



*Dr. Blosa Science*

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**The Science Foundation College**  
**Uganda East Africa**  
Senior one to senior six  
**+256 778 633 682, 753 802709**  
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## Economics paper 1 set 8 and marking guide

1(a)(i) What is factor prices? (1mark)

Factor prices are the rewards offered to factors of production for the service rendered.

Or

A factor price is the unit cost of using a factor of production, such as labor or physical capital.

(ii) Name three different factor prices in an economy

- Rent for land
- Wages or salaries for labour
- Interest for capital
- Profit for entrepreneurship

(b) What is the importance of price elasticity of demand to the producer? (4marks)

- Fixing prices for his goods i.e. lowers price in case of elastic demand, increases price in case of inelastic demand or maintains price in case of unitary elasticity.
- Wage determination i.e. pays high wages when the commodities produced have inelastic demand and low wages when commodities produced have elastic demand
- Wage discrimination; worker who have elastic demand such as casual workers are paid less than workers with inelastic demand such as doctors.
- Advertisement; products with elastic demands are highly advertised than those with inelastic demand
- Shifting of tax burden: i.e. if the demand is inelastic the larger part of the indirect tax can be shifted upon buyers by increasing price. On the other hand if the demand is elastic the burden of tax will be more on the producer
- Output decisions: The elasticity of demand helps the businessman to decide about production such as optimum quantity. A businessman chooses the optimum product- mix on the basis of elasticity of demand for various products. The products having more elastic demand are preferred by the businessmen. The sale of such products can be increased with a little reduction in their prices.

(c)(i) Define the term “marginal propensity to save.” (2marks)

Marginal propensity to save is the proportional of consumer’s additional income that is saved

Or

Marginal propensity to save (MPS) is an economic measure of how savings change, given a change in income. i.e.  $MPS = \frac{\Delta S}{\Delta Y}$

(ii) Given that, the increase in national investment expenditure is 50 million shillings, and the marginal propensity to save is 0.2, calculate the final level of national income. (2marks)

$$K = \frac{1}{MPS} = \frac{1}{0.2} = 5$$

$$\text{But } \frac{\Delta Y}{\Delta I} = \frac{1}{MPS}$$

$$\begin{aligned}\Delta Y &= \frac{1}{MPS} \times \Delta I \\ &= K \times 50,000,000 \\ &= 5 \times 50,000,000 \\ &= 250,000,000\end{aligned}$$

Hence change in income is 250 millions

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(d) State four features of an economy which has attained the drive to maturity stage of economic growth (4marks)

- Long sustainable growth
- Very high degree of industrialization
- Very low rate of population growth
- New production techniques
- High and well developed infrastructure
- High rate of investment i.e. over 10 – 20% of GNP
- High level of managerial skills
- Increased levels of research and innovativeness
- Economy become self-sustaining

(e)(i) Define the term “industrial inertia” (1mark)

**Industrial inertia** refers to the tendency of an industry or industries to remain located in an area even after the advantage of its location in that area are no longer significant.

(ii) Why should the government influence the location of an industry? (3marks)

- To reduce on regional imbalance in terms of development
- To improve on social infrastructure like roads, hospital, schools, etc.
- To gain political support
- To provide employment opportunities in different regions
- To reduce on the level of social costs associated with industrialization
- To control monopoly tendency
- To encourage exploitation of resources like minerals
- To enable provision of basic infrastructure to the industries in the form of transport, power, health and education

- For strategic reasons

(f)(i) Distinguish between seasonal unemployment and technological unemployment

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

**Technological unemployment** a phenomenon where new inventions change the nature of work, eliminating some specific jobs while also creating new higher paying jobs and launching entirely new industries e.g. use of computers to replace labour in production process.

(ii) State two ways of solving seasonal unemployment

- Try to diversify the economy. This could be hard to do in touristy areas.
- Regulations which involve paying workers throughout the year, even if work is temporary.
- Government creating jobs in the off-season to improve infrastructure
- Introduction of irrigation methods in agriculture
- Diversify skill development
- Development of vocational industries

(g) How is the balance of payments deficit corrected under

(i) a floating exchange rate? (2marks)

- Export promotion
- Import substitution
- Import restriction
- Adoption of barter trade

(ii) a fixed exchange rate? (2marks)

- Foreign exchange control
- Devaluation
- Borrowing
- Sales of assets abroad

(h) State four reasons why an increase in money supply may not necessarily lead to inflation (4marks)

- When there is an increase in foreign exchange earnings from export and tourism
- When the marginal propensity to save (MPS) is high
- When demand for goods and services reduce
- Where there is high rate of interest on capital
- Where there are effective price control measures in economy
- Where taxes are high on income
- Where there is strict financial discipline
- Where there is large subsistence sector
- Where there is an increase in the volume of imports
- Where there is high level of liquidity preference.
- If the level of economic growth is equal to the level of money supply growth

(i)(i) What is centrally planned economy?(2 marks)

**A centrally planned economy**, also known as a command economy, is **an economic system where a government body makes economic decisions regarding the production and distribution of goods.**

Or

**A centrally planned economy** is where resources are owned and allocated by the state through central planning authority to determine what, how, for whom and how much to produce.

(ii) State two disadvantage of a central planning. (2marks)

- It discourages hard work
- It involves bureaucracy
- It ignores the interests/freedom/choice of individuals
- It encourages development of monopoly
- It leads to misallocation of resources against consumer's wishes.
- It leads to poor quality of products
- There is excess capacity utilization of resources
- It encourages corruption
- Lack of competition and associated efficiency leading to poor quality products
- Lack of innovation.
- encourage violence in society to oppose government decisions
- Increase poverty increases because the government fails to provide to everybody.

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

A regressive tax is a tax whose rate in terms of percentage reduces as the level of income increase. Here the low income earners pay a higher proportion of their income in form of taxes than the rich.

Or

A regressive tax is one where the average tax burden decreases with income.

(ii) State two effects of a regressive tax. (2marks)

- It reduces the demand for goods like tobacco and alcohol products.
- It lowers aggregate demand
- Leads to social unrest
- It promotes income inequality between the rich and the poor
- It reduces consumption of goods consumed by the poor
- It encourages tax evasion by the poor
- Leads to poverty.

## SECTION B

2(a) Examine the role of price mechanism in free enterprise market

**Price** is the amount of money that has to be paid to acquire a given product:

- Price acts as a signal for shortages and surpluses which help firms to determine what to produce and how to produce it
- Determines the value of goods and services.
- High prices act as incentives to increased supply of goods and services and economic growth
- Guides producers on what techniques to use i.e. technology to use
- Helps consumer in making consumption plan
- Determines people's income distribution, the price mechanism is a system of real flows from producers to consumers and from consumers to producers

- Ensures efficient utilization of resources; the factors of production (land, labour, capital) will be used for their most valuable purposes.
- High prices is an incentive for improvement on quality of the product
- Prices help to redistribute resources from goods with little demand to goods and services which people value more.
- Income distribution in the economy is determined by price mechanism. High incomes or revenues go to those expensive goods.
- Distribution of goods and services; the price mechanism determines the products are for. Goods and services are normally produced for those to can pay high prices
- Where to produce commodities from is determined by price mechanism. Production units tend to be located in places where there is demand for the products
- Price mechanisms determines when to produce; goods are produced when their demand is higher to ensure profit maximization

(b) What are the merits and demerits of the price mechanisms?

Merits of price mechanism

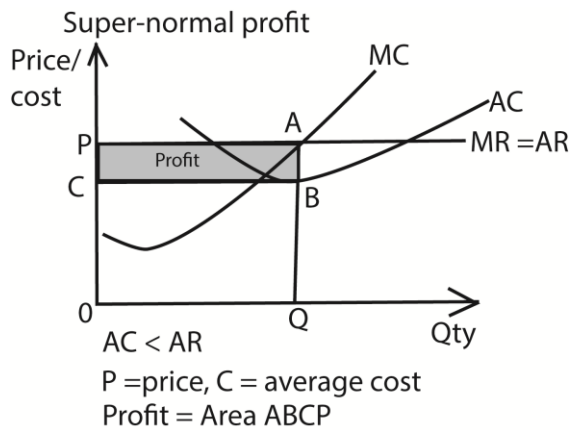
- Increases variety of goods and services
- Encourages competition leading to high quality goods and services
- There is efficiency in production basing on consumer's demand
- It reduces administrative costs
- Reduces costs of production due to non-government intervention
- Encourages hard work
- Encourages decentralization of economic power where individuals maker their own decisions
- Encourages entrepreneurship

Demerits of price mechanisms

- It leads to instability in output and unemployment
- There is consumer's ignorance due to market imperfections
- It promotes income inequality
- High competition is always wasteful as it leads to duplication of activities
- There is divergence between private and social benefits
- It can be inflationary
- It promotes monopoly power
- It leads to exploitation of the population
- It encourages speculation and gambling
- It makes government planning difficult
- Price mechanism fail to project future needs
- Over exploitation resource for instance high profits from charcoal can lead to deforestation
- Excessive price fluctuations
- Failure to respond promptly to immergences such as war and catastrophes.

3(a) How are profits maximized in a perfectly competitive market in short run

Profits in a perfectly competitive market in short run are maximized at a point where  $MC = MR$  when  $AC < AR$  and MC curve cuts AC curve from below as shown in diagram below



(b) Examine the advantages and disadvantages of perfectly competitive market

Advantages of perfectly competitive market.

- There is efficient allocation of resources leading to low prices
- Fair treatment of customers due to fair prices
- Ensure equitable distribution of income due to free entry and exit of firms into the market
- Increased output in economy
- Production and consumption of quality goods and service
- Consumer exploitation is limited.
- Increased investment due to abnormal profit
- It reduces unemployment due to free mobility of labour
- Modern technology may be employed in process to enable production of high quality goods and services
- There is no need to spend money on advertising which reduces costs of production because products are homogeneous.
- the start-up and production costs are very low,

Disadvantages of perfectly competitive market

- Perfect competition cannot lead to proper allocation of resources such as utilities like roads, water and electricity.
- It leads to unemployment when firms are outcompeted and close
- It limits consumer's choice since the commodities are homogeneous.
- It leads to monopoly tendencies after inefficient firms are forced to close
- It leads to production of harmful products since there is no government intervention
- It leads to income inequality as a few remain in business after high competition
- there is no incentive for sellers to innovate or add more features to the product because in case of perfect competition profit margin is fixed and customers are free to move to other sellers
- leads to over-exploitation resources
- Duplication of activities that lead to wastage.
- In the case of perfect competition firm which has the best location is likely to generate more sales than firm which is not located on prime location and hence location playing its part rather than customer service of the seller or product features is a limitation in perfect competition.

4(a) Distinguish between economic growth and economic development

**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.

Or

**Economic development** is defined as an increase **in a country's wealth and standard of living**.

(b) Examine the factors necessary for enhancing the economic growth of an economy

Factors necessary for economic growth are:

- **Availability of natural resources** in term of quantity and quality e.g. land water, natural forest, national parks, etc. produce goods and services.
- **Capital accumulation** through savings and channelling these savings into investment in agriculture, industry and infrastructure.
- **Improvement in quality and quantity of labour** through formal and informal education.
- **Technological advancement** to produce volume and quality of goods and service.
- Increase in the number and quality of entrepreneurs
- **Availability of market** including local and foreign market
- **Ideal population growth** to provide labour and market
- **Political stability**
- **Socio-cultural** attitude should be changed so as to stimulate economic growth
- **Appropriate planning and effective implementation** of economic programs.
- **Level of investment**. High level of investment in an economy increases the production of goods and services.

5(a) Differentiate between under population and over population (4marks)

**Under population** is a situation in which there are too few people to realize the economic potential of an area or support its population's standard of living. In this case increase in population will lead to an increase in average product.

**Over population** is a situation where the number of people living in an area exceeds the available resources. In this case an increase in population will lead to a fall in average product.

(b) Examine the effect of high population growth

Advantages of high population growth

- A high population also provides a large market for goods and services within a given country.
- A big population size provides labour which combined with other factors of production ensure full utilization of resources
- It encourages specialization since people under take different production activities
- Leads to increase in government revenue through taxation
- It encourages competition and improvement in quality of products and service
- If labour force is skilled, it may be exported

- A big population size ensures political security and a big number joins security organs to protect the people
- It increase the ease of distributions of good and service because when people are concentrated in one area
- It is a source of cheap labour since many people are willing to work at a low wage rate.
- A high population encourages the exploitation of idle resources.
- It also encourages a high level of innovation and invention as people try to look for survival in a competitive environment.
- It encourages increased agricultural output as people try to produce enough food for their own survival.

#### Disadvantages of high population growth

- Increase government expenditure on infrastructure like schools and health care
- Increased environmental degradation/pollution, garbage accumulation
- It fuels income inequality since not all people will get access to natural and economic resources
- It worsens unemployment in an economy
- It leads to brain drainage because skilled labour is not well remunerated.
- It worsens balance of payment because high populations tends to lead to high importation
- It reduces the marginal propensity to save
- It leads to high illiteracy rate due to lack of enough education facilities
- Increased dependence burden from the young children
- Causes political instability since majority of the people disgruntled for not gaining access to national resources.
- Leads to starvation due to shortage of food
- Disease outbreak
- Leads to rural-urban migration
- Water shortage
- congestion

6(a) "Protectionism rather than free trade should be adopted if countries are to benefit from international trade." Discuss (20 marks)

Protectionism should be adopted because of the following arguments

- It **protects domestic/infant industries**; trade restrictive policies like quotas, import duties, etc. reduce on demand of imported products thereby reducing competition form the local products.
- **Discourages dumping and foreign subsidies** into the countries' economy
- Improve balance of payment position by reducing the value of imports and increasing the value of exports
- It **improve self-sustenance** since it encourages consumption of local products
- It is a source of revenue to the government from import duties.
- **Creation of employment** opportunities from local firms
- **Prevents importation of undesirable goods** like tobacco and expired drugs
- **It controls import inflation** i.e. duties limits demand for imported expensive products.
- It encourages use of local natural resources
- It improves on the country's terms of trade by encouraging exports over imports.

- **National security.** If a product is used in the manufacturing of military goods or other security sensitive products, it may not be wise to import it from another country.
- **Higher GDP:** Protectionist policies tend to boost the economy's GDP due to a rise in domestic production
- **Protects intellectual property;** to encourage research and development.
- **Source of government revenue:** Tariffs form a good source of revenue for governments

#### Arguments against protectionism in foreign trade

- It **leads to domestic inflation** due to lack of competition
- Leads to poor quality local goods due to lack of competition.
- It **promotes inefficiency** in protected firms.
- It promotes monopolist tendency from protected domestic firms.
- **Limited choices for consumers; domestic** industries provide limited variety of goods and services.
- **Leads to malpractices** such as smuggling, and hoarding since national may have high preference to imported goods.
- **It is costly** when government has to provide subsidies and tax holidays.
- It may **frustrate inflows of foreign resource** which may limit the level of foreign private investment in the country.
- Discourages specialization
- **Stagnation of technological advancements:** As domestic producers don't need to worry about foreign competition, they have no incentive to innovate or spend resources on research and development (R &D) of new products.
- **Economic isolation:** It often leads to political and cultural isolation, which, in turn, leads to even more economic isolation.
- **The danger of retaliation and "trade wars":** Continuous protectionist measures by a country might lead to retaliation of other countries and they might also put protectionist measures on the imports.
- **Reduced export competitiveness:** Continuous protection to domestic industries (such as subsidies) might make them inefficient in terms of cost and technology.
- **Promotes income inequality;** because rich that own the industries charge their customers highly
- **Political Corruption.** Protectionism leads to political corruption. The big and influential industrialists try to secure protection for their industries, even though they are quite strong to face foreign competition, by offering bribes to corrupt political leaders and government officials.
- **Strained Foreign Relations.** When a government restricts its imports by levying heavy import duties the other countries retaliate in the same manner. This produces unnecessary strain on their political relationship.

#### Arguments for free trade

- It leads to **improvement of quality of goods and services** due to competition
- Lowers consumer prices due to substitution effect
- **Promotes efficiency** because it encourages goods or services to be produced where natural resources, infrastructure, or skills and expertise are best suited to them.
- **Widens market** since goods produced in one country can be consumed in another country
- **Source of government revenue** for export and import duties
- **Creates employment** from free international labour mobility
- **Encourages specialization** reducing cost of production

- **It strengthen international co-operation** through trading partners
- **Discourages monopolistic tendencies**
- **Promotes industrialization** through free movement of technology and materials.
- It **promotes the vent for surplus theory**. The Idle resources in one country are put to effective use so as to increase on export volumes
- **Improves customer's choice** because of variety of goods from other countries
- **Promotes innovations and inventions** due competition
- **Reduces corruption**
- **Reduces malpractices** such as smuggling.
- **Reduces domestic inflation**

Arguments against free trade

- **Suffocates development of local industries** from over competition of established international firms
- Encourages dumping
- It increases external economic dependence on MDCs
- May worsen balance of payment when importation exceeds exportation.
- Leads to importation of undesirable goods such as tobacco and drugs
- May cause unemployment due to closure of local industries and outsourcing of labour
- Leads to over exploitation of resources
- Leads to erosion of culture

7(a) Explain the quantity theory of money (8marks)

Irving Fisher's Quantity of theory of money states that the general price level of goods and services in an economy varies directly with the quantity of money in the circulation.

$$MV = PT$$

$$P = \frac{MV}{T}$$

Where M = quantity of money in existence,

V = the transactions velocity of money which means the average number of times a unit of money turns over or changes hands to effectuate transactions during a period of time.

P = average price or price level

T = total number of transactions or the total goods and services transacted.

The theory assumes that

- Demand and supply of money are equal and proportional
- Supply of money is exogenously determined
- T and V do not change
- Price is only affected by changes in money supply.
- there is full employment and economy is stable
- money is only demanded for transaction motives
- all business transactions are effected by used of money

(b) What are the limitations of the quantity theory of money?

- It assumes that velocity and number of transactions are kept constant, but this is not true because money supply increases also the volume of transactions increase and this affects velocity of money
- It assumes that the quantity of money (M) is directly proportional to the general price (P). But prices of different commodities do not change in the same proportions even if money (M) doubles. Therefore assumed general price level does not exist.
- The theory ignores existence of barter trade in which transactions take place without use of any money supplied. Therefore in some cases, price is determined by other factors other than the amount of money in the circulation. The theory fails to consider other factors that lead to change in price other than the quantity of money in the circulation
- In case of high liquidity preference, an increase in the quantity of money does not lead to an increase in price since much of the money is kept and not spent
- The theory only considers the transactions motive of holding money but again ignores motives of holding money such as precautionary and speculative motives. This is unrealistic because people do not only hold money for transaction purposes.
- The theory attempts to explain changes in the value of money but does not explain how the value of money is determined. Therefore the theory is weak in explanations and assumptions.
- The theory emphasizes the supply of money and does not talk about money demand yet practically the level of money demand determines how the money is to be spent and consequently affects economic activities in economy.
- The theory only gives relationship between money and the general price level but fails to give relationship between money and real factors in the development process
- The theory ignores the effect of government price control through minimum and maximum price legislations where an increase in money supply in economy will not lead to change in general prices level.
- It is assumed that increase in money supply lead to increase in the general price level assuming that whenever money is supplied is used for consumptions. However in case where there is marginal propensity to save (MPs) is high, it does not lead to an increase in general prices, since the additional quantity of money in the circulation is saved.
- This is not a theory at all, if it is a truism shows that M, V, P and T are related if it does not show us how these variable change,
- According to the theory, M, V, P and T are independent of each other, which is not true. A change in M can affect V and T so a rise in M can increase P but T can increase as well due to an increase in aggregate demand.
- When output increases and employment expands, money supply may increase without affecting the price level
- It ignores other causes of inflation other than an increase in money supply

8(a) Distinguish between “dead weight debt” and a “funded debt” (4marks)

**Dead weight debt** is money borrowed to finance unproductive activities such financing war or it is a debt which is not covered by any corresponding physical assets and whose repayment and interest have to be made from other sources.

Funded debt is money borrowed on long term basis (over one year) and repayment includes interest. Such a debt has security in form of promise in case of sale of bonds or in form of assets.

(b) What are merits and demerits of government borrowing?

### Merits of government borrowing include

- To fill the foreign exchange gap. Public borrowing especially external debts are important in supplementing foreign exchange earnings of a country
- To fill domestic savings gap. Public borrowing supplements domestic savings that can be low
- To curb inflation; borrowing from internal sources reduces money from the circulation leading to fall in aggregate demand
- To save people from unforeseen calamities/crisis such as floods and land slides
- **It allows governments to spend more on public services and projects than they raise in taxes so as to improve standards of living.**
- It helps the government to cover budgetary deficits.
- It promotes national savings as citizens buy government bonds.
- It provides citizens the chance to earn interest.
- To get funds to pay off a previous loan or debt servicing
- To stabilize the balance of payment position by investing the borrowed funds in export oriented industries and production for domestic consumption to reduce the amount of imports.
- To finance important but expensive projects such as dams and roads
- Improves international relationships
- It helps avoid depleting locally-available loans for private investment

### Demerits of government borrowing

- Public borrowing leads to **foreign exchange outflow** and consequently balance of payment deficits in long run during debt servicing
- **Loans are public burdens** because it is the public that will repay the loans through increased taxes to the government
- **Borrowing encourages laziness** among the nationals and consequently dependence on foreign nations. This retards the rate of economic growth.
- **External borrowing leads to inflationary situation in economy.** This is because externally borrowed funds are exchanged into local currency, which increase the amount of money in the circulation leading to demand push inflation
- **Servicing external debt leads to reduced domestic saving,** investment and low per capita accumulation in the country. This retards the rate of economic growth
- **Borrowing encourages extravagancy.** If a government borrows a lot of funds from external sources and spends these funds extravagantly, it reduces the sense of responsibility and this puts the nation into heavy debt burden for misuse of funds.
- In **paying back the loan, the government has to cut down its expenditure** on some services such as education, health, etc. and this reduces the standard of living.
- **Unproductive long term loans shift the** repayment to future generation that do not necessarily have benefited from such loans.
- **At times borrowed funds are accompanied by expatriates** who in most cases repatriate profit to their home countries. This also limits generations of employment opportunities for that nationals.
- **Internal borrowing worsens income inequality.** This is because the poor are asked to pay huge sum of money in form of taxes to repay the rich who often lend to the government. Thus the resources tend to flow from the poor to the rich

- **In case the external debt s to be repaid in terms of goods and services**, it deprives the citizen of a variety of the goods and services that would be locally consumed
- A **heavy public debt (due to borrowing)** can lead to selling off government property to pay off the debt. This property can however, be sold at a giveaway price which is a loss to the country.

Thank you

Dr. Bbosa Science