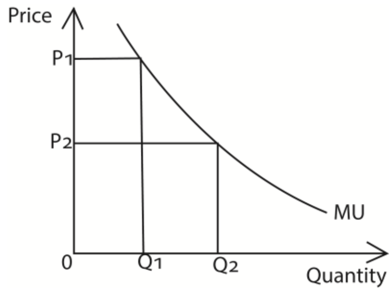
Economics paper 1 set 9 and marking guide

1(a)(i) State the law of diminishing marginal utility. (2marks)

The law of diminishing marginal utility states that **all else equal, as consumption increases, the marginal utility derived from each additional unit declines**.

(ii)Explain the relationship between diminishing marginal utility and the demand curve (2marks)

- As marginal utility falls, demand also falls since consumers will be willing to consume additional units at lower prices
- Both have negative slope i.e. they obey law of demand



(b)(i) What is resale price maintenance?

This is the price set by the producer/manufacturers of a product and it is maintained up to the final consumer e.g. the price of a newspaper, postage stamps, and soft drinks

(ii) State two merits of resale price maintenance

- Protects consumers from exploitation
- Reduces competition between large scale and small scale retailer
- Increased producer's sales and profits
- It controls price stability and inflation

(c)(i) Define the term marginal propensity to consume. (2marks)

Marginal Propensity to Consume (MPC) is **the proportion of additional income that is spent on consumption**. Or it is the ratio of change in consumption to change in income i.e. MPC $=\Delta C/\Delta Y$

(ii) Given that a country's national income is Ushs. 100millions, the marginal propensity to consume is 0.6. Calculate the country's final level of income (2marks)

Multiplier = 1/(1-MPC) = 1/(1-0.6) = 1/0.4= 2.5

Final level of national income = initial income x multiplier = 2.5 x 100m = 250m

(d) (i) What is under population? (1mark)

Under population is a situation of having a lower density of population than is normal or desirable to achieve full potential of economic output.

(ii) Mention any three disadvantages of under population (3marks)

- Limited market size
- Low labour supply
- Limited competitiveness, innovations and inventions
- Low tax revenue

(e)(i) Define the term "frictional unemployment". (1mark)

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

(ii) What are causes of frictional unemployment? (3marks)

- **Ignorance of the existing job opportunities** due to failure to get in touch with the media or when the jobs are unadvertised.
- **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 delays labour to get a new job immediately.
- **Poor working conditions** which force labour to change jobs.
- **Boredom at place of work** which makes people change place of work
- **Conflicts/difficulties** in place of residence that force people to change place of residence and hence jobs
- **High level of education**

(f) State any four policy measures to control cost-push inflation in an economy (4marks)

- Subsidization policy i.e. subsidizing producers
- Reduction in bank interest rates
- Reduction in taxes
- Maximum price legislation
- Use of non-monetary reward/fringe benefits
- Wage control measures

(g)(i) Distinguish between barter terms of trade and income terms of trade. (2marks)

The most common is the net barter (or commodity) terms of trade index, or **the ratio of the export price index to the import price index**.

Income terms of trade (ITT) is **is the ratio of value of exports to the price index of imports**

(ii) State any two obstacles to success of barter trade in an economy

- Perishability of some goods
- Bulkiness of items that make their transport difficult
- No standard value for measurement purpose

- Indivisibility of some commodities
- Limited credit transaction
- Problem of double coincidence of wants

(h)(i) Differentiate between floating exchange rate and fixed exchange rate

A ***pegged rate***, or ***fixed exchange rate***, is determined by the central bank of the country while **managed or floating** exchange rate is determined by the dynamics of market demand and supply.

(ii) Give any two advantages of floating exchange rate

- 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

(i)(i) What is meant by "economic planning" (2marks)

Economic planning is a deliberate government attempt or efforts to **design** measures to influence and control economic activities towards achieving economic goals in a given period of time.

(ii) Differentiate between comprehensive planning and perspective planning (2marks)

A comprehensive plan **provides a vision for the future of the country along with the steps that are needed to make that vision a reality** and covers all sectors of economy.

Perspective planning is a long term government planning that sets its target to occur for long period of time over 10 years.

(j)(i) What is meant by incidence tax? (2marks)

A tax incidence refers to the final resting place of a tax i.e. the person or any entity that finally bears the burden of a tax.

(ii) Differentiate between a taxable capacity and taxable base

Taxable Capacity means the maximum capacity of the people of a country to bear the burden of taxation without much hardship

A **taxable base** is a range of economic activities on which government levy taxes. They include t**he total amount of income, property, assets, consumption, transactions, or other economic activities.**

SECTION B

2. (a) Outline the

(i) Features of an Oligopolistic market structure (6marks)

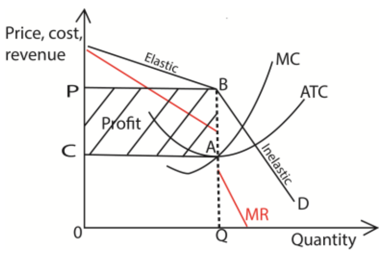
- Few firms/suppliers and many buyers existing in the market
- Homogeneous products (perfect oligopoly) and differentiated products (imperfect oligopoly)
- Price wars/cut throat competition
- Price leadership for largest and low cost firms
- Non-price competition through advertising, after sales services, etc.
- Mutual dependence among firms.
- Limited information about the market
- Limited variety of products
- Abnormal profit earned both in short run and long run.
- P= AR> MR = MC at equilibrium level of output
- High degree of uncertainty
- No unique pattern of pricing.

(ii) Advantages of an oligopolistic market to consumers (6marks)

- High quality products due to competition
- Provision of efficient service
- Provision of prizes and gifts to consumers
- Prices charged are relatively stable
- Provision of after sales services
- Prices tend to be low due to competition
- Consumer are satisfied through differentiation of products
- Advertising of products keeps consumer aware about the use of products on the short run
- There is intensive research and product development.

(b) Explain how an Oligopolistic firm maximizes profit in short run

The oligopolist maximizes profits where MC = MR, which results in an equilibrium output of Q units and an equilibrium price of P. The oligopolist faces a kinked-demand curve because of competition from other oligopolists in the market. MC and ATC curve pass through the gap between MR curves; C is unit cost.



Abnormal profit is represented by area ABPC.

3(a) Explain how price index are computed. Illustrate your answer. (08marks)

Procedure taken

- Define the objectives of calculating the price index e.g. wage determination.
- Choose an area where the data is to be collected
- Get the price for each good in a basket
- Choose a base year (a year when prices were relatively stable)
- Simple index of the base year should be given unit 100
- Attach weights to each good in the basket
- Obtain prices in the current year

A hypothetical table is shown below

Commodity	Base year prices	Base year simple index	Current year prices (4years later)	weight
A	200	100	700	5
B	150	100	500	4
C	500	100	1000	3
D	100	100	300	2
E	700	100	1200	1

Simple calculation/illustration

(i) Simple price index = (current year price/base year price) x 100

For A: (700/200) x 100 = 350

For B: (500/150) x 100 = 333.3

For C: (1000/500) x 100 = 200

For D: (300/100) x 100 = 300

For E: (1200/700) x 100 = 171.4

(ii) Average simple price index = Total simple price index/total number of commodities

=(350 + 333.3 + 200 + 300 + 171.4)/5

= 1354.73/5

= 271

(iii) Weighted price index = simple price x weight

A: 350 x 5 = 1750

B: 333.3 x 4 = 1333.2

C: 200 x3 = 600

D: 300 x 2 = 600

E: 171.4 x 1 = 171.4

(iv) Average weighted price index = sum of weighted price index/sum of weight
= (1750 + 1333.2 + 600 + 600 + 171.4)/(5 + 4 + 3 + 2 + 1)
=4454.6 / 15
= 297

(b) Why may price indices be unreliable indicators of cost of living?

- Unrepresentative results due a few places sampled which do not cover the whole country.
- It is difficult to assign weight to different because of differences in tastes and preferences.
- Difficult in choosing the representative families, from where necessary data has to be collected.
- Difficult to find a base year with stable prices
- Variations of prices with seasons.
- Choice of the prices to be collected whether wholesale prices or retail prices
- Different methods: whether simple index number or weighted index number give different values
- Inadequate skilled labour to collect information
- Regional differences in prices of basic needs
- Lack of standard units for sale of the basic needs across the country
- Inadequate funds for the process of compilation of data for instance money for transport and stationery
- Individual income may change consumption patterns
- Wrong information from interviewee.
- Unstable taste and preferences of interviewees.
  Unrepresentative basket of goods due to different income groups.
- Price discrimination may make it difficult to choose a price of a commodity.
- Food basket may change when a new commodity enters market.
- 4. (a) Why should developing countries industrialize?
- It increases the volume of goods and services that in turn increase human choice hence increases consumer sovereignty
- It increases a country's tax base and government's revenue. Also ensures provision of social services like education
- It raises the general standards of living of people overtime especially when per capita income grows over a long period of time
- It is powerful tool against poverty. Those who contribute towards economic growth escape the vicious cycle of poverty
- It brings about employment opportunities in many growing sectors of economy. This finally leads to income redistribution

- It improves the balance of payments of the country concerned. Increased output leads to increased exports and consequently reduces balance of payment deficit.
- Since industrialization increases output, the general price level is expected to fall. Commodities become relatively cheap. This reduces the rate of inflation and increases the rate of consumption.
- It contributes to a country's prestige because as economy grow faster, its military and economic strength grow
- It supplies agricultural sector with inputs such as fertilizes and insecticides
- Leads to foreign exchange earnings
- It leads to increasing returns to scale, which is not the case with agricultural sector. This therefore leads to fast economic growth and development
- Leads to economic diversification
- It is not subjected to vagaries of climate such as draught and floods
- Leads to development of skills
- It encourages full exploitation of resources

(b)Examine the limitation of import substitution strategy of industrial development.

- Limited domestic market to sustain development of industries.
- Import substitution requires a lot of protection and subsidies rarely affordable by government.
- Lack of competition make infant domestic industries leading to poor quality goods and services
- Industries to produce import substitutes require very high capital (such as machinery) not affordable by local investors
- The use of capital intensive techniques reduce employment opportunities
- Cause imported inflation due high cost of inputs
- Low technology and skilled manpower fail to produce import substitutes
- Import substitution industries in urban area because of availability of market lead to rural-urban migration
- Decrease in government revenue to reduce import duties
- Import substitution encourages foreign investors resulting in profit repatriation
- It requires stable political environment to attract foreign investors.
- Import substitution leads to poor quality goods due to lack of competition and poor technology
- Import substitution industries tend to concentrate on production of consumer goods instead of capital assets. This limits future investment
- It encourages monopolies
- Import substitution requires a lot of skilled labour that cause high expense for training abroad.

5 (a) What is meant by economic integration? (4marks)

Economic integration is **a mutual arrangement among nations that typically includes the reduction or elimination of trade barriers and the coordination of monetary and fiscal policies. Such as ECOWAS (1975), EAC (2001)**

(b) Examine the merits and demerits of economic integration (16marks)

Merits/advantages of economic integration

- 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

Demerits of economic integrations

- **Loss of sovereignty;** Members of economic unions typically are required to adhere to rules on trade, monetary policy, and fiscal policies established by an unelected external policymaking body
- **Diversion of trade;** That is, trade can be diverted from nonmembers to members, even if it is economically detrimental for the member state.
- **Employment shifts and reductions.** Economic integration can cause companies to move their production operations to areas within the economic union that have cheaper labour prices. Conversely, employees may move to areas with better wages and employment opportunities.
- **Difficult in managing coordinate monetary and fiscal policies**
- **Challenges in controlling external trade and production units**
- Elimination of central banks
- **Higher tariffs and reduced free trade due to protectionism**
- **Loss of customs revenues.**
- **May result in unfair distribution of gains.** Due to free movement of goods and services which sometimes move in one direction
- **Leads to consumption of low quality goods from member countries**
- **Leads to surplus output due to limited market**
- **Sabotage and foreign influence like IMF and world bank** that undermine integration

6(a) Distinguish between devaluation and currency depreciation

Devaluation is a deliberate/legal government policy to lower the value of the domestic currency in relation to foreign currencies.

Currency depreciation is **a fall in the value of a currency in terms of its exchange rate versus other currencies due to forces of demand and supply**.

(b) Why may devaluation fail to achieve the objectives it is intended in an economy.

- 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
- When devaluating country is experiencing inflation this leads to lower demand for the domestic products
- When devaluating country is not a major supplier/producer of export commodity in question
- When devaluating country lack export promotion structure to increase export volumes
- May lead to development of inferior goods due to lack of competition

7(a) Differentiate between decentralized planning and centralized planning. (4marks)

Decentralized planning is **a type of economic system in which decision-making process is distributed amongst various administrative regions/level or localized within production agents**

Centralized planning **type of economic system in which decision-making process is done at a national level by specialised authority such as a National Planning Authority.**

(b) Account for existence of decentralized planning in developing country.

Reasons for/advantages of decentralized planning in developing country

- It involves local people in formulation and implementation of plans which is a key to developing economy.
- It takes into account the local environment unlike centralized planning
- It reduces interference of the central government in development plans
- It allow equitable distribution of employment opportunities
- There a close link between planners and implementer of the plans leading to better supervision and control
- There is limited bureaucracy
- It relieves the central government of some obligations.
- It encourages regions (districts) to utilize local resources especially manpower
- Encourage people’s participation in development plans and efficient communication
- It reduces rural-urban migration because it creates employment opportunities in rural areas
- It allows regions to cater for its interests leading satisfaction of regional needs.
- Promotes division of labour between central and local governments
- Leads to skill development at local level.
- Motivates local government to implement their plans

8(a) What is meant by unbalanced budget (4marks)

A government budget is said to be **unbalanced** if the estimated government receipts are not equal to the estimated government expenditure.

(b) Why may government deliberately plan for an unbalanced budget?

Reasons for surplus budget

- To reduce aggregate demand by withdrawing excess amount of money from circulation
- So that government uses surplus budget to improve on the balance of payment position for instance by promoting import substitution industries
- To accumulate reserves for future investment/needs
- To improve the confidence of the population in the government
- To prepare for disasters
- To improve cooperation with other countries through provision of aid.

Reasons for deficit budget

- To reduce the burden of taxation from people
- To increase the level of supply
- To increase the level of aggregate demand in case of deflation
- Encourage saving among the general public
- Stimulate a level of economic growth
- Making borrowing cheaper for projects
- Lifting economy from slump or depression

Thank you

Dr. Bbosa Science