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Chapter 1: Introduction to economics

Definitions of economics

Economics is concerned with the use of scarce resources to satisfy human endless needs. It deals with the ways in which production, distribution and consumption of goods and services change over time to satisfy human needs.

Reasons why we study Economics

1. To understand the basic economics concepts and principles.
2. To help the students understand how to use the scarce economic resources in order to improve on the well-being of the society,
3. To help students participate and effectively understand the development process of their nations.
4. To assist students in understanding the formulation and implementation of economic policies needed for economic growth and development. For instance policies on unemployment, inflation, Government spending, etc.
5. To help the students understand the need for international trade among countries and how each country is faced with scarcity of resources.
6. To help students appreciate the role of planning both for the present and future generations.

Concepts used in economics

Economic theory; this is a body of principles and concepts which help us to explain, understand and make predictions in economics, It is divided into two parts namely;

- (a) **Microeconomics**. This is the study of economic actions of individuals and small economic units, That is, it looks at the functioning of individual economic units e.g. the price of the commodity in the particular market, demand and supply of one commodity, output of one firm etc.
- (b) **Macroeconomics**. It refers to the study of the economy as a whole or as an entity. OR It is the study of the aggregate behavior individual economic units in an economy as a whole. It considers the behavior of all the economic activities in a given economy. For example unemployment, inflation, aggregate demand and supply etc.

Positive and Normative economics

Positive economics is **objective, fact based and concerned** with what the world was, is and will be. For instance; "An increase in taxation will result in less consumption" and "A fall in supply of petrol"
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will lead to an increase in its price" are verifiable facts of life

Normative economics is subjective and value based, that is what people think the world would have been. Having a belief that the income should be distributed evenly in the economy is an example of normative economics. It is concerned with value judgments of individuals.

Wealth refers to the stock of assets and other resources existing in an economy at a given time that can be measured in terms of either real goods or money value and can be used to generate more income.

Characteristic of Wealth

1. It is relatively scarce. That is, it is limited in supply,
2. It provides satisfaction (utility)
3. It has money value. That is, it has price.
4. Wealth can be used to produce more wealth.
5. The ownership of wealth is transferable, That is, it can be exchanged.

Economic wants are desires that can be satisfied by consuming a good, service, or leisure activity. For example food, shelter, security etc.

Characteristics of wants

1. They are recurrent (endless)
2. They are competitive in nature
- J. They are dynamic, that is, they keep on changing from time to time
11. They are complementary, that is, they are jointly used.

The fundamental economic questions

The economic questions influence resource allocation. They include;

1. When to produce? That is, the period or season of production, whether to produce now or in future.
2. Where to produce from? That is, the location of the business, whether to produce near the source of the raw materials or near the market
3. How to produce? That is, the method or technique of production, whether to use capital intensive technology or labour intensive technology.
4. For whom to produce? That is, the nature of consumers who are to consume the products.
5. What to produce? That is, the nature of the commodity to be produced. Whether capital or consumer goods, for export or for domestic consumption etc.

Types of Goods

- (a) **Consumer goods**; these are goods meant for final consumption. They do not involve more processing. For example food stuffs, books, clothes, etc.
- (b) **Producer (Capital) good**; these are goods which are used in the production of other goods. For example raw materials, machines, etc.
- (c) **Intermediate goods**: These are goods that still need more processing in order to obtain final goods. For example cotton lint.
- (d) **Durable goods**; these are goods which are long lasting. For example buildings, machines, etc.
- (e) **Free goods**; these are goods which exist naturally in abundance such that one's desire can be satisfied at zero prices. For example, water, sunshine, air, etc.
- (f) **Economic goods**; these are goods which are relatively scarce as compared to human wants and their consumption involves a cost.

Characteristics (Features) of economic goods

- They have monetary value.
- They are marketable
- They provide satisfaction (utility) to the consumer
- They are relatively scarce
- They are transferable in terms of ownership.

(g) **Private goods;** these are goods which are enjoyed exclusively by individual e.g. personal cars, clothes, houses etc.

(h) **Public goods;** these are goods provided by the government (state) and they are collectively owned by the members of society in such a way that their consumption by an individual does not reduce the amount available to other individuals at the same time, for example public roads, hospitals, defense etc.

Characteristics (Features) of public goods

- They are **non-divisible**, that is, they are equally available to all individuals in society
- They are **non-excludable**, that is, their consumption by an individual does not reduce the amount available to others at the same time.
- Their **consumption does not** involve a direct cost.
- They are provided by the state on behalf of the citizens
- There is non-rivalry in their consumption, that is, there is no competition in their consumption,

(i) **Merit goods;** these are goods whose consumption is deemed intrinsically desirable to the consumers such that their social benefits exceed the private gains when consumed, For example education, health care and safe water etc.

(l) **Essential goods (Necessities);** these are goods that man cannot do without. For example food, shelter, water etc.

(k) **Normal goods;** these are goods whose demand increases as the consumers' income increases.

(j) **Inferior goods;** these are goods whose demand decreases as the consumers' income increases. They are mainly demanded by the low income earners, for example second hand clothes,

(m) **Giffen goods;** these are goods which take a large proportion of consumer's income such that when their prices increase, consumers tend to reduce on the consumption of other goods and buy more of them. For example basic food stuffs like banana, posho, etc.

Note: All Giffen goods are inferior good; but not all the inferior goods are Giffen.

(n) **Substitute goods;** these are goods which serve the same purpose. For example tea and coffee,

(o) **Complementary goods.** These are goods that are jointly used together, for example cars and petrol, cameras and films, guns and bullets etc.

(p) **Services;** these are intangible items used to facilitate the production of goods and services. For example banking services, transport services, services of a teacher.

Basic (fundamental) economic problems (principles)

There are three fundamental economic problems (principles). These include scarcity, choice and opportunity cost

- **Scarcity.** This refers to limited supply of resources required to produce goods and services required to meet human needs. However, because of scarcity of resources, man decides to meet some of the needs from the available alternatives by making choice.
- **Choice.** This refers to making right selection from the given alternatives to satisfy human wants basing on the available scarce resources. Choice is determined by the scale of preference. The *Scale of preference* refers to the list of needs arranged according to the in order of priority (importance), starting with the most pressing needs. By making choice, some alternatives are left out hence opportunity cost,
- **Opportunity (Real) cost;** this refers to the value of the second best alternative foregone when choice is made basing the available scarce resources.

For example if an individual has 100,000/= and she wants to buy two commodities X and Y

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Y whereby the price for X is 100,000/= and the price Y is 150,000/=. If he buys commodity X using all his money, she foregoes the value of commodity Y which is worth 150,000/=

Some uses (importance/applications) of the concept of opportunity cost

1. It helps the producer in allocation of resources. That is, determining what to produce, when produce, how to produce, where to produce and for whom to produce
2. It helps consumers in making consumption choices. That is, consumers choose to buy a commodity that maximizes utility.
3. It is used in pricing factors of production. That is, the price of a factor of production must be placed at a higher level than its opportunity cost.
4. It is applied in international trade under the principle of comparative advantage in which a country specializes in the production of a commodity where it has the least opportunity cost.
5. It is used in planning and budgeting for public and private expenditures in presence of scarce resources.
6. It helps workers to make employment decision, based on the opportunity cost of leisure

Limitations of the concept of opportunity cost

1. Some factors of production are specific in that they cannot be put to alternative uses.
 1. It is not applicable where costs and benefits cannot be measure in monetary terms.
 3. The concept assumes perfect market which is not applicable in the real world.
 4. It is not applicable in situations where factor immobility exists.

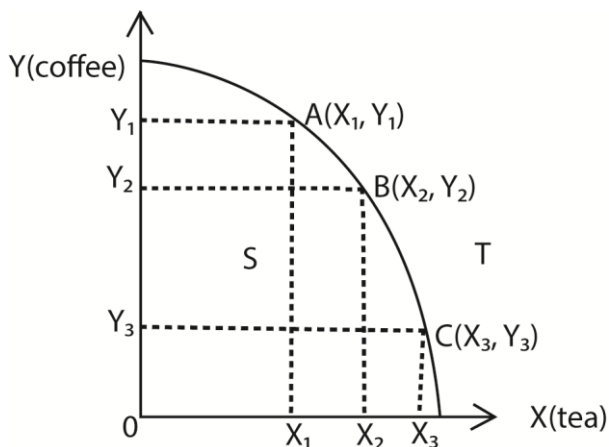
The Production Possibility Frontier (PPF) / (Opportunity Cost curve)

The **production possibility frontier (PPF)** is a locus of points showing all possible combinations of two commodities that can be maximally produced when all resources are fully and efficiently utilized at a given level of technology,

The PPF assumes the following,

1. Production of only two commodities.
2. Constant technology
3. Full employment of resources.
4. Constant prices of commodities
5. Perfect mobility of factors of production

Illustration of the PPF



The PPF above shows that all resources are used to produce two commodities X (tea)

and Y (coffee). Along the PPF curve, there are various combinations like A, B and C each representing two commodities produced in different quantities or units.

- At point A, more units of Y (coffee) are produced than X (tea). And at point C more units of X (tea) are produced than Y (coffee).
- The PPF curve can be used to explain the concepts of scarcity choice and opportunity cost as follows;

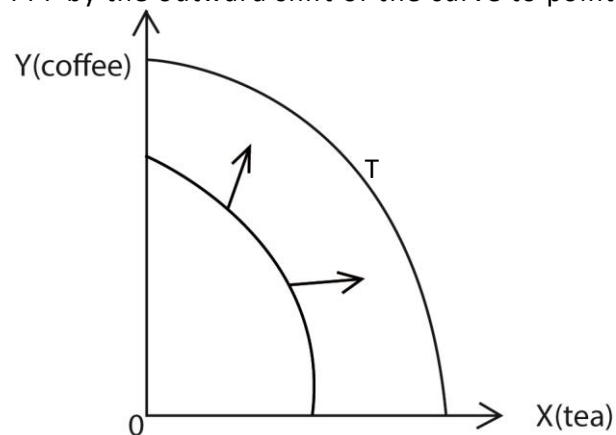
Scarcity; since resources are scarce man is forced to produce along the PPF, that is, man cannot produce beyond the PPF using the available resources and at constant technology,

Choice; since there are so many alternative combinations to be produced along the PPF, man has to choose the appropriate combination from the given alternatives. He may decide to choose either combination at point A, B, C or at any other along PPF

Opportunity cost; Along the PPF, if a man chooses to produce at point A and leaves out point B, then the value of the combination at point B becomes the opportunity cost.

- **Efficient production;** this is represented by all points along the PPF that is, the points along the PPF show the efficient utilization of the available resources. Points inside the curve like point S imply inefficiency in production in form of underutilization of resources. Points outside the curve like T cannot be attained using the available resources and technology.

Economic growth; this refers to the persistent increase in the volume of goods and services produced in a country in a given time. Economic growth is illustrated on PPF by the outward shift of the curve to points like T as illustrated below;



The outward shift can be as a result of the following factors

1. Improvement in technology through innovations and inventions. **Innovation** refers to the improvement on the existing techniques and methods of production while **invention** refers to the total discovery of new techniques and methods of production.
2. Increase in labour force.
3. Improvement in the existing infrastructure.
4. Political stability.
5. Discovery of new resources in the economy,
6. Increase in capital stock.
7. Improvement in entrepreneurial skills.
8. Increase in the efficiency of workers

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Economic systems

An economic system is an organization of ownership, allocation and distribution of resources in a given economy. There are three main types of economic systems.

1. Free enterprise economy (market /capitalism/Laissez faire economy).
2. Centralized economy (planned/command economy).
3. Mixed economy

Market (Free enterprise/Laissez fair) Economy

This is an economic system where productive resources are owned, controlled and allocated by private individuals without government intervention. Resources are allocated by forces of demand and supply.

Feature (Characteristics) of a Market Economy

1. There is private ownership and allocation of resources
2. Freedom of entry and exit in economic activities
3. There is perfect competition among firms
4. Producers aim at maximizing profits
5. There is limited or no government intervention in economic activities
6. There is existence of consumer sovereignty (Freedom of choice by consumers)
7. Resource allocation is based on forces of demand and supply
8. There is promotion of self-interest,

Advantages (merits) free market economy

1. It provides a society with the right goods or services at the right time due to competition
2. **A market economy promotes entrepreneurship;** because the emphasis within a market economy is on innovation, it creates an environment where entrepreneurship can thrive.
3. **It reduces the need to store products;** because the laws of supply and demand are enforced in a market economy, manufacturers produce goods based on the demands that the society requires.
4. **Market economies tend to provide more jobs;** because it allows very many small firms to thrive thereby creating employment.
5. It **increases efficiency in resource allocation.** The major aim of private firms is profit maximization
6. It **encourages competition in production.** This leads to the production of high quality goods and services at reduced prices hence better standard of living.
7. It leads to the **production of a wide range of commodities.** This widens the consumers' choice hence better standards of living through utility maximization.
8. It **reduces government expenditure in form of administrative costs.** This is because it does not require government officials to monitor the economic activities.
9. It **encourages technological progress.** This is achieved through inventions and innovations due to competition among private individuals, this leads to the production of better quality goods and services.
10. **It promotes consumer sovereignty in the economy.** Consumers have a wide variety of products to choose from.
11. There is **no resource wastage during the production process.** Products and services are produced based on customer demands and what they are willing to pay.

Disadvantages (demerits) free market economy

1. **Damage to the environment** – economic activities can damage the environment; the wellbeing of

the environment is not the focus of the market economy. Government regulations will have to mandate the safety of the environment.

2. **Monopolies** – technology breakthroughs can result in monopolies. Monopolies tend to take advantage of consumers.
3. **The disparity between income and wealth** – if the return on capital is higher than the economic growth it will cause an income and wealth disparity. Destabilizing the economy in the long run.
4. **Automatic resource allocation** – may result in specific not-very-profitable yet vital sectors left-off without enough resources which might have severe consequences over the long run.
5. **Crises prone** – for example, the profit motive may result in the adoption of automation and worker exploitation thereby dropping the disposable income and hence reducing consumption and plunging the economy into a recession
6. **No government intervention** – can lead to manufacturers charging the customers whatever fee they want.
7. **Inequality** – It faces inequality problems among the citizens.
8. **Profit as a motive** – As the government is in no control of production, profit is the only motive for the production of goods.
9. **Poor working conditions** – There might be poor working conditions as there is no government regulation in place.
10. **Unemployment** – Unemployment may rise as there is no government check in the market.
11. It leads to production and consumption of harmful products in the economy. Such goods include cocaine, marijuana, alcohol etc. This leads to deterioration in the standards of living of the consumers.
12. It leads to resource wastage through excessive advertisement and duplication of goods and services. This leads to misallocation of resources in the economy.
13. The system does not cater for structural changes like flooding, famine which require proper government planning.
14. It encourages market imperfections like price fluctuations, product shortages, etc. in the economy due to lack of government control.
15. The system does not cater for the underprivileged and vulnerable members of the society like the lame and the poor who would otherwise be catered for by the government.
16. The system under mines the provision of basic /essential goods and services which are non-profitable. This is because the private individuals aim at venturing in activities in which they maximize profits.
17. It leads to divergence between private and society interests. This is because private individuals may maximize profits at the expense of the society in terms of negative externalities like environmental pollution in terms of noise and water pollution.

Command (Planned /centralized) Economy

This is an economic system where the resources are owned, controlled and allocated by the government (state) on behalf of its citizens. Planning and major economic decisions are made by the state (the planning authority).

Features (characteristic) of a Planned Economy

The primary features of a centrally planned economy include:

- All resources are owned and managed by the government.
- The market forces are not allowed to set the price of the goods and services.
- Government policies are put in place to execute economic plans.
- Most economic plans are created by the Government, except for a few sectors.

- Effective and equal economic stability is the objective.
- Central authority distributes the resources at its own will.
- Market factors are restricted from financial bias.
- There is no Consumer or producer sovereignty.
- Profit is not the main objective, instead the government aims to provide goods and services to everybody.
- Government decides what to produce, how much to produce and for whom to produce.

Advantages (Merits) of the Planned Economy

1. **Unemployment is low** as the Government controls employment.
2. **Least financial wastage** as supply of resources is regulated.
3. **Affordable market prices** because monopolies are controlled
4. **Profit is not a primary objective.** Instead, the economy focuses on public welfare.
5. **Negligible inequality of wealth.**
6. **Restriction on essential sector monopoly.**
7. **The government is in position to provide public goods like roads, hospitals, water supply, power supply etc.** which cannot easily be provided under the market economy. Such public goods directly improve on the welfare of the citizens.
8. **The government is in position to provide essential goods and services** which are non-profitable making. Some business ventures are commercially unprofitable and not attractive to the private sector which is profit orientated and yet they may be economically and socially desirable. The state comes in to provide such vital services through parastatal bodies. For example security.
9. **The system can cope up with the rapid structural changes.** For example drought, famine, etc. through proper planning by the central planning authority.
10. **The system caters for the unprivileged group of people in the society** like the lame and poor hence equal distribution of opportunities.
11. It **controls the production and consumption of harmful products the economy.** The government is in position to regulate the production of such commodities like alcohol and cigarettes through taxation. This helps to improve on the standards of living of the citizens.
12. **The system promotes economic stability in form of price controls and other macroeconomic policies by the government.**
13. **Some key areas like production of fire arms cannot be left in the hands of private individuals.** This is because it may cause insecurity in the country hence the need for the planned economy,
14. There is no duplication as the allocation of resources is centrally planned.
15. **Each person receives the same chance to pursue their goals or dreams**

Disadvantages (demerits) of a planned economy

1. **Consumers cannot choose and only those goods and services are produced which are decided by the government.**
2. **Lack of profit motive may lead to firms being inefficient.**
3. **Lot of time and money is wasted in communicating instructions from the government to the firms.**
4. Lack of competition leads to the production of poor quality products hence low standard of living
5. The system is associated with levels of corruption and embezzlement of government funds for personal benefits. This leads to misallocation resources.
6. The government has a lot of responsibilities to carry out efficient planning for the whole country.
7. It leads to budgetary deficit and balance of payment problems for the country. This is as a result of increased government expenditure in form of supervision and subsidization of parastatals which are not economically productive.
8. It limits consumer sovereignty. This is due to limited production of a variety of goods and services and government planning on behalf of the consumers. This limits the choice of consumers,

9. There is high degree of bureaucracy in decision making. This is because of the existence of one central planning authority for all economic activities in the economy.
8. It leads to imbalance of regional resource allocation and development. This is due to state influence in resource distribution basing on political support
9. It leads to emergence of state monopolies. This leads to provision of poor quality services hence poor standards of living.
10. It leads to low productivity of workers: This is due to lack of motivation and strict supervision by the government.

Mixed economy

This is an economic system where the productive resources are owned, controlled and allocated by both the government and private individuals. Decision making and planning is done by both the private individuals and the state for example, Uganda.

Features/characteristics of mixed economy

1. Ownership of resources is by both the government and the private individuals
2. Resource allocation is by both the government and forces of demand and supply
3. There is existence of indicative planning
4. Production is for both profits and welfare maximization
5. Co-existence of both the public: and the private sector

Revision Questions

Section A questions

1. (a) Distinguish between positive statements and normative statements as used in economics
(b) Give 2 examples of normative statements.
 2. (a) Distinguish between scarcity, choice and opportunity cost
(b) Explain how scarcity is related to choice and real cost
 3. (a) Define the term real cost
(b) Give any three uses of opportunity cost concept to the producer
 4. (a) Distinguish between Micro-economics and macro-economics.
(b) Give three assumptions underlying the production possibility frontier.
 5. Identify four circumstances under which the concept of opportunity cost is applied in economics
 6. Give four limitations of the concept of opportunity cost in resource-allocation?
 7. (a) What is meant by a transformation curve.
(b) Mention three factors that may lead to a shift in the transformation curve
 8. (a) Define the term a "want"
(b) Mention any three features of a want
 9. (a) Define the term scale of preference
(b) State any three economic questions.
 10. (a) Distinguish between a free good and an economic good
(b) State four traits of an economic good.
 11. (a) What is meant by the term wealth
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- (b) Give three characteristics of wealth
- 12. (a) Define a market economy
 - (b) Mention any three features of the market economy
- 13. (a) Distinguish between a merit good and a public good
 - (b) Give two examples of merit goods.
- 14. Outline four features of public goods
- 15. (a) Distinguish between substitutes and complements
 - (b) Give two examples of complements,
- 16. Distinguish between the following types of goods
 - (a) Capital goods and intermediate goods
 - (b) Inferior goods and Giffen goods
 - (c) Substitute goods and complementary goods
- 17. (a) What is meant by a "laissez faire" Economy
 - (b) Give three features of a "laissez faire" Economy.
- 18. (a) Distinguish between a barter economy and a command economy
 - (b) Give four features that qualify Uganda as a mixed economy.
- 19. (a) Define the term "price" as used in economics
 - (b) Mention three circumstances under which the production possibility curve may shift outwards
- 20. Outline four characteristics (features) of a market economy

Section B questions

- 1 (a) Distinguish between a command economy and a market economy
 - (b) What are the advantages and disadvantages of a market economy?
- 2 (a) what is meant by a planned economy.
 - (b) Explain the advantages and disadvantages of a planned economy