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## Economics paper 2 set 5 and marking guide

1(a) The price of sugar increased from Ugsh. 800/= per kilogram to Ugsh. 1200 per kilogram. The quantity of sugar supplied in the market increased from 2,000 tons to 5000tons.

(i) Calculate the price elasticity of supply for sugar

$$\begin{aligned}
 P.E.S &= \frac{\text{change in qty supplied of } Q}{\text{change in price of } P} \times \frac{P_1}{Q_1} \\
 &= \frac{5000-2000}{1200-800} \times \frac{800}{2000} \\
 &= \frac{3000 \times 0.4}{400} = 3
 \end{aligned}$$

(ii) Giving reasons briefly state whether supply is elastic or inelastic.

Elasticity of supply is elastic because the value obtained is greater than 1

(b) Relate the level of profits earned in an economy to

(i) risks

The greater the risk, the higher the potential for profit. In other words risky ventures tend to be more profitable.

(ii) Innovation

High profits enhance innovations and increase innovations lead to high profits

(c) What is meant by the following?

(i) Accelerator principle

The acceleration principle is an economic concept that draws a connection between fluctuations in consumption and capital investment.

It states that when demand for consumer goods increases, demand for equipment and other investments necessary to make these goods will grow even more. Or it is the number of times an initial change in consumption multiplies itself to bring a final change in investment

(ii) Multiplier concept

A multiplier is simply a factor that amplifies or increase the base value of something else. A multiplier of 2x, for instance, would double the base figure. A multiplier of 0.5x, on the other hand, would actually reduce the base figure by half.

(d) State four ways in which your economy is economically dependent.

- Foreign capital dependence
- Trade dependence
- Technological dependence
- Manpower dependence
- Ideological dependence
- Sectoral dependence
- Direct dependence

(e) Give four reasons why economic growth may not necessarily be accompanied by economic development.

- When there is uneven income distribution existing in the country
- When there is high unemployment level
- When there is no improvements in the quality of goods and services
- When there is high inflation tendencies
- When there is high level of foreign dependence
- When there is increasing national debt
- When there low levels of education
- When there is political instability
- When there is worsening balance of payment

(f) State four disadvantages of agricultural mechanization in developing countries

- It creates technological unemployment
- It promotes rural-urban migration amongst the unemployed
- Cause income inequality
- It leads unbalances regional development
- It requires skilled and semi-skilled labour
- It is difficult to mechanize where there is land fragmentation
- High maintenance costs
- Over usage of machines may lead to environmental degradation
- Few crops can be mechanized.
- Expensive to purchase machines

(g) Mention four methods that may be used by a trade union to settle disputes

- Collective bargaining
- Boycott of work; to refuse take part in an activity as a way of expressing strong disapproval
- Seminars
- Strike
- Picketing; an activity in which a worker or group of workers protest outside a building to prevent other workers from going inside.
- Arbitration
- Press wars
- Slowdown production
- Industrial courts

(h)(i) Distinguish between “free trade area” and common market.

A **free trade area** is a region in which a number of countries have signed a free trade agreement and maintain little or no barriers to trade in the form of tariffs or quotas among one another.

A **common market** is a formal agreement where a group is formed amongst several countries that adopt a common external tariff. In a common market, countries also allow free trade and free movement of labour and capital among the members of the group.

(ii) What are the advantages of economic integration

### Advantages of Economic Integration

- a reduction in the cost of trade leading to improved product availability
- market expansion and efficiency gains
- increase investment to cater for bigger market
- economic and political stability because of stronger economic ties, which provide an incentive to resolve conflicts peacefully and lead to greater stability
- Trade liberalization due to minimal government intervention
- Increase in employment opportunities and labour mobility
- Leads shared costs of public goods or large infrastructure projects

(i)(i) Define balance of payments

The balance of payments (BOP) is a statement of all transactions made between entities in one country and the rest of the world over a defined period of time.

Or

The balance of payments (BOP) transactions consist of imports and exports of goods, services, and capital, as well as transfer payments, such as foreign aid and remittances in a given period of time.

Or

It is the difference between a country's foreign exchange earnings from her visible and invisible export and her forex expenditure on visible and invisible imports during certain period of time

(ii) State three ways of correcting a balance of payments

- External borrowing
- Devaluation and exchange depreciation; Devaluation raises the domestic price of imports and reduces the foreign price of exports of a country devaluing its currency in relation to the currency of another country.
- Trade restrictions to discourage imports.
- Use of foreign exchange reserves.
- Increasing domestic production through imports substitution industries
- Tight money policy and increased direct taxes to reduce disposable income
- Export promotion to increase export earnings
- Manpower development to reduce expenditure on expatriates
- Export diversification to increase export earnings.

(j) (i) Differentiate between managed and pegged exchange rates

A **pegged rate**, or **fixed exchange rate**, is determined by the central bank of the country while **managed or floating** exchange rate is determined by the dynamics of market demand and supply.

(ii) Give two disadvantages of floating the currency in economy

- It leads to uncertainty in forex market
- It encourages speculation
- It leads to inflations
- It leads to fluctuation of foreign exchange earnings.
- Lack of Investment: The uncertainty introduced by floating exchange rates may discourage direct foreign investment (i.e., investment by multinational companies).
- May lead to crisis: there is a possibility that with a floating exchange rate such short-run problems as domestic inflation may be ignored until they have created crisis situations.
- May lead to instability of prices

## SECTION B

2. Study the table below and answer the questions that follow:

Commodity	Average price 2000 Ug. Shs.	Simple index 2000	Average price 2002 Ug. Shs.	Simple index 2002	Weight	Weighed index 2002
Sugar (kg)	800	100	1000	-	3	-
Soap (bar)	450	100	600	-	5	-
Maize (kg)	220	100	400	-	6	-
Meat (kg)	700	100	1200	-	2	-
Fuel (L)	550	100	950	-	4	-
Clothing (m)	1200	100	1500	-	1	-

(a) Calculate

(i) Simple index for 2002

$$\text{Simple index for 2002} = \frac{P_{2002}}{P_{2000}} \times 100$$

$$\text{For sugar; SPI} = \frac{1000}{800} \times 100 = 125$$

$$\text{For soap; SPI} = \frac{600}{450} \times 100 = 133$$

$$\text{For maize; SPI} = \frac{400}{220} \times 100 = 182$$

$$\text{For meat; SPI} = \frac{1200}{700} \times 100 = 171$$

$$\text{For fuel; SPI} = \frac{950}{550} \times 100 = 173$$

$$\text{For clothing; SPI} = \frac{1500}{1200} \times 100 = 125$$

(ii) Weighted index for 2002

Weighted index for single commodity = price relative x weight

$$\text{For sugar; W.I} = 125 \times 3 = 375$$

$$\text{For soap; W.I} = 133 \times 5 = 665$$

$$\text{For maize; W.I} = 182 \times 6 = 1092$$

For meat;  $W.I = 171 \times 2 = 342$

For fuel;  $W.I = 173 \times 4 = 672$

For clothing;  $W.I = 125$

(b) Why is the computation of price index usually difficult

- Selection of base year when prices were stable, it should be free from abnormal conditions like wars, famines, floods, political instability, etc.
- Inadequate skilled labour to collect information
- Lack of standard units for sale of the basic needs across the country
- Seasonal price variations
- Price discrimination may make it difficult to choose a price of a commodity.
- Individual income may change consumption patterns
- Inadequate funds for the process of compilation of data for instance money for transport and stationery
- Regional differences in prices of basic needs
- Unstable taste and preferences of interviewees.
- Wrong information from interviewee.
- Data collection is a tedious exercise
- Selection of Commodities in a basket: the items selected should be

- representative of the tastes, habits and customs of the people.

- be recognizable,

- stable in quality over two different periods and places.

-The economic and social importance of various items should be

Considered

- Choice of the prices to be collected whether wholesale prices or retail prices
- Selection of Average whether arithmetic or geometric means. Theoretically, geometric mean is the best for this purpose. But, in practice, arithmetic mean is used because it is easier to follow.
- Selection of Method: whether simple index number or weighted index number.
- Unrepresentative basket of goods due to different income groups

3(a) Giving examples, distinguish between horizontal merging of firms and vertical merging of firms.

**Vertical integration** is the merging or coming together of firms operating at different stages of production process within the same industry for example agricultural firm and a grocery

**Horizontal integration** is the merging or coming together of firms operating at the same stage of production process, producing related or similar products, e.g. merging of banks or supermarkets.

(b) Examine the economic factors that make merging of firms difficult.

- Fear of loss of their names and identity; building a business takes quite some time, so firms fear to enter entering ventures leading to loss of their names or identity.
- Firms have different objectives such as profit maximization, sales maximization, etc.
- Some firms fear diseconomies of scale that are likely to occur with merging
- Firms in unrelated field are not likely to merge
- Some firms fear loss of autonomy
- Managers fear complexity that may arise after merging
- Some firms prefer competition
- Decision making is likely to be slow after merging
- Fear to undertake high risks due to merging
- Government policy of discouraging monopoly which accrues through merging.

4(a) Examine the factors that determine labour supply in your country (Uganda)

- Low pay and remuneration in Uganda lead to low labour supply.
- Poor working conditions discourage supply of labour.
- Limited skills lead to low supply of labour
- Low degree of mobility of labour (both occupational and geographical due to lack of proper skills and cultural rigidity leads to low labour supply.
- Period of training; the period of training in Uganda is long leading inelasticity labour the supply of labour in short run
- Gender composition; labour supply is low because few women take part in employable jobs
- Few pensionable jobs discourage labour supply
- Population composition; the high population growth rate in Uganda means low proportions of adults to supply labour
- Number of the disabled; a large number of disabled people reduce labour supply.
- The size of supporting ratio, (ratio of working class to non-working class); this is very low in Uganda and therefore labour supply is low
- The degree of complementarity of labour; the supply of labour in Uganda is low as it is not complementary.
- The degree of substitutability of labour; the labour can easily be substituted, its supply tends to be low
- Retirement benefits: these are lacking in Uganda and therefore people tend to work longer increasing labour supply.
- Discrimination barriers to certain professional e.g. law, medicine limit labour supply.
- Real wage; an inflationary period discourages labour supply due to falling real wages.
- Government policy; the government as a major employer of labour determines labour supply
- General social and political conditions in the country determine the supply of labour.

(b) Account for differences in wages in your country. (10marks)

- **Variation in levels of skills;** skilled employees are paid more than unskilled employees
- **Differences in bargaining power of an individual;** individual with high bargaining power are paid relatively more.
- **Difference in people's ability to work;** hardworking people are paid more
- **Differences in expertise and responsibility;** workers who hold high responsibilities such as head teachers are paid more than those of low responsibility such as cleaners.
- **Differences in the degree of elasticity of labour.** Workers whose labour supply is inelastic tend to get higher wages due to quasi rent received.
- **Difference in the marginal rate of technical substitution:** this refers to the ease with which labour can be substituted for capital. Labour in Uganda is easily substituted for capital, hence its demand is low leading to low wages.

- **Difference in talents and natural gifts**, talented employees are paid more such as in entertainment and games.
- **Imperfect knowledge in labour market**; some worker receive low wages because they lack knowledge for regions where labour is paid higher.
- **Differences in level of education** especially in public services wages are tied to education level.
- **Differences in future expectation and prospects or promotion**; workers expecting promotion will accept low pay in short run.
- **Risk of employment**: risky jobs such as mining attract high wages
- **Discrimination in labour market** due to corruption favors some workers with higher wages.
- **Gender**: women are usually paid less than men in the same responsibility.
- **Differences in number of hour worked**; work for longer hours attract higher wages.

5(a) Define the term stagflation.

Stagflation refers to economic stagnation associated with a high unemployment rate accompanied by high inflation. It could be due to laying off of workers and shortage of commodities.

Economic policymakers find this combination particularly difficult to handle, as attempting to correct one of the factors can exacerbate another

(b) Examine the effects of inflation on the economy of your country

**Inflation** is defined as a “general upward price movement of goods and services in an economy.”

### Positive effects

- **It stimulates people’s efforts. People** tend to work harder during inflation so as to maintain their material wellbeing
- **It leads to increased production.** Production is more profitable during times of inflation because of high prices
- **Government revenue from taxes increases because of high income.** Hence the government is able to finance projects.
- **Full utilization of resource to increase production.** Including redundant resources such as clay for pottery and scrap for iron and steel production.
- **Entrepreneurship is stimulated.** Due to high level of profit
- **Inflation leads to fair distribution of incomes and wealth.** People holding stock and shares of companies which do not carry fixed rate of interest tend to gain during inflationary situation.
- **Rural urban migration is discouraged.** Due to high cost of living in towns
- **It results into industrialization.** Due to high profits.
- **Boosts Real Estate, Energy, Value Stocks** since landlords can protect themselves against inflation by raising rents, even as inflation erodes the real cost of fixed-rate mortgages.

### Negative effects

- **During inflation money losses value**; thus creditors lose in terms of real value while debtors gain
- **It leads to income inequality.** This because fixed income earner receive less and lose in real term while business people gain in price increases.

- **Reduces purchasing power**
- **Hurts the Poor Disproportionately.** Lower-income consumers tend to spend a higher proportion of their income overall and on necessities than those with higher incomes, and so have less of a cushion against the loss of purchasing power inherent in inflation.
- **Leads raising bank interest rates**
- **It worsens the government's budget deficits.** During inflation governments revises its plans and contracts which is quite expensive.
- It **leads to rural-urban migration** since people tend to leave less paying jobs like agriculture and run for urban jobs.
- It **discourages people from keeping money in the bank** and at home and prefer keeping money in real assets.
- It **worsens a country's balance of payment position** because countries do not like to import from countries experiencing inflation.
- **Inflation requires a country to carry out devaluation** from time to time which makes imports expensive leading to import inflation.
- **Inflation discourages investment.**
- It **worsens the value of local currency.** People therefore prefer to hold money in form of foreign currency.
- Inflation **encourages speculation** and speculation leads to hoarding of essential commodities. This worsen people's standards of living.
- It **leads to political anarchy** because people resent regime in power.

6 Given that Bank A had initial deposits of U.sh 10,000 and the required cash ratio was 20%

(a) Explain how the bank create more credit

Case I: Suppose the banker does not have several branches outside, then we use credit multiplier.

Total credit created = initial deposit x credit multiplier

$$\text{Note: credit multiplier} = \frac{1}{\text{cash ratio}} = \frac{1}{20\%} = \frac{1}{0.2} = 5$$

$$\Rightarrow \text{Total credit created} = 10,000 \times 5 = 50,000/=$$

Case II: suppose the bank has several branches, say 1, 2, 3 and 4, we use continuous process

Bank	New deposit	Cash ratio	Reserve ration	New loan
1	10,000/=	20%	2000	8000
2	8000/=	20%	1600	6400
3	6400/=	20%	1280	5120
4	5120/=	20%	1024	4096

$$\text{Total credit created} = 10,000 + 8000 + 6400 + 5120 = 29,520/=$$

(b) Examine the factors limiting credit creation in your country.

- **Lack of Cash:** The total amount of cash, available to the banking system limits the volume of credit that can be created.
- Many people have **inadequate securities** to secure loans leading low credit creation.
- **Poor banking habits of the people:** few people are in the habit of using cheques, the grant of loans leads to the withdrawal of cash from the credit creation stream of the banking system. This reduces the power of banks to create credit to the desired level
- **Unfavorable policies of the central bank.** The high reserve ratio set by central bank limits them from creating more credit.
- **Excess reserves:** some banks keep more cash in reserves than the legal reserve requirements; this limits their power to create credit.
- **Delayed clearance of cheques** limits expansion of reserves of the commercial banks and their ability to create credits

- **Large subsistence sector**, whose output doesn't pass through the market but instead passes through barter system, this limit demand for money and borrowing.
- **High liquidity preference**; people prefer to hold wealth or assets in cash or near cash form than saving with commercial banks. Hence limit total deposit and lending
- **Existence of many banks**. The various commercial banks compete for customers which tend to limit the creation of credit in individual commercial banks.
- **Uneven distribution of commercial banks**. Commercial banks are concentrated in urban areas which limit credit creation process to small section of urban people.
- **Political instability** discourages potential investors leading to low demand for money hence limited credit creation.
- **High bank and interest rates**. The high bank rate limit central banks from borrowing and hence limits the process of credit creation
- Limited profitable ventures that discourage potential investors from investing. This cause low demand for money hence limited credit creation
- **Persistent inflation** which discourages commercial banks from lending and leads to low credit creation

7(a) Examine the causes of unemployment in your country

Causes of unemployment in Uganda

- **Technological progress and increased use of capital intensive methods** such as computers replace labour force and lead to unemployment
- **Changes in season**: seasonal variations in economic activities cause seasonal unemployment for example in agriculture during dry seasons.
- **Poor land tenure system**; land lord's system leaves some land idle leaving the landless unemployed in agriculture
- **Changes in taste/market/demand** may cause reduction in investment reducing demand for labour hence Keynesian unemployment.
- **Lack of skills**, many Uganda do not obtain practical education leading to unemployed job seekers
- **Rural-urban migration**; many people who abandon agriculture to urban areas fail to get jobs due to limited opportunities
- **High population growth rate** has caused land shortage for agriculture leading to unemployment in rural areas
- **Poor/negative attitudes towards work**. Highly educated people despise some jobs like agriculture and opt to remain unemployed
- **Discrimination in the labour market**. Sometimes jobs are given to people affiliated political party, sex, tribe leaving the rest unemployed.
- **IMF conditions** such as retrenchment cause unemployment.
- **Physical and mental incapacitations** lead to unemployment
- **Low investment and failure to create more jobs**.
- **Ignorance about job opportunities**; limited knowledge about availability of jobs leads to unemployment.
- **Under developed infrastructures** such as poor transport network limits labour mobility and also hinder productive venture that would create jobs.
- **Frictional unemployment** during when people are changing.

(b) What are steps being taken to solve problems of unemployment?

- **Ensuring political stability and crime reduction;** encourages investment and job creation.
- **Improvement of infrastructure;** several roads are being constructed and renovated to encourage investment and labour mobility.
- **Power generation and rural electrification;** encourages investment in rural area increasing job opportunities
- **Education reforms;** Encourages vocational education; to provide people with employable skills.
- **Promotion of economic integration;** to expand market and investment and labour creation and mobility.
- Measure to reduce population growth such family planning
- **Privatization** of public enterprises increases efficiency and job creation.
- **Liberalization of economy.** Attract more potential investors
- **Development of financial institution** like banksto provide credit to local investors to boost production and hence job creation
- **Setting up investment institution** such Uganda investment authority (UIA) to promote investment and job creation.
- **Modernization of agricultural sector.** This reduces the rural under employment and encourages the population to engage in agriculture.
- **Advertising existing jobs.** Job centers are being created to provide job awareness.
- **Adopting land reforms** that increase land usage.
- **Adopting the price policy** to stabilize prices of agriculture outputs to encourage employment in agricultural sector
- **Diversification of Agriculture:** to increase profitability of agriculture.
- **More assistance to self-employed people:** with finances and technical training to grow and create employment.
- **Decentralization of industrial activity** in to spread employment across the country.
- **High rate of capital formation:** government should make investments leading high job creation

8(a) What are the features of good tax system?

- **Equity/fairness.** A good tax system aims at equitable distribution of income through the proportional and progressive tax
- The tax payer should be certain of exact amount imposed on him.
- The collection of tax should be timely with few administrative problems.
- The tax system should allow various types of tax according to different taxable capacity.
- **Stabilization and allocation of resources.** Taxations should aim at stabilizing economic structure e.g. increasing tax to curb inflation
- i.e. the cost of collection need not exceed 5% of the expected total revenue.
- A good tax system should be able to generate revenue and at the same time avoid adverse effects on productive potential of economy.
- The tax system should be flexible providing adequate revenue needed depending on the changing requirement of the economy.
- Taxes should be administered in simple and understandable languages to avoid misinterpretations from the payer and collector.
- The government should be able to raise or reduce revenue as needed.

- It should **minimize double taxation**. A tax payer should not be taxed more than once in a given year.
- A good tax system should have a wide variety of taxes to exploit the potential tax base.
- The tax system should balance between the amount of revenue collected and services rendered from the collected taxes.
- A good tax system should be affordable by the tax payer.

(b) Explain why it may be necessary to levy different forms of taxes in an economy.

- To **raise revenue** by exploiting all potential taxable avenues base
- To **protect domestic industries** for cheap imports
- To **reduce income inequality** by taxing the rich more than the poor.
- To **protect peoples health by charging heavily harmful products** such as tobacco to reduce consumption.
- To **improve on the country's balance of payments position** by discouraging imports and encouraging exports
- To **discourage dumping into the country** and promote local production through lower taxes on domestic firms
- To **encourage growth of major sector** like education and health by imposing low taxes.
- To **break monopoly powers** especially land monopoly to encourage land sale to landless.
- To **protect the scarce resource**; like forest and mineral from over exploitation.
- To **reduce inflation** through direct taxes on income
- To **control economic variables like employment**, saving, investment, saving, etc.
- To **redistribute wealth** from the rich to the poor.
- To **solve environmental problems** created by consumption of some goods such pollution from gasoline.

Thank you

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