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Economics paper 2 set 3 and marking guide

1. (a) (i) Distinguish between mobility of labour and division of labour.

Mobility of labour refers to the ease with which labour can move from one job to another or activity to another or from one geographical area to another when there is a change in the conditions in the labour market; whereas **division of labour** refers to the separation of a work process into a number of tasks, with each task performed by a separate person or group of persons such that each worker or group of workers engages in a task, which he/she performs efficiently.

- (ii) How are the two related?

The relationship between the two is that the higher the division of labour the lower the mobility and vice versa.

- (b)(i) What is government expenditure multiplier?

Government multiplier refers to the ratio of change in national income to a change in government spending.

i.e. $\text{Government multiplier} = \frac{\text{change in national income}}{\text{change in government expenditure}}$

- (ii) How does government multiplier operate?

The multiplier effect occurs when an initial injection into the circular flow causes a bigger final increase in real national income. This injection of demand might come for example from a rise in exports, investment or government spending on infrastructure, civil servants, recurrent budget, etc.

- (c) List four consequences of an inflationary gap

The inflationary gap occurs when the relative rise in real GDP causes an economy to increase its consumption, leading prices to climb in the long run.

Positive consequences include:

- Stimulates investment
- Increases tax revenue
- Higher wages
- Increases producer's profit margin
- Stimulates hard work leading to increased output

Negative consequences include

- Increased cost of production
- Increased prices of commodities
- Lower standards of living
- Discourages saving
- Distorts government planning

- Encourages speculative activities hence discouraging consumption
- Cause industrial unrest
- Encourages dumping

(d) Using specific examples from your country distinguish between “footloose” and rooted industries.

A footloose industry is an industry which can be located anywhere. Proximity to the location of raw material is not required. A key industry is one that can be located in the areas of location of raw materials e.g. soda, electronics, garments manufacturing, etc. at industries at Namanve industrial park whereas rooted industries are industries setup in specific area due to special pull or location factors e.g. cement industry in Tororo where there exist limestone.

(e) Briefly explain the liquidity preference theory

Liquidity preference is the desire by individuals or firm to prefer holding or keeping their assets or wealth in money or cash form.

According to Keynes, the demand for money is the desire to hold cash for transactions, precautionary and speculative motives.

The higher the liquidity preference, the more the rate of interest paid to cash holder to part with liquidity. At the liquidity trap, interest is too low to break liquidity preference so people hold cash.

(f) State any four objectives of development

- To reduce income inequality and poverty or aims at equality of income distribution
- To attain full employment or reduction in unemployment levels.
- To minimize inflation
- To attain micro-economic stability
- To reduce the balance of payment disequilibrium.
- To achieve high rate of economic growth
- To attain a self-sustaining, integrated and independent economy

(g)(i) What is meant by vent for surplus theory in economics?

Vent for surplus theory explains the view that the exploitation of idle domestic resources for export can lead to an increase in national income

(ii) Mention two disadvantages of free trade

- Loss of tax to the government
- Encourages dumping
- Discourages growth of infant industries
- Leads to balance of payment problems
- Leads to import inflation
- Results into unemployment due to closure of domestic infant industries

(h)(i) Define proportional tax

A proportional tax (flat tax) is an income tax system that requires the same percentage of income from all taxpayers, regardless of their income.

Advantages of proportional tax

A proportional tax gives taxpayers incentive to earn more **because people to be taxed at the same percentage of their annual income.**

Disadvantage of proportional tax

Proportional tax is a regressive tax is a tax applied uniformly, taking a larger percentage of income from low-income earners than from middle- and high-income earners.

(ii) Give any two merits of progressive tax over proportional tax

- Reduces income inequality
- Increases government revenue
- Reduces social tension between the poor and the rich
- Encourage hard work
- Increases consumption of goods especially by the low income earners.

(i)(i) Mention two disadvantages of unplanned economy

- Escalates market imperfections like consumer ignorance in the market
- It leads monopolies
- Escalates income inequality
- Leads to economic instabilities such as inflation, unemployment
- Regional imbalances occur
- Discourages domestic industrial growth

(ii) What effect would failure to raise foreign exchange have on development plan?

- Government resort to borrowing so as to cater for development and recurrent expenditure creating foreign debts and dependence
- Failure to implement development plan
- Decline in economic performance
- Failure to provide social service to the country.

(j)(i) What is public debt management?

Debt management is a way to get public debt under control through financial planning and budgeting. The goal of a debt management plan is to use these strategies to help government lower her current debt and move toward eliminating it.

(ii) State two fiscal policies and monetary policies of debt management used in your country.

Fiscal policies of debt management include

- Surplus budget to create sinking fund
- Pay as you use method
- Exceptional financing
- Imposition of capital levy on the rich to generate more revenue

Monetary policies of debt management include

- Use of reserves
- Sale of government securities
- Borrowing from the central government

SECTION B

2. Under what circumstance may capital intensive techniques of production be employed despite the existence of surplus labour

Answer

Note: this calls for advantages of capital intensive and disadvantages of labour intensive techniques of production

- Machines are easier to control the labour. Labour tends to ask for continual increments in wages and other incentives which increases marginal cost of production
- If large quantities of identical goods are required then a company will be more likely to use capital intensive methods of production.
- Capital intensive can easily be automated.
- Machines can carry our dangerous tasks which will reduce accidents.
- Machines can carry out repetitive tasks that humans would find boring.
- Machines can work continuously, 24/7
- Labour is expensive in terms of training, supervision and retrenchment.
- There are some industries where labour-intensive techniques are not applicable e.g. in heavy manufacturing.
- It encourages training of skilled labour to use machines e.g. workers using computers and tractors
- It produces standard commodities which compete on world market in quality and price
- In agriculture, it encourages the use of modern methods of farming e.g. use of fertilizers leading to more output.
- It encourages scientific research that leads to development of new production techniques.
- Since LDCs rely on foreign investment from MDCs, which use capital intensive technology, it suits LDCs more than labour intensive technology.
- Capital intensive techniques of production require smaller working spaces compared to labour intensive techniques.
- It helps in provision of social and economic overheads such infrastructure.
- Labour intensive techniques of production do not encourage full utilization of resources that would of resources that would have been done by machines

3. (a) Explain the difference between saving and investment.

Saving refers to part of disposable income which is kept aside for future use.

Saving = disposable income – consumption

Whereas investing money is the process of using your money to buy assets that value over time and provide high returns in exchange for taking on more risk. It is expenditure on capital good e.g. factories and machines, human capital (skills) and stock.

(b) What factors determine the level of investment in your country?

- **The level of infrastructural development:** well laid and developed social economic infrastructure encourages the level of investment is it is easier to transport raw materials to the factory and finished goods to the market
- **The level of interest rate.** When the rate of interest rate is low, it becomes cheaper for investors to borrow money from financial institution leading to increased investment.
- **Availability and size of the market.** Presence of big size market for output encourages investment
- **The level of income.** Increase in level of income increases the level of saving leading to increase in level of investment

- Political stability increases the confidence and level of investment
 - **Business expectations.** When there is expectation of income boom, the level of investment increases.
 - **Marginal efficiency of capital.** This refers to the expected return from employing additional unit of capital. The high the marginal efficiency of capital the higher the level of investment.
 - **The amount of liquid assets available to the investor.** Physical assets cannot be invested alone. Therefore investors need to have additional liquid assets (cash) to buy raw materials as well as rewarding other factors of production. Thus the more liquid assets available the higher the level of investment.
 - **Invention and innovation.** These normally reduce average cost of production as well as introducing new fashions and products that increase marketability of output. This increases the level of investment
 - **The government policy.** This can take the form of taxation as well as subsidization. When the government offer subsidies to investor and tax holidays, the level of investment increases.
 - **The need to develop new products such as in telecommunication;** increase the level of investment.
 - **Wage costs;** if wage costs are rising rapidly, it may create an incentive for a firm to try and boost labour productivity, through investing in capital stock.
 - **Depreciation;** Some investment is necessary to replace worn out or out-dated equipment.
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4. (a) State and explain the objective of International Monetary Fund (IMF)
- To promote international monetary co-operation.
 - To ensure balanced international trade. It increases international liquidity through the special drawing rights (SDRs) facility where each member has an allocation with the IMF which it can use to settle debts
 - To ensure exchange rate stability
 - To eliminate or to minimize exchange restrictions by promoting the system of multilateral payments.
 - To grant economic assistance to members countries for eliminating the adverse balance of payment through lending.
 - To minimize the imbalances in quantum and duration of international trade
 - To give advice to member countries on economic policy
 - To give technical assistance to countries which require highly skilled manpower
 - To assist countries to restructure their economies through structural adjustment facility.
 - To compensate countries which experience a decline in export due to natural calamities e.g. drought, floods
 - To assist countries to get loans for financing development projects approved by IMF. This is done through stand-by- arrangements where IMF gives loans recommendation to such countries which can borrow from other countries or from financial institution.

(b) How far have these (IMF) objectives been achieved?

Achievements of IMF

- **Establishment of a Monetary Reserve Fund:** The Fund has played significant role to achieve the sizeable stock of the national currencies of different countries.
- **Monetary Discipline and Cooperation:** The IMF has shown the supremacy in maintaining monetary discipline and cooperation among the member countries. To achieve this objective, it has given assistance only to those countries which make stimulus efforts to solve their problems.
- **Check on Competitive Currency Devaluation:** There was a common tendency to make currency devaluation to boost up the exports. Thus, it creates disharmony in their economic and political relations. But with the coming up of IMF, the entire situation changed together. Now, no member country could devalue its currency without the permission of the Fund. It is only permissible under certain circumstances.
- **Technical Assistance to Members:** such as training and technical facilities in specific areas of economic management such as export guidance
- **No Interference in Domestic Affairs:** Another notable contribution of the Fund is that it does not interfere in the internal economic policies of member countries directly or indirectly
- **Special Interest in the Problems of Underdeveloped Countries:** The Fund has continued to provide assistance in financial matters and to support the balance of payment to its member countries.
- **Stability of Foreign Exchange Rate:** The Fund has contributed an excellent role in attaining a stability in the foreign exchange rate.
- Standard by making gold as the measure for the par value of national currencies.
- **Eliminate Disequilibrium in Balance of Payment:** The Fund keeps a reserve of currencies of the different member countries to provide assistance in correcting disequilibrium in their balance of payment. It can declare the short supply of currency as 'a scarce currency' and asks the country to revalue her currency so that the exports may decline and imports from other countries may increase.
- **Improvement of Multilateral Trade and Payments:** The Funds has facilitated in the establishment of a multilateral trade and payments and also facilitated for the expansion of balanced growth of international trade.
- **Expansion in World Market:** The establishment of the fund has given stimulus to the expanding of world market.
- **Special Drawing Right (SDR):** The Fund had succeeded in establishing a scheme of SDR for international liquidity. Further, fund also took many steps to improve international liquidity.
- **Helpful in Times of Difficulties:** The Fund has been useful to all member countries faced with economic crisis at national level. On account of hike in petrol prices many countries of the world experienced acute shortage of foreign exchange. In order to ease this situation, it set up Petrol Facility Fund.
- **The liberalization policies of IMF** especially on trade have reduced problems of scarcity and structural inflation
- **Policies such as privatization** have helped to improve efficiency, accountability, management and reducing corruption.
- **Inflation has been controlled through** the need to reduce government expenditure as required by IMF

Criticism/Failures of IMF

- **Limited Scope:** International Monetary Fund has very limited scope as it strictly deals with the imbalances of payments arises out of current trade transactions but fails to make adjustments in repayments of war loans or of blocked starting or with exports and imports of capital.
- **Indifferent Treatment:** Another shortcoming of the Fund is that the Fund adopts discriminate policy in favour of certain countries in its day-to-day functioning. It is said that IMF is only a “Rich countries Club.” It provides special treatment to western countries while ignores the interests of backward and underdeveloped countries.
- **Failure to Remove Exchange Controls:** IMF has utterly failed to achieve the objective of eliminating exchange controls and trade restrictions.
- **Failure to Attain Exchange Stability:** The fund has completely failed to maintain foreign exchange rate, exchange rates of different countries have been continuously changing despite the existence of the Fund.
- **No Solution of Liquidity Problem:** Although the Fund had taken certain steps to improve the liquidity of financial resources but it could not find any solid solution to the problem.
- **Failure to Tackle the Problem of Dollar System:** Another objection is raised that the IMF failed to tackle the problem of petro dollars. Despite great dollar shortage felt by the sterling countries, the Fund failed to declare the dollar a ‘scarce currency’ and to adopt the necessary measures to make the dollar freely available.
- **Defective membership of the Executive of the Fund:** Another glaring shortcoming of fund is that the Executive of the Fund has been so organised under the safeguard of the interests of the rich countries like America and UK, Truly, these countries have dominance over the executive only due to defective procedure of selection of members to the executive of the Fund.
 - **It has tended to interfere with the internal economic affairs/conditions of the member states.** This is because the member countries have to fulfil the IMF conditions to get financial assistance.
 - **The IMF policies have instead widened the gap between the poor and the rich.** This is because its programs favour the rich.
 - Foreign exchange wastage has become a common problem in LDCs due to IMF liberalization conditions that lead to importation of unnecessary goods.
 - Increased debt burden has resulted in a bid to stabilize the BOP positions as required by IMF.
 - Retrenchment has aggravated the problem of unemployment and reduction people’s welfare.
 - IMF policies have failed to protect the peasant farmer in LDCs because of abolition of price control programs such as minimum price legislation.
 - Divestiture conditions of IMF have greatly affected the locals. Since they do not have capital to purchase expensive state enterprises sold off

- The IMF lost its primary mission when the international financial system moved away from the gold standard to a floating **exchange rate system**.
 - the loans enable member countries to pursue reckless domestic economic policies knowing that, if needed, the IMF will bail them out
5. (a) What is the relationship between the levels of income, expenditure and employment
When the level of income is high, it promotes or increases aggregate demand for consumption of goods and services thus high expenditure which encourages investment and thus more employment opportunities and vice versa.
- (b) Outline the factors that may the relationship examined in (a)(i) above (i.e. between the levels of income, expenditure and employment)
- Limited size of domestic and international market.
 - Poor infrastructures such as roads, school and hospitals.
 - Inflation
 - Low level of entrepreneurship
 - Political instability discourages investment
 - High population growth that consumes all the income
 - Low business skills from limited education
 - Cultural beliefs
 - High taxes discourage investment
 - Corruption
 - Profit repatriation instead of reinvestment.
6. Discuss the factors that have enabled developed countries to benefit more from international trade than developing countries
- Economies of scale. Developed countries produce large quantities at low costs making their goods and services cheaper.
 - Quality of goods. Use of modern machinery and processes in developed countries make the quality of good higher than those of developing countries
 - Knowledge of international trade. Developed countries have high experience in the trade compared to developed countries
 - Value of good. Developed countries trades in high technology expensive goods while LDCs trade in low priced
 - Deteriorating terms of trade due to the discovery of synthetic fibres, which compete with natural fibre and increase in prices of capital goods.
 - LDCs depend on multinational and these work in favour of their home countries.
 - Unstable political system. These lead outflow, increase in foreign exchange expenditure on security and discourage foreign investor.
 - International trading policies like IMF and World bank tend to favour developed countries
 - When LDCs try to cooperate through regional integration, they are limited by funds. Even some activities of these bodies (e.g. free trade areas) are financed by developed countries which impose very high “tariff walls” on commodities from less developed countries. Therefore LDCs find it difficult to export commodities to developed countries.
7. (a) Show the major objectives of national budgets in Uganda
- Creating and maintaining a high level of employment. This is done through reducing taxes and increasing government expenditure on various development projects

- Guides the government on how to spend public funds in order to achieve economic stability and national development
- To stimulate faster rate of economic development through efficient use of natural resources.
- It informs the government on the performance of the past budget. The government therefore is in position to work out loopholes and plan.
- It is important in attracting foreign aid
- To achieve well equitable distribution of income through progressive tax system.
- To raise government revenue for development of social and economic infrastructure.
- To control inflation
- To correct balance of payment
- To help government in protecting infant domestic industries
- To plan manpower development

(b) Explain how a national budget act as

(i) a regulatory instrument

- It protects domestic industries from competition of dumped commodities
- Reduces income inequalities by taxing the rich more
- Restrict consumption of harmful commodities e.g. cigarettes
- They enable the government to reduce BOP problems by taxing more on imports and less on exports

(ii) A distributive socio-economic instrument

- Establishing and maintaining public good like roads, security and defence
- Maintenance of government enterprises
- Encouraging the private sector through lending, purchasing of shares and starting joint venture.
- Balancing national development by spending on development of backward areas.
- Motivating government employees e.g. through salaries.

8. (a) With examples from Uganda, distinguish between profit making and non-profit making parastatal organization.

Parastatal organizations are public enterprises which are owned by the state. They are created by acts of Parliament with aims of rendering certain services or producing certain goods.

Profit making parastatals are established by acts of Parliament to make profits for the government Such as National Water and Sewage Corporation, Uganda airline.

Non-profit making parastatal are enacted by act of Parliament to provide services to the public such as National Bureau of Standards (UNBS), Uganda National Examination Board(UNEB)

(b) Why may a country like Uganda sell of parastatal enterprises to individual industrialists?

- To encourage efficiency
- To make timely decisions
- To reduce government responsibility and expenditure on nonperforming enterprises
- To increase government revenue from private firms
- To provide employment from efficiently run business
- To encourage competition and improvement of quality of goods and service
- Due to lack of adequate capital to fund the enterprises
- Due to conditionality of IMF
- To promote technological impotation, when a foreign investor buy the enterprise, he comes with the technology

- To encourage diversification; a private investor may introduce new goods and services in once inefficient public business.
- To enable government concentrate on provision of social service. The transfer of direct control and ownership and responsibility over inefficient enterprises to private sector give government time to provide essential services.
- Need to improve the country's balance of payment position through increased resource utilization, output levels which increase the export volumes and earnings.