ,managed or floating** exchange rate is where the rate of domestic currency in terms of other currencies is determined by the dynamics of market demand and supply.

(ii) Mention any three merits of flexible exchange rate system in an economy (3marks)

- Helps correct balance of payment
- Floating exchange rate currencies can be traded without any restrictions
- It encourages more foreign exchange inflows
- It is automatic mechanism for correcting trade imbalance
- Promotes investment
- Limits illegal foreign exchange trade
- **Lower Reserves:** For a floating exchange rate, central are not required to keep large foreign currency reserve amounts for defending the exchange rate.
- **No import inflation**
- **Flexible**
- **Independence:** Freely floating exchange rates allow the governments and central banks of a nation to have a great degree of independence
- **Lack of policy constraints**- the government are free with a floating exchange rate system to pursue the policies they feel are appropriate for the domestic economy without worrying about them conflicting with their external policy.
- **Can be a useful absorber when there is an external economic shock** – for example, a currency might depreciate in recession giving a lift in export industry

(j)(i) Distinguish between a domestic debt and an external debt

In public finance, **internal debt or domestic debt** is the component of the total government debt in a country that is owed to lenders within the country.
**External debt** is the money that the central government owes to foreign governments and external agencies.
(ii) Give two problems of an external debt.

- Encourage over dependence
- It has high administrative costs
- Worsen the country's BOP position
- Limited capital accumulation due to reduced expenditure on capital goods.
- Affects the level of consumption due to high taxation.
- Reduces the volume of imports into the country
- External debts can be inflationary.
- **It often leads to a vicious cycle of debt for countries**. The debt cycle refers to the cycle of continuous borrowing, accumulating payment burden, and eventual default.

SECTION B

2 (a) Differentiate between maximum price legislation and minimum price legislation

A minimum price is a price set by the government above equilibrium price below which it is illigal to sell or by a commodity.

Maximum price legislation is the a price set by the government below equilibrium price above which it is illigal to sell or by a commodity.

(b) Examine the merits and demerits of government price control.

**Arguments for government control of prices of essential good**

- Price stability: resale price maintenance ensures that prices are stable since retailers cannot increase the set prices which are indicated on the commodities. This reduces inflation
- Through maximum price legislation: price control protects the consumer against exploitation by producers because the producer cannot sell the commodity above the price
- Improves customer's standard of living: it achieved by maximum price legislation which enables customers to afford the commodities
- Controls monopoly: maximum price legislation controls monopoly power in an economy since the prices of the commodities are set below the equilibrium prices and this encourages new firms to join the production process as the monopolists will not be earning too high abnormal profit which tend to increase their economic power
- Stabilization of producer's income: as price control ensures price stability, this lead to stability in producers income from their sales. This enables them to effectively plan their production activity since they are certain about their expenditure and revenue.
- Reduce income inequality; this is achieved as all produces receive equal incomes from their produce as well as paying the same amount of money on factors of production. Consumers also pay the same amount of money hence reducing income inequality among then
- Save time: resale price maintenance save time that would be spent on bargaining. Customers are aware of the prices and have one option of paying for the commodity or not.
- Minimum price legislation encourages production. Prices are set above the equilibrium prices and this encourages producers to produce more output in order to maximize profit since prices are higher than would be equilibrium price

- Enables fair distribution of commodities across the society: through rationing, price control ensures that essential commodities that are seemingly scare are availed to different people
- Discourages consumption of undesirable goods: when the prices are set high demand for undesirable goods falls reducing consumption.
- Easy to calculate total sales: this benefits the producer in estimating his total sales and revenue since the prices are indicated on the commodities. This helps the tax officials to charge a meaningful corporate tax without under tax or overtax.
- Helps an economy to offset an economic depression by selling a price that is higher than equilibrium price.

Arguments against government control of prices

- Reduces incentives to work hard: the maximum price legislation discourages produced since their prices are set below equilibrium prices. This finally leads to reduced output
- Leads to multi-practices: the fixing prices below equilibrium prices lead to hoarding, black market, bribery, corruption and selling of scarce commodities only to friends.
- Leads to shortage on the market caused by increased demand and reduced production
- It leads to unemployment: prices set below equilibrium prices discourage investment and some firms may pull out of business.
- Leads to increased surplus on the market: the minimum price legislation increases the level of output. The surplus leads to wastage of resource.
- Increased cost of living: the minimum legislation increases the prices of commodities
- Increased cost of production: when the price factor inputs are fixed high above equilibrium, it leads to increased cost of production which may force small producers to close down and lead to monopolistic tendencies
- Leads to inefficient allocation of resources: the price mechanism is not allowed to operate freely and this lead to misallocation of resources since the market forces of demand and supply are not allowed to operate freely
- Resale price maintenance denies customers from bargaining price reduction because prices are fixed. Produces may not be able to reduce their prices reducing demand for commodities.

3(a) What are a monopolistic competitive market

- Large number of buyers and sellers
- Free entry and exist of firms
- Product differentiation or branding
- There are many suppliers of the different brands
- No firm has full control over the price
- Firms deal in close substitutes performing the same purpose e.g. bathing soaps
- Firms operate at excess capacity in the long run
- Firms face a downward slopping demand curve which is more elastic that of a monopoly.
- There is persuasive advertisement
- There is no government intervention in fixing prices of commodities produced.
- Lack of Perfect Knowledge
- Less Mobility
- More Elastic Demand.
- Companies compete based on product quality, price, and how the product is marketed.

(b) How does a monopolistic competitive firm determined out put, price and profit in the

(i) short run (6marks)

Short-run refers to that period in which a monopolist cannot change the fixed factors. However, the monopolist is free in determining price due to lack of competition

In short run equilibrium whether the firm makes an abnormal profit, normal profit or loss, it depends on the level of AC and AR which can be shown as follows:-

- If AR=AC, the firm receives a normal profit.
- If AR> AC, the firm receives abnormal profit.
- If AR< AC, the firm bears the loss.

The following conditions must be fulfilled in order to attain equilibrium under monopoly:-

- MR must be equal to MC
- MC must intersect MR from below.

The equilibrium position of a monopoly firm can be graphically presented as follows:-

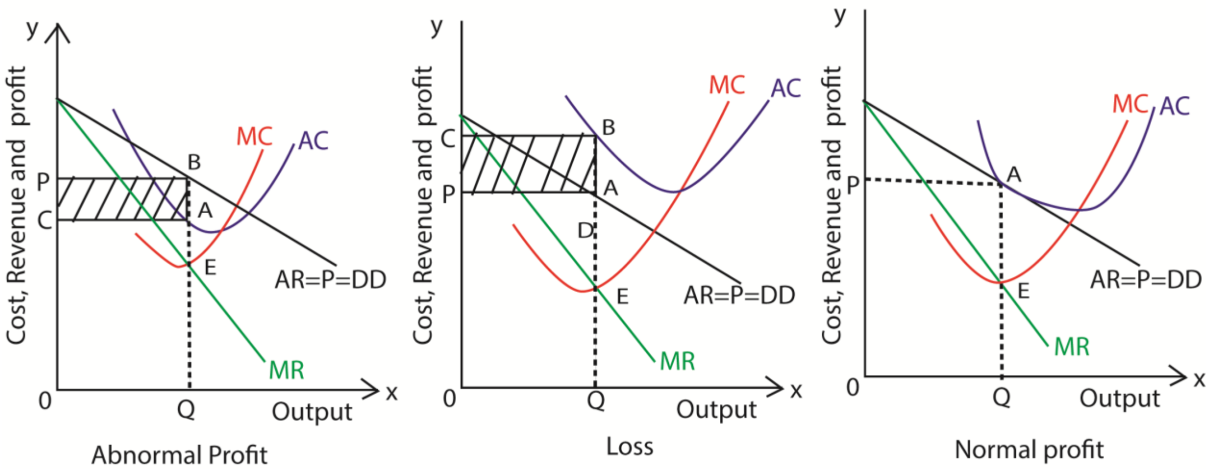



Fig. (a) Fig. (b) Fig. (c)

**Abnormal profit**

In the first Fig. (a), the equilibrium point is 'E' when MC cuts MR from below. The equilibrium level of output is determined at OQ. The level of revenue earned is OP and the cost incurred is OC. Since Revenue is greater than cost, the firm earns abnormal profit equal to the shaded area (ABPC).

**Loss**

In the second figure, point E is the equilibrium point where MC intersects MR from below. The equilibrium level of output is OQ. The cost incurred is OC and the revenue earned is OP. Since cost is higher than revenue, the firm bears loss equal to the shaded area (ABCP).

**Normal profit**

In the third figure, we can see that the equilibrium point is at 'E' where the conditions for equilibrium are fulfilled. The equilibrium level of output is OQ. The revenue and cost are at the same level (OP). The firm earns just a normal profit to sustain its business in the long run.

(ii) long run (6marks)

The firm earns normal profit because of the free entry of new firms; the supplier's substitutes enter the market, so demand is shared among more brands.

4 (a) Distinguish between import substituiton and export promotion strategy of industrialization (4marks)

**Export promotion** refers to government policy and strategies of expanding the volumes of output destined for export.

**Import substitution** refers to establishment of industries to produce goods and services that were formerly imported into the country with the aim of reducing foreign exchange expenditure on imports.

(b) Examine the advantages and disadvantages of import substitution strategy in industrial development:

Merits/advantages of import substitution strategy

- Reduces its foreign dependency through the local production of industrialized products and leads to self-sustenance of economy.
- It yield steady flow of income since prices of industrial products tend to be stable
- Improves skills and marginal productivity
- It provides market for agricultural products
- Reduces balance of payment position since it reduces proportion of imports
- Improves terms of trade because it promotes exportation
- It encourages development of infrastructure such as roads, schools, hospitals, etc.
- Provide government revenues through taxation
- Industries in rural areas reduce rural-urban migration
- Promotes efficient utilization of local resources
- Creates employment
- Promotes customers choice through a variety of products
- control import inflation since the volume of imports is reduced

Disadvantages of import substitution strategy

- It leads to unemployment due to use of capital intensive techniques of production
- Encourage profit repatriation since most factory owners are foreigners
- It promotes monopolistic tendencies as industries are expensive to start
- Leads to wastage of resources due to limited domestic consumer market
- Due to high production costs it leads to cost push inflation
- High protectionism leads to inefficiency of domestic industries and inferior goods and services
- Protectionism is very expensive to implement
- Encourage use of imported inputs such as machinery leading to imported inflation

- Low standards of living due to limited variety
- It leads to rural-urban migration because of localization of industries in urban areas
- Import substitution industries concentrate on production of consumer goods instead of capital assets. This limits the rate of investment for the future.

5 (a) Explain the marginal product theory of distribution as applied to labour.

The marginal productivity theory of distribution emphasizes that a worker should be paid a wage which is equal the value of its marginal product

The theory is based on the following assumptions

- No government interference
- The law of diminishing returns operate
- Workers and employers can calculate MRPL
- All factors of production are substitutable
- Output can be quantified in measurable units
- All factors are fully employed
- Bargaining power of employer and employee are equal
- The major goal of the firm is profit maximization
- Perfectly competitive market
- Factors of production are divisible

(b) What are the limitations of the marginal productivity theory of distribution in determination of wages?

- The theory assumes that there is no government interference, but government usually interferers in wage determination
- The theory assumes the law of diminishing returns, but this does not apply at all times since government sometimes establishes minimum wages
- The theory assumes that employers can calculate $MRP_L$ but labour employers cannot calculate the marginal product and it changes with time leading to wage instabilities.
- It assumes that all factors of production are substitutable but some factors of production are not substitutable
- It assumes that output can be quantified in measurable units to quantify the output
- It assumes that all factors are employed, but all factors of production are not fully employed.
- The theory assumes that the bargaining power of labour and management is equal, this is not true because most times workers are exploited.
- It assumes perfect competitive labour market but there is no perfectly competitive labour market.
- Wages are usually determined by several other factors rather than marginal product of labour.
- The labour is not perfectly mobile.
- The theory assumes that there exists perfect competition in all the markets. But in reality, perfect competition is only an imaginary concept. In modern days, perfect competition does not hold good.
- The marginal productivity theory holds good in the long run only while it ignores the short period

- The theory assumes employment can be increased by wage cut. Moreover, according to Keynes, the volume of employment is not determined by wage rate but by effective demand.
- Production is the result of the co-operative efforts of all the four factors of production and it is not possible to separate out the contribution of one factor.

6(a) Examine the cause of structural unemploymnt in an economy (8marks)

- **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 becomes 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.

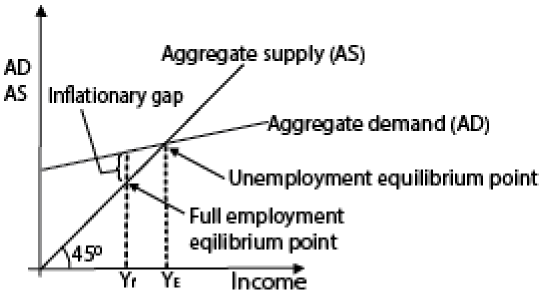
(b) What measures should be taken to curb unemployment in an economy (12 marks)

- **Ensuring political stability and crime reduction**; encourages investment and job creation.
- **Improvement of infrastructure**; several roads are being constructed and renovated to encourage investment and labour mobility.
- **Power generation and rural electrification**; encourages investment in rural area increasing job opportunities
- **Education reforms;** Encourages vocational education; to provide people with employable skills.
- **Promotion of economic integration**; to expand market and investment and labour creation and mobility.
- Measure to reduce population growth such family planning
- **Privatization** of public enterprises increases efficiency and job creation.
- **Liberalization of economy**. Attract more potential investors
- **Development of financial institution** like banksto provide credit to local investors to boost production and hence job creation
- **Setting up investment institution** such Uganda investment authority (UIA) to promote investment and job creation.
- **Modernization of agricultural sector**. This reduces the rural under employment and encourages the population to engage in agriculture.
- **Advertising existing jobs.** Job centers are being created to provide job awareness.
- **Adopting land reforms** that increase land usage.
- **Adopting the price policy** to stabilize prices of agriculture outputs to encourage employment in agricultural sector

- **Diversification of Agriculture:** to increase profitability of agriculture.
- **More assistance to self-employed people:** with finances and technical training to grow and create employment.
- **Decentralization of industrial activity** in to spread employment across the country.
- **High rate of capital formation:** government should make investments leading high job creation

7. (a) Distinguish between a deflationary gap and an inflationary gap (4marks)

Inflationary gap is the amount by which the actual aggregate demand exceeds 'aggregate supply at level of full employment'.

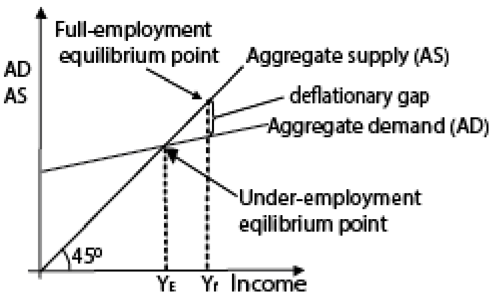



The diagram above shows that the bigger the inflationary gap, the smaller the level of national income since income increases from $Y_f$ to $Y_E$. Also,

Inflationary gap causes a rise in price level which is called **inflation and leads to an increase in employment and income.**

Deflationary Gap:

Deflationary gap is the amount by which aggregate demand falls short of aggregate supply at level of full employment'. As shown in the figure below deflationary gap is a measure of amount of deficiency of aggregate demand.




The bigger the gap the national income since the income increases from $Y_E$ to $Y_f$.

Deflationary gap causes a decline in output, income and employment along with persistent fall in prices.

(b)Examine the policies that a country should adopt to close

(i) A deflationary gap (8marks)

- **Fiscal policy**: the government should reduce taxes on people's personal income so that they are left with enough disposable income to spend.
- The government should increase her expenditure on social services so as to increase the amount of money in the circulation which leads to increase in aggregate demand.
- There is a need to reduce the interest rates so that people can be encouraged to borrow for consumption which increases aggregate demand
- Government should increase wages as well as encouraging trade unions to demand increases in wages from private institutions to increase aggregate demand
- The government should encourage tourist and immigrants into the country to increase aggregate demand.
- The government should encourage export of excess output to reduce on the aggregate supply and the earnings to increase aggregate demand
- The government should control political instability so that people are encouraged to work and earn incomes to increase aggregate demand
- Adopt expansionary monetary policy: the government through the central bank print or issue more currency to increase the level of aggregate demand.
- Discourage imports which tend to increase aggregate supply and reduce aggregate demand for domestic good and service
- Encourage subsidies, the consumer can be offered subsidies to increase their levels of consumption thereby increasing aggregate demand.

(ii) an inflationary gap

Decrease aggregate demand through

- Reductions in government spending
- Increasing taxes
- Reduction of exports
- Price control
- interest rate increases
- improvement of investment climate
- strict income and wage control

8. (a) Differentiate between the following

(i) Preferential Trade Area and Free trade area (3marks)

**Preferential Trade Area** occurs when countries reduce tariffs among themselves and leaving those tariffs for nonmember countries as they are.

A **free trade area** is a region in which a number of countries have signed a free trade agreement and maintain little or no barriers to trade in the form of tariffs or quotas among one another.

(ii) Custom Union and Common Market (3 marks)

**Custom union** is when member countries abolish all tariffs among themselves and adopt a common external tariff policy against nonmember countries.

**Common market** is when member countries abolish all tariffs among themselves, adopt a common external tariff policy against non-member countries and there is free movement of factors of production among themselves.

(b) Examine the merits of regional integration. (14 marks)

- Production on scale leads a reduction in the cost of production and reduced inflation
- Leads to increase in product availability and customers' choice.
- market expansion and efficiency gains
- increase investment to cater for bigger market
- economic and political stability because of stronger economic ties, which provide an incentive to resolve conflicts peacefully and lead to greater stability
- Trade liberalization due to minimal government intervention
- Increase in employment opportunities and labour mobility
- Leads shared costs of public goods or large infrastructure projects
- Encourage joint research and skill development
- Promotes proper utilization of resources due to competition among member countries

Thank you

Dr. Bbosa Science