



Dr. Bosa Science

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+256 778 633 682, 753 802709

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Economics paper 1 set 13 and marking guide

SECTION A

Answer all parts of this question.

1. (a) (i) Differentiate between inferior goods and complementary goods. (02 marks)
(ii) Give any two examples of complementary goods. (02 marks)
- (b) (i) What is meant by the term Real Gross Domestic Product? (01 marks)
(ii) Given that nominal Gross Domestic Product is Shs. 150,000,000,000 and the consumer price index is 105, calculate the real Gross Domestic Product. (03 marks)
- (c) State any four features of Rostov's transitional stage of economic growth. (04 marks)
- (d) (i) Define the term cyclical unemployment. (01 mark)
(ii) Suggest any three measures that should be adopted to minimize cyclic unemployment in an economy. (03 marks)
- (e) (i) Differentiate between partial planning and perspective planning. (02 marks)
(ii) Mention any two demerits of partial planning in an economy. (02 marks)

SECTION B

Answer any four questions from this section.

2. (a) How is national income measured in an economy? (06 marks)
(b) Explain the problems faced when compiling national income in an economy. (14 marks)
3. (a) Distinguish between economic growth and economic development. (04 marks)
(b) Explain the benefits of economic growth in an economy. (16 marks)
4. (a) Account for the price fluctuations of agricultural products in an economy. (10 marks)
(b) Suggest measures that should be taken to stabilize prices of agricultural products in an economy. (10 marks)
5. (a) Describe the process of credit creation by Commercial banks. (10 marks)
(b) What factors limit the ability of Commercial banks to create credit in an economy? (10 marks)
- 6 (a) Explain the causes of inflation in an economy. (06 marks)
(b) Suggest measures that should be taken to control inflation in an economy. (14 marks)
7. (a) Describe the features of a good tax system. (08 marks)
(b) Explain the role of taxation in the development of a country. (12 marks)

Guide

SECTION A

Answer all parts of this question.

1. (a) (i) Differentiate between inferior goods and complementary goods. (02 marks)

Inferior goods are goods whose demand reduces/falls as consumer's level of income increases

While

Complementary goods are those goods that are jointly demanded such that an increase in demand for one of them increases demand for another

- (ii) Give any two examples of complementary goods. (02 marks)

- Car and petrol
- torch and dry cells
- Gun and bullets
- Bow and arrow
- fountain pen and ink
- chalk and chalk board
- shoes and shoe polish
- toothpaste and tooth brush

- (b) (i) What is meant by the term Real Gross Domestic Product? (01 marks)

Real Gross Domestic Product refers to the monetary value of goods and services produced within a given country in a given period of time expressed at base year prices

- (ii) Given that nominal Gross Domestic Product is Shs. 150,000,000,000 and the consumer price index is 105, calculate the real Gross Domestic Product. (03 marks)

$$\text{Real GDP} = \frac{\text{Nominal GDP}}{\text{Price index}} \times 100 = \frac{150,000,000,000}{105} \times 100 = \text{Shs. } 142,857,142.857$$

(c) State any four features of Rostov's transitional stage of economic growth. (04 marks)

- cultural barriers begin to reduce/society becomes less conservative
- the economy becomes dualistic in nature
- savings rise to 5% of GDP / GNP/ NY
- investment increases to 5% of GDP GNP, / NY
- emergence of entrepreneurs in the economy
- illiteracy rates reduce
- Emergence of foreign trade / the economy becomes open
- Adoption of better and efficient more method of production/ improvement in technology.
- improvement in socio - economic infrastructures
- industrialization start to take root / emergence of industrialization

(d) (i) Define the term cyclical unemployment . (01 mark)

Cyclical unemployment is one that arises due to deficiency in effective , aggregate demand for final goods and services especially in times of economic recession / depression

(ii) Suggest any three measures that should be adopted to minimize cyclic unemployment in an economy. (03 marks)

- increase government expenditure
- reduce direct taxes or taxes on incomes
- use of expansionary monetary policy
- subsidization of consumers
- employment
- increase wages/salaries
- increase exports
- reduce imports

(e) (i) Differentiate between partial planning and perspective planning. (02 marks)

Partial planning refers to planning that covers part of the economy/a few sectors/ one sector

While

Perspective planning refers to long term planning in which long term targets are set in advance for a period of ten or more years

(ii) Mention any two demerits of partial planning in an economy. (02 marks)

- worsens income / wealth inequalities causes regional imbalances in development
- results into sectoral imbalance in development
- encourages underutilization of the available resources/ low output encourages sectoral dependence
- limits employment creation / low employment opportunities
- limited / low tax revenue

SECTION B

Answer any four questions from this section.

2. (a) How is national income measured in an economy? (06 marks)

- **Income approach** involves adding up the total money value of all incomes received by persons and enterprises for rendering productive services in an economy in a year.
- **Expenditure approach** involves adding up the amount of money spent on final goods and services in a given year.
- **Output/product/value added approach** involves summing up the contributions (value added) of all firms or sectors at each stage of production of final goods and services in the economy.

(b) Explain the problems faced when compiling national income in an economy. (14 marks)

- Problem of valuing unpaid for services inadequate statistical data/ information errors e.g. omissions and commissions
- difficulty of calculating the value of depreciation
- shortage of trained personnel and equipment
- Problem of double counting e.g. transfer payments
- Difficulty of valuing substance output / non -marketed output
- problem of estimating incomes from, abroad
- problem of determining boundary of production
- problem of valuing inventories and work in progress
- difficulty of determining government expenditure
- problem price changes / inflation
- Problem of illegal activities e.g. smuggling, prostitution, drug trafficking etc.

3. (a) Distinguish between economic growth and economic development. (04 marks)

Economic growth is the sustained persistent **quantitative** increase in the country's volume of goods and services as measured by an increase in Gross National Product (GNP) in a given period of time usually a year compared with the previous period.

Economic development is the sustained persistent **quantitative and qualitative** increase in the country's volume of goods and services as measured by an increase in Gross National Product (GNP) and general welfare in a given period of time usually a year compared with the previous period.

(b) Explain the benefits of economic growth in an economy. (16 marks)

- **It facilitates the exploitation and utilization of the idle local resources.** This increases the level of national income in the economy.
- **It increases government revenue through taxation.** Economic growth widens the tax base in form of numerous production activities set up hence generating more tax revenue to the government, The revenue realized is used to construct social and economic infrastructure like hospitals, roads, schools etc.
- **It leads to a fall in the general price level of goods and services hence improving the standards of living of the people.** As the economy grows, a variety of goods and services are produced and this results into a fall in the general price levels hence an increase in the volume of commodities consumed.
- **It facilitates technological development in the country.** Economic growth encourages the use of modern production techniques through inventions and innovations hence increasing efficiency in production.
- **It improves the balance of payment position of the country.** As the economy grows the production of goods and services for both the domestic market and for exports increases. This helps the country to save and earn foreign exchange hence better balance of payment position.
- **It leads to an increase in employment opportunities.** This is in form of increased resource utilization and other economic activities set up. This increases the income of the people.
- **It leads to the development of social and economic infrastructure.** As the economy grows, there is development of social and economic infrastructures in form of roads, schools, hospitals, financial institutions etc. so as to facilitate trade in the economy.
- **It promotes urbanization and industrialization of the economy.** This is as a result of increased number of production and economic activities.

- **It reduces the dependence of the economy on other economies.** As the economy grows, per capita income raises and this leads to an increase in self-reliance and sustenance of the economy.
- **It improves the standards of living of the people.** This is due to increased production of a variety of goods and services at reduced prices in the economy. This increases consumption and utility maximization by the people.
- **It reduces income inequalities in the economy.** As the economy grows, it is possible for the government to redistribute part of the increased employment opportunities and income through the use of appropriate government policies like progressive taxation.
- **It increases the monetization of the economy.** This is because economic growth promotes trade and commerce in the economy.
- **It breaks the vicious circle of poverty.** As output expands, savings and incomes increase there by breaking the vicious circle of poverty .
- **It promotes social cultural transformation.** As the economy grows there is a change of life style of people as a result of increased incomes. This helps to break the remove the high levels of conservatism and backward cultures which are obstacles to development.

4. (a) Account for the price fluctuations of agricultural products in an economy. (10 marks)

- **Perishability and difficulty of storage** this forces farmers to sell at any available price e.g. tomato, cabbage
- **Bulkiness of products** makes mobility of products to areas of high price difficult.
- **Long gestation period of agriculture products** restricts supply when prices are high.
- **Fluctuations of yield.** High yields leads to low prices and low yields lead to high prices
- **Low technology** limits value addition to increase demand
- **Technological advancement** in developed countries has promoted the raw material saving methods reducing demand for agricultural output.
- **Growing competition from synthetic substitutes**
- **Agricultural products are used as mere inputs industrial products** making absorption of excess supply leading to price instability.
- **The poorly planned production**
- **Dependence on natural factors** such climate for production that are not predictable
- **The price inelastic demand for agricultural products.** a big change in price brings about a small change quantity demanded.
- **Weak bargaining position on world market;** prices of agricultural products are dictated by importers in MDCs.
- **Lack access to market information**
- **Speculations of demand**
- **Change in the import-export policy;**
- **Inflation**
- **Seasonal nature of demand for certain products;** such as flowers in celebration seasons.

(b) Suggest measures that should be taken to stabilize prices of agricultural products in an economy. (10marks)

- **Buffer stocks.** The government should buy up part of the supply when output is in excess, store this surplus and later sells it to the consumer in times of reduced supply.

- **Stabilization fund.** The government through marketing boards can maintain or increase prices of agricultural products, depending on world market prices. If profits are made, they are saved and used to stabilize prices and incomes of the farmers.
- A variety of agricultural activities should be introduced e.g. crop farming, poultry, animal husbandry etc. to reduce over dependence on one or a few sources of agricultural income in a bid to stabilize farmers' income.
- **Encourage formation of cooperatives** to bargain fair prices
- Introduce irrigation schemes to ensure continuous supply of agricultural products.
- **Stability in prices of agriculture** can also be attained by improving transport system to enable easy marketing
- There is a need to improve, develop and expand storage facilities to accommodate excess output in agriculture.
- **Price control.** Government should establish the minimum and maximum prices for agricultural output.
- **Market expansion.** Government should expand agricultural output market through economic integrations

5. (a) Describe the process of credit creation by Commercial banks. (10 marks)

- Receiving of the initial deposit by the first bank (Bank A) from a client (depositor/customer)
- Keeping the percentage of the deposit as a cash ratio/reserve by the first bank (Bank A)
- Lending the balance to a credit worthy customer by Bank A
- Receiving the money lent out as a new deposit in another / second bank (Bank B)
- keeping of a percentage of the deposit in Bank B as a cash ratio / reserve
- lending the balance to a credit worthy customer by Bank B
- The process continues till the initial deposit diminishes in the banking system at the end of the process.

$$\text{Total credit created} = \text{Total deposit} = \frac{1}{CR}$$

(b) What factors limit the ability of Commercial banks to create credit in an economy? (10 marks)

1. **Use of restrictive monetary policies by the central bank.** The central bank limits the powers of commercial banks to create credit by using the restrictive tools of the monetary policy for example increasing bank rate, selling government securities to the public, increasing minimum legal reserve requirement etc.
2. **Presence of inadequate credit worthy borrowers.** In developing countries, there is lack of enough credit worthy borrowers due to lack collateral securities. This leads to excess liquidity in commercial banks due to limited borrowing hence limiting the process.
3. **The theory assumes that borrowers deposit cheques they get in the same bank.** This is not always true. Therefore one bank keeps on losing deposits to other banks hence limiting the process of credit creation by a single bank.
4. **The process of credit creation keeps on diminishing towards zero.** This limits the amount of credit created.
5. **High levels of liquidity preference.** In developing countries, individuals prefer keeping their money with them instead of depositing it in banks. This results into less bank deposits hence limiting the process of credit creation.
6. **Low demand for bank deposits.** In developing countries, there is low demand for bank loans because of poor investment climate. This is mainly due to the political instabilities, insecurity, poor infrastructure etc. and this results into less money lend out hence limiting the process.

7. **High interest rates charged by Commercial banks.** These discourage the potential borrowers from demanding for loanable funds for investment hence limiting the process of credit creation.
8. **Limited number of banking institutions in developing countries.** The number of banks is few and they are not widely distributed to mobilize enough savings. This limits the amount of credit created.
8. **High fractions of Cash ratio in commercial banks.** A lot of bank deposits are left in commercial banks in cash form instead of lending it out hence limiting the credit creation process.
9. **Ignorance of the public about the availability of loanable funds in commercial banks.** This leads to a small number of individuals accessing bank loans hence limiting the process of credit creation.
10. **Corruption of bank officials**
11. **Political instability**

6 (a) Explain the causes of inflation in an economy. (06 marks)

- Rising production costs (e.g. rising wages, interest rates, fuel prices etc.)
- natural hazards leading to fall in supply from agriculture sector
- break down of infrastructures and key industries
- political instability (that destroys productive infrastructures)
- importation of goods from countries experiencing inflation
- excessive inflow of incomes from abroad
- greed for profits by traders.
- speculation by traders and consumers
- excessive money supply / excessive issuance of currency
- excessive government expenditure
- declining value of the local currency relative to other currencies i.e. depreciation of the local currency
- excessive exportation of essential goods/ increasing demand for exports
- excessive / uncontrolled credit creation
- excessive borrowing from the central bank
- excessive aggregate demand over aggregate supply

(b) Suggest measures that should be taken to control inflation in an economy. (14 marks)

- Increase direct taxes
- reduce government expenditure
- liberalization of the economy
- provide incentives to investors / improve investment climate
- development of infrastructure
- modernization of agriculture
- privatization of state enterprises
- encourage importation from cheaper sources
- improve political climate
- control government borrowing from the central bank
- reduce indirect taxes on essential goods and services
- Use of restrictive / contractionary monetary policy
- Control export of essential goods
- establishment of import substitution industries
- encourage use of instruments of credit adopt currency reform
- undertake price control i.e. maximum price control
- adopt wage control measures e.g. freeze and wage restraint
- control issuance of currency

7. (a) Describe the features of a good tax system.

(08 marks)

- **It should be comprehensive.** That is it should have a wider coverage whereby a variety of taxes should be imposed on various tax bases so as to raise enough
- **It should impose a minimum tax burden to the tax payer.** This helps to reduce tax evasion and avoidance.
- **It should be** That is, there should be a balance between the tax revenue collected and the services rendered through public expenditure.
- **It should be efficient.** That is, the tax imposed should not involve high collection and administrative
- **It should be flexible (Buoyant).** That is the tax revenue should vary directly with the changes in the tax
- **It should consider the principle of double taxation.** This states that, the tax payer should not be taxed more than once on the same tax base in a given
- **It should be productive.** That is, it should yield enough revenue to the government necessary to meet her re-recurrent and development
- **It should help to achieve the national objectives** for example to promote economic stability, reduce income inequality, control inflation
- **It should accommodate and harmonize the conflicting interests** of the tax payer and tax administrators. Therefore, it should recognize the basic rights of the tax payer. The tax payer should pay the tax without harassment
- **It should promote equity economically and socially** so as to minimize income inequalities among tax

(b) Explain the role of taxation in the development of a country. (12 marks)

- **raises government revenue** so as to meet her recurrent and development expenditures.
- **Achieve equitable distribution of wealth and incomes** by using progressive tax system where the tax rate increases with an increase in the tax payer's income. '
- **Protect the local in/an industries from unfair foreign competition** through the use of high import taxes.
- **Controls inflation** by increasing tax rates on individual's incomes in order to check on aggregate demand in the economy
- **Means achieving balance of payment stability.** This is done by discouraging imports inform of high import duties and encouraging exports by subsidizing the exporters.
- **Controls monopoly powers.** The monopolists are highly taxed while other firms are subsidized to allow fair competition.
- **Discourages the production and consumption of harmful products** for example drugs, cigarettes etc. This is done by imposing heavy taxes on the producers of those commodities.
- **Reduces over dependency on foreign aid and borrowing.** Taxation helps the government to generate revenue locally.
- **Promotes individual responsibility and self-reliance among the citizens** as they have to work hard in order to pay taxes
- **Allocates and regulates the use of resources in order to achieve optimum production.** This is because the government revenue can be used to set up productive ventures which can be used to benefit the whole society e.g. social and economic infrastructure.
- **Ensures steady economic growth and development through** increased investment and production. This can be achieved by manipulating the fiscal policy e.g. giving tax holidays and exemptions to the investors.

- **Reduces population growth rate** in case the tax is based on the number of children born by a given family.
- **Prevents dumping**

Thank you

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