Economics paper 1 set 7 and marking guide

1(a) Explain four functions of price in free enterprise economy.

- Allocate resources i.e. resources tend to move to where prices are high.
- Acts as incentive to growth
- Determine the value of goods and services
- Guides producers of goods to produce
- Guides producers on what techniques to use in production process
- Guides consumers to make consumption budgets or plans
- Motivates producers and final consumers.

(b)(i) State two characteristic of economic good.

- It has money value i.e. marketable
- It yields utility to an individual or society
- It is relatively scarce
- It has opportunity cost

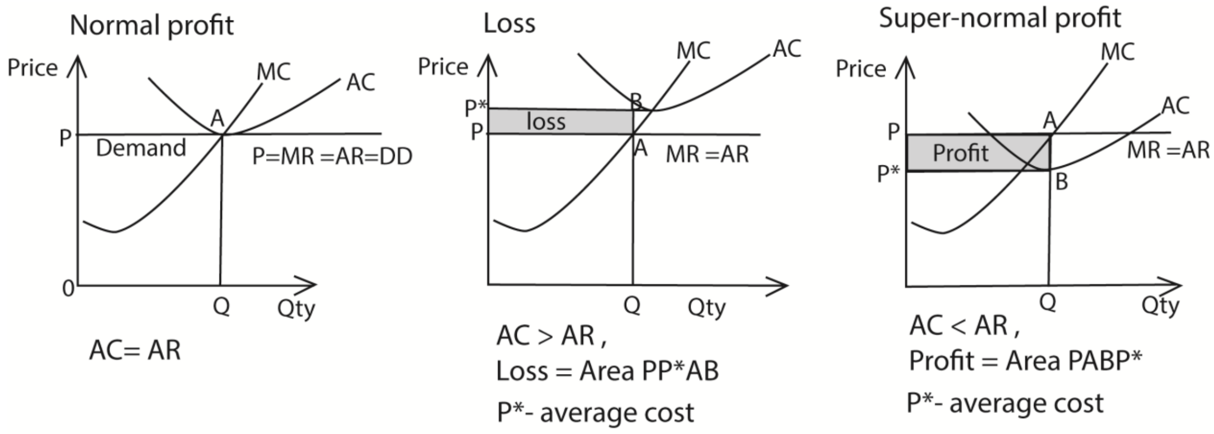
(ii) Explain two characteristics of a public good.

- Non-excludable means that it is costly or impossible for one user to exclude others from using a good such as road, streetlights.
- Non-rivalrous means that when one person uses a good, it does not prevent others from using it.
- Widely available: Public goods must be non-excludable and available to everyone
- Indirectly or collectively paid for.

(c) With the help of diagrams, distinguish between the short run equilibrium position of a monopolist and that of a firm under perfect competition

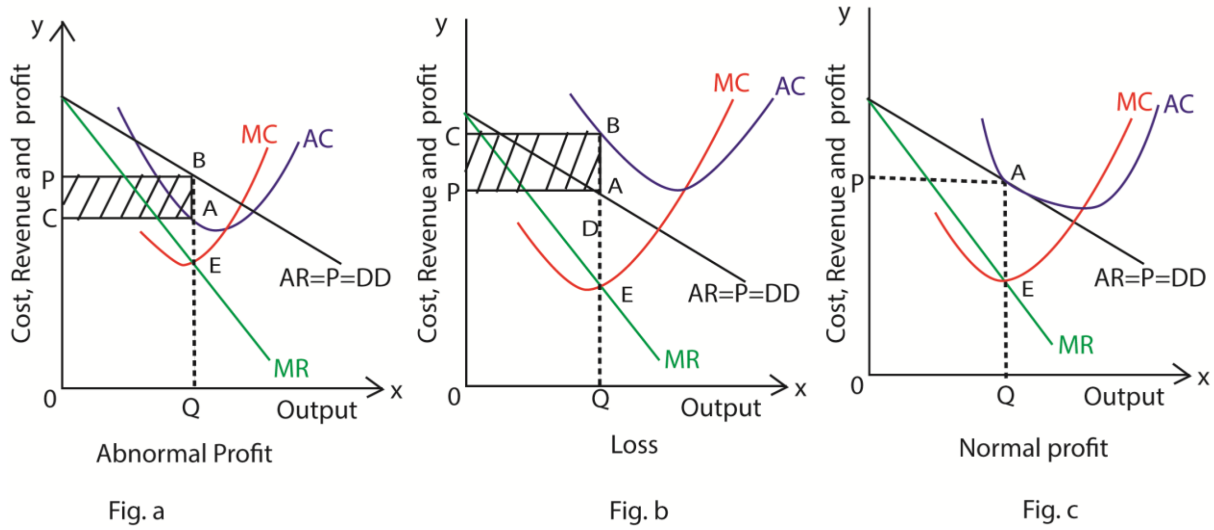
For perfect competition,

- Equilibrium is attained when MC= MR=AR and MC curve cuts the MR curve from below
- Three possibilities: Normal profit (MC = MR = AR =AC= DD = P); Loss (AC > AR) and super-normal profit (AC < AR) as shown in diagram below



For Monopoly in short run

- 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.



(d)(i) Define supplementary requirements

Supplementary requirements (special deposits) refer to the deposits above the cash and liquid assets of a commercial bank that are kept in frozen form by the Central Bank.

(ii) What is meant by the term liquidity?

Liquidity refers to the ease with which an asset can be converted into cash without significant loss of value.

(e)(i) Given gross national product at market price, what adjustments are required to obtain net national product at factor cost?

$GNP_{FC} = GNP_{MP}$ – Net indirect taxes

$NNP_{FC} = GNP_{FC}$ – Depreciation

(ii) What is meant by capital consumption allowance?

Capital consumption allowance refers to the amount of money deducted or put aside for the purpose of recovering the depreciation of assets that occur during the production process.

Or

Capital consumption allowance (CCA), sometimes referred to as depreciation, is **the amount of money a country/firm has to spend each year to maintain its present level of economic production**.

(f) (i) Distinguish between dividends and profits.

Dividends refer to the part of the company's profit that a firm pays periodically to shareholders as a reward from capital invested.

Profits refer to the difference between total revenue and total cost of a business entity,

Or

Profit refers to that amount which the company earns after paying all operating as well as non-operating expenses from the sales done by the company during the year.

or

Profit refers to the payment to entrepreneur for his role in production process.

(ii) Distinguish between demand deposits and time deposits

Demand deposits are deposits on a **demand deposit account (DDA)** that can be withdrawn at any time without advance notice.

Time deposit is where a depositor can withdraw his money at a fixed time of maturity and is operated by fixed account holder.

(g)(i) What is meant by special drawing rights (SDRS)?

Special Drawing Rights (SDRs) The SDR is **an international reserve asset created by the IMF to supplement the official reserves of its member countries**. The SDR is not a currency. It is a potential claim on the freely usable currencies of IMF members.

(ii) What are foreign reserves?

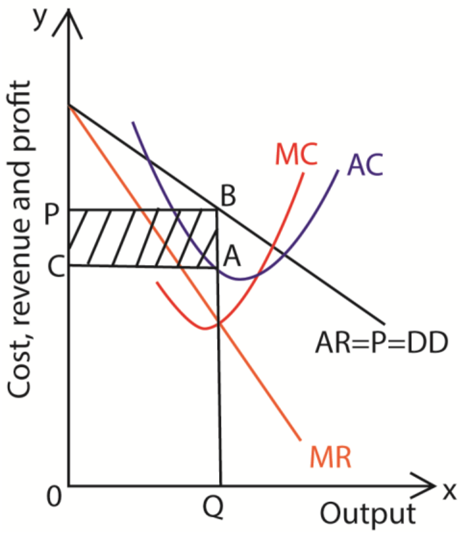
Foreign reserves refer to the money in foreign currency held by the country's central bank

Or

Foreign exchange reserves are **assets held on reserve by a central bank in foreign currencies**.

(h) At what point of the demand curve does the monopolist fix his price?

The monopolist fixes his price at a point where the output line meets the demand curve (AR) or the consumers' willingness to pay which yield maximum revenue as shown below



The monopolist fixes price at point B

(i)(i) What is meant by economic policy?

Economic policy refers to the strategies and measured adopted by the government to manage the economy as a means of achieving its economic objectives such as price stability and full employment.

Or

Economic policies **are measures and strategies which governments use to manage their economy**.

(ii) State and explain two arguments in favor of exchange control.

- Stabilize the forex market by avoiding constant appreciation and depreciations of currency.
- It effective in dealing with a problem of capital movements in that the government's monopoly over the foreign exchange cat effectively stop or reduce the capital refusing to release foreign exchange for capital transfer.
- To encourage importation of priority goods so as to promote a high standard of living.
- To enhance the development of priority sectors. This is done by providing better foreign exchange rates to the government.
- To solve a problem of balance of payment.

(j)(i) Distinguish between a tax and fee.

A tax is compulsory payment to the state by individuals and business enterprises. Or it is a payment for non-direct exchange of goods and service.

A fee is a payment made by an individual for a personal service rendered to him/her.

(ii) Explain why indirect taxes are said to be convenient.

- They are difficult to evade
- They are comprehensive i.e. cover wider areas
- Their burden are not felt because they are voluntary taxes
- They are not a disincentive to effort
- They are flexible i.e. their rates can be adjusted accordingly

- They involve less cost of assessment.

SECTION B

2(a) Explain the law of demand (10marks)

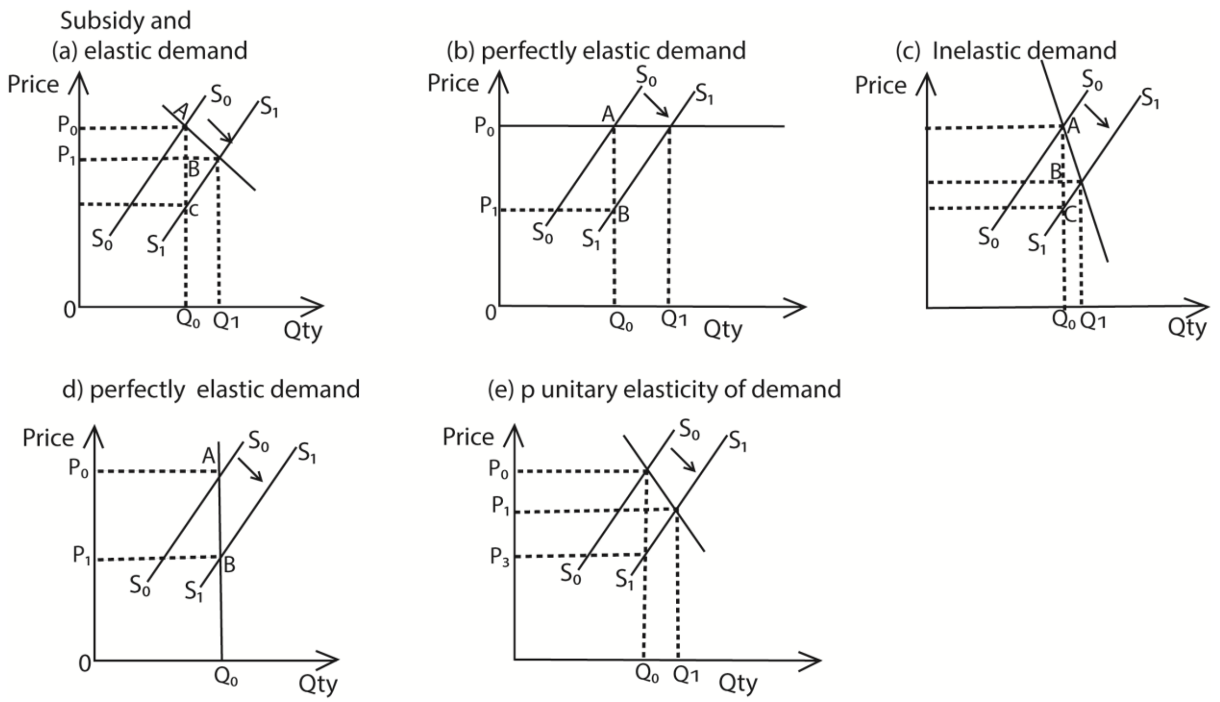
The law of demand states that the higher the price of goods and service, the lower the quantity demanded and vice versa. A normal demand curve slopes downwards from left to right because of the following

- **The law of diminishing marginal utility.** As a person consumes more units of a commodity, the extra satisfaction derived from extra units of the same commodity diminishes. Therefore a consumer will only be willing to purchase more of the units at a lower price explaining a downward sloping curve.
- **Substitution effect.** As price of a commodity falls consumer purchase more units of the commodity and less of its substitutes. However, as its price rises, consumers purchase less of it and buy more of its substitutes. Thus at higher prices, less of a commodity is purchased and more is purchased at lower prices.
- **Real income effect.** As price of a commodity falls, the real income of the consumer increase and therefore he is able to buy more of a commodity at a lower price. But as the price rises, the real income of the consumer falls and is only able to buy less.
- **Presence of low income earner.** Ordinary people or low income earners buy more of a commodity when the price falls because that is when they can afford to purchase it. Increase in price of a commodity lowers demand. The rich do not affect the demand curve as they are well capable of buying more commodities even at high prices
- **Commodities with different uses.** As prices of these commodities increase consumer reduce the quantity demanded by only purchasing what is essential e.g. lighting n case of high price for electricity. However when prices reduce consumer demand for more to use for luxurious purpose.
- **New buyers.** Due to the fall in the price of a commodity new buyers get attracted towards it and buy it. Thus, this increases the demand for the commodity.
- **Tendency To Satisfy Unsatisfied Wants.** There is always a human tendency to satisfy unsatisfied wants. Each and every person has some unsatisfied wants. When the prices of goods, such as apples, falls, the consumer will buy more of that commodity as he wants to satisfy his unsatisfied wants. As a consequence of this habit of humans, the demand curve slopes downward to the right.

(b) Apply the concept of price elasticity of demand to subsidies.

Its applicability depends on the degree of elasticity and can be explained in terms of how the benefits from subsidy are shared between the producer and the consumer.

Note: subsidies shift the supply curves to the right



(i) **A subsidy and elastic demand**

In this case a subsidy benefits both the producer and the consumer. However, the producer benefits more than the consumer as illustrated in fig. (a) above

The total subsidy is AC. AB belongs to the consumer and BC to the producer which is greater than AB. The producer increases his production from OQ_0 to OQ_1.

(ii) **Subsidy and perfectly elastic demand**

In this case, a subsidy benefit only the producer as illustrated in fig (b)

The total subsidy AB goes to the producer as he increases his production for OQ_0 to OQ_1.

(iii) **Subsidy and inelastic demand**

Here the subsidy benefits the consumer more than the producer as illustrated in fig. (c) above.

AC is the total subsidy. AB goes to the consumer and BC to the producer which is less than AB. However a producer increases production from OQ_0 to OQ_1 but with a smaller margin compared to a fall in price from OP_0 to OP_1.

(iv) **A subsidy and perfectly inelastic demand**

In this case the whole subsidy benefits the consumer in form of reduced prices as illustrated in fig. (d) above.

AB is the total subsidy which wholly goes to the consumer. The producer's production remains constant. i.e. OQ_0.

(v) **A subsidy and unitary elasticity of demand.**

In this case the subsidy is shared equally between the consumer and the producer as illustrated in fig. (e) above

The total subsidy is AC. AB benefits the consumer and BC the producer. However, the increase in the production fromOQ_0 to OQ_1 is equally followed by a decrease in price from OP_0 toOP_1.

5(a) Given the table below

Output	Total cost
0	600
3	1650
4	1860
5	2100
6	2400
7	2800
8	3400
9	4300
10	5800

(i) What is the average fixed cost when output is 10 units

AFC = $\frac{TFC}{Q} = \frac{600}{10} = 60$

(ii) What is average variable costs when the output is 4

AVC= $\frac{TVC}{Q} = \frac{1860-600}{4} = \frac{1260}{4} = 315$

(iii) What level of output represents the break-even point of the firm?

Output	Total cost	AC	AVC	MC
0	600	-	-	600
3	1650	550	350	350
4	1860	390	315	210
5	2100	420	300	240
6	2400	400	300	300
7	2800	400	314.3	400
8	3400	425	350	600
9	4300	478	411	900
10	5800	580	520	1500

The level of output that represents the **breakeven point** of the firm is at the lowest point of AC, where **MC= AC which is 7**

(iv) What level of output represents the shut-down point of the firm?

The lowest output that represents the **shut-down point** of a firm is the point where AVC is lowest i.e. MC = AVC which is 6

(v) If the marginal revenue is constant at 600 per unit of output. What would be the equilibrium output of the firm?

Equilibrium point occurs when MR = MC; that would be at output 8

(b) State and explain four reasons firms of different sizes may exist in the same industry.

- When the **Long-Run Average Cost curve (LRACC) has a flat bottom** over a wide range of output, then firms of different sizes producing at any quantity along this flat bottom can compete. For instance if The flat section of the long-run average cost curve range between 500 to 20000 output, single manufacturing plant producing a quantity of 5,000 has the same average costs as a single manufacturing plant with four times as much capacity that produces a quantity of 20,000.

- **Size of the market.** I case of small market, some firm will decide to remain small so as to produce what is just enough for the available market despite the fact the market has a potential to expand
- **Differences in entrepreneurial Skills**: An entrepreneur of outstanding ability will be able to procure as much finance as he may need, hire the requisite labor force and build up a huge business. But an entrepreneur of moderate ability will run business on a moderate scale and a man of limited entrepreneurial skill will be content with a small business
- **Managerial Ability:** firms with a manager of great ability, the size of the firm will grow to considerable dimensions. On the other hand, a mediocre manager will have a small-sized firm to manage.
- **Availability of Finance:** firms with large startup capital will be bigger than those with small startup capital
- **Lack of ambition to grow**. Most owners of small scale firms do not have the ambition or wish of growing large due to fear of sacrificing control and interdependence of a firm.
- **Stage of development**. Firms may be small because they have just started and have not gotten time to grow.
- Use of the b**y-product of other firms.** Some firms remain small because they use by-products of bigger firms as input and their expansion will depend on operation of big firms e.g. sweet firm alongside sugar firm.
- Provision of **raw material to other firms**. Firms remain small when they serve a source of raw materials to big ones.

4(a) Why is the GNP of USA higher than that of Uganda (8 marks)

- USA has got more raw materials or resources which are well exploited than Uganda.
- USA has got better and advanced technology which is constantly being improved on than Uganda.
- USA has got more capital in both liquid and hard the Uganda
- USA has got better infrastructure such as modern roads, railways than Uganda
- USA has a lower population growth than Uganda hence have low dependency rate.
- USA has got less cultural rigidities that hinder development as compared to Uganda
- USA has got a high level of political will and incentives than Uganda
- USA has got higher level of entrepreneurship than Uganda
- USS is highly monetized than Uganda

(b) Explain how national income is estimated and indicate three problems of each method. (12marks)

(i) Income approach. Here the incomes received by factors of production are added. Such incomes include rent, salaries, wages, interest and profits.

Problems faced in using the income approach measure.

- Double counting. this means including some commodities more than once e.g. counting inventories (inputs and unfinished goods) several times at different stages
- Inadequate information. E.g. on private expenditure and income, wages in the private sector.
- Transfer payment like gifts are difficult to determine. In most cases it is not clear whether such payment are for free or for work done.
- Shortage of qualified and motivated manpower to compile data

(ii) The expenditure approach.

Here we add up the value spending on all final goods and services. Such expenditures include consumption, investment, government expenditure and net exports.

Problems faced I using expenditure approach

- Government utilities like roads, security etc. are usually subsidized and thus it is difficult to determine their actual value.
- Net exports and income earned from abroad are not easy to determine. For example foreign exchange from smuggled output is unknown; some income earned abroad is not declared and therefore not recorded.
- There is insufficient funds and facilities to compile data
- Illegal activities e.g. prostitution, gambling, smuggling generate income which is difficult to measure.
- The effect of inflation is difficult to adjust and is likely to be misinterpreted to mean increase in output.

(iii) The product (output) approach.

In this method, all goods and services produced during the year in various industries are added up.

This is also known as value-added to GDP or GDP at the sector of origin's cost factor. It includes the following items: agriculture and allied services; mining; development, construction, the supply of electricity, gas, and water, transport, communication, and trade; banking and industrial real estate and property ownership of residential and commercial services and public administration and defence and other services (or government services). It is, in other words, the amount of the added gross value.

Problems faced in using product (output) approach.

- Non-monetary output; commodities which are not taken to market are difficult to give value e.g. subsistence output, work done by house wives, leisure foregone when work is done, houses built by owners.
- It is difficult to determine when output was produced e.g. perennial crops.
- The effect of inflation is difficult to adjust and is likely to be misinterpreted as increase in output.
- There are difficulties of determining what to include and what to exclude (subsistence output)and determine methods of valuing different items.
- Possibility of double counting

5(a) What are sources of public revenue? (10 marks)

- Direct and indirect taxation are the major sources of government revenue.
- Fees; these are charged on services rendered by the government e.g. license fee, stamp duties
- Borrowing internally or externally by selling securities or from World Bank
- Printing money by the Central Bank.
- Fines and penalties charged on law breakers such as traffic offences.
- Gifts and grants especially from abroad in form of cash and other items
- Gambling e.g. from National lottery
- Profits earned from public corporations
- Revenues from state properties e.g. forests and national parks
- Local authorities from property rates and government allocations.

(b) A good tax system should yield enough revenue to the government. Discuss. (10marks)

Taxes are a source of revenue to meet government recurrent and development expenditures for provision of invisible public utilities e.g. medical service, maintenance of law and order, road system etc. however a tax system should also conform to the following principle in order to yield the required revenue;

- **Affordability**. A good tax system should be affordable by the tax payer.
- **Equity/fairness.** A good tax system aims at equitable distribution of income through the proportional and progressive tax
- **Certainty.** The tax payer should be certain of exact amount imposed on him.
- **Convenience.** The collection of tax should be timely with few administrative problems.
- **Diversity.** The tax system should allow various types of tax according to different taxable capacities.
- **Economical** i.e. the cost of collection need not exceed 5% of the expected total revenue.
- **Simplicity.** Taxes should be administered in simple and understandable languages to avoid misinterpretations from the payer and collector.
- **Productivity.** The tax system should balance between the amount of revenue collected and at the same time avoid adverse effects on productive potential of economy.
- **Elasticity or flexibility**. The government should be able to raise or reduce revenue as needed
- **Comprehensiveness.** A good system should have a wide variety of taxes to exploit the potential tax base
- **Optimality.** The tax system should balance between the amount revenue collected and the services rendered from the collected tax revenue

- **Stabilization and allocation of resources**. Taxations should aim at stabilizing economic structure e.g. increasing tax to curb inflation
- **Harmony.** The tax imposed should not create conflict between the tax payer and tax authority for instance It should **minimize double taxation**.

6(a) State and explain the ways in which agriculture is dominant in Uganda's economy

- Agriculture is the major sources of food for rapidly growing population both in urban and rural areas
- Agriculture contributes the biggest percentage to Uganda's GDP. It is estimated at between 60 – 65% of the total money value of goods and service produced.
- Agriculture is the biggest forex earner
- Agriculture is the major employer of the Uganda population
- Agriculture is the major sources of internal revenue through taxes levied on agricultural activities.
- Agriculture is the major source of raw materials for agro-based industries in Uganda
- Agriculture occupies the biggest percentage the total land area.

(b) Since agriculture is the dominant sector in less developed countries, it should receive the main emphasis in developed countries

Arguments for emphasis on agriculture development in LDCs

- It is the source of employment for LDCs for unskilled and semiskilled workers.
- It is the source of food
- It the source of raw materials for industries
- It is the source of foreign exchange earner from exports
- Developed agricultural sector reduces rural urban migration
- It is a source of market for industrial goods such as hoes, pangas, fertilizers and pesticides.
- It encourages investment in agro-industries
- Encourages development of infrastructures such as roads, schools, etc.
- It leads to increased incomes in domestic economy and improvement in standards of living.
- It is a source of technological advancement through research and capital goods.
- It is a source of government revenue through taxation
-

Arguments against emphasis on agricultural development in LDCs

- Fluctuation in GDP of the country since production is mainly based on a substance level
- Low foreign exchange earnings due to poor quality of produces
- Low infrastructural development resulting from low incomes
- Limited technological development and progress because the sector offers a limited scope for new and modern production techniques.
- BOP problem due to low foreign exchange earnings
- Capital outflow because large scale production is done by foreigners
- Low pace of development because agriculture is associated with low productivity
- Land wrangles since in LDCs agriculture is carry out on communal land.
- High level of unemployment and under employment because the biggest percentage of farmers depend on natural factors.

7(a) Explain the factors responsible for unfavorable balance of payment. (10marks)

- Importation of expensive manufactured goods such as cars that increase foreign exchange expenditure
- Low output /limited industrialization leading to low export volumes
- Exportation of primary products yielding low foreign exchange income
- High inflationary tendencies causing low demand for goods and services
- Limited variety of exports cause low foreign exchange incomes
- Debt servicing drains foreign exchanges from the country
- Persistence political instabilities leading high military expenditure causing high military imports
- Profit and income repatriation by foreign investors and imported skilled manpower.
- High government expenditure on foreign trips
- High population growth rates leading to high dependence, low marginal productivity and high consumption
- A large subsistence sector cause low productivity
- Low technology leads low productivity and poor quality goods and service yielding low incomes from exports
- Unfavorable natural factors such as floods and draughts leading low agricultural outputs.
- Liberalization leading to dumping of cheap substitutes that kill domestic industries from unfair competition.
- Corruption and swindling of government revenues

(b) Discuss the methods for **reducing foreign exchange expenditure** when trying to overcome a balance of payment deficit. (10marks)

- Adaptation to import substitutes to reduce import loss of foreign exchange
- Trade restrictions to reduce dumping
- Reduce corruption and swindling of government revenues
- Devaluation policy to promote consumption of local products as the imports become expensive
- Manpower planning to reduce expenditure on expatriates
- Barter trade arrangement to minimize use of foreign exchange in international trade
- Substituting foreign trips with teleconferencing.
- Debt rescheduling
- Restriction on profit and income repatriation
- Increasing government efficiency causing reduction in extravagant expenditures on foreign expensive goods.

8(a) Normally what arguments do trade unions put forward when demanding for higher wages?

- **Rising cost of living.** Workers agitate for higher wages so as to cope with rising cost of living.
- In case of **failure to pay the minimum wage.** When the employer refuses to pay wages set by government, workers agitate for that wage set to avoid exploitation.
- When there is **failure to implement the earlier wage increment** agreed upon by the employer, the workers agitate for higher wage again.
- When there a **low labour supply.** When the demand for service or demand for worker exceeds the existing supply of workers, they demand for higher wages
- When there is an **increase in wages to workers of similar jobs** in other firms.
- When the **job is risky** such as mining, workers demand for higher wages.
- In case of **increased workload without wage adjustments,** workers ask for higher wages
- Then there is **exploitation.** When workers are feel exploited, they will agitate for higher wages.
- **Increased profitability**. When the profit margin of the firm rises, all workers call for an increase in wages so as to benefit.
- In case of **improved productivity**. Workers demand for higher wages when their output level (output per unit of labour employed) has increased.
- In case of an **increase in demand of for products**; the worker demand for higher wages

(b) How come trade unions in less developed countries are unable to raise wages for their members?

- **Government interference:** the government is the major employer but usually interferes with decision made by trade unions e.g. it may refuse to give high wages as anti-inflationary measure
- **Poor leadership.** Worker lack adequate leadership skills to organize successful trade unions.
- **Inadequate funds to Union's activities** especially in crisis such as in case of strike.
- Weak industrial sector. Most people are employed in agricultural sector where workers are scared and cannot easily be organized into Trade Unions
- **Corruption:** members of Trade Unions administration are corrupt to push members' interests.

- There is a **problem of labour mobility**. Workers are continuously changing jobs leading the problem of permanent membership and goals Of Trade Unions.
- **Limited/Weak bargaining powers** since Trade Unions form a small percentage of the total labour force.
- **Open unemployment in economy scares Trade Union members**. In case they strike, they can easily be fired.
- **Ignorance of the benefits of Trade Unions** by most worker who do not mind their working conditions.
- **Poor communication network** among Trade Union members during strikes
- **Worker employed on probation and contract are reluctant** to join Trade Unions for fear of suspension.
- **Indifferent workers** do not care about Trade Unions.
- **Small membership**. Membership may too small to be significant.
- **Political influence**. activities of trade unions may be hijacked by politicians for their selfish aims.

Thank you

Dr. Bbosa SCience