Economics paper 2 set 8 and marking guide

1(a)(i) Distinguish between price elasticity of demand and income elasticity of demand. (2marks)

Price elasticity of demand is the degree of responsiveness of demand of a commodity due to a change in its price.

Income elasticity of demand is the degree of responsiveness of demand of a commodity due to a change in Consumer's income.

(ii) State two factors that affect the elasticity of demand in your country. (02marks)

- Degree of necessity
- Nature of the product
- Availability of substitutes
- The income levels
- The number of users of a product
- Time period
- Amount of adversity
- Speculations about a price

(b) (i) What is price discrimination? (1mark)

Price discrimination is the process (practice) of selling the same commodity to different consumers at different prices by the same seller in a given period of time, for reasons not associated with costs. For example prices of entertainment tickets at different costs for public and students or children and adults.

(ii)State three necessary conditions if price discrimination is to succeed in your country

- The commodity should **not have close substitute.**
- **Businesses must prevent resale.** Prevention of re-sale could be enforced in many different ways. For example students can only receive student discounts with a legitimate student ID, children can easily be identified from adults.
- The **market in question must be geographically distant /spatially separated** in case of seats for football or entertainment such that it is easy for monopolist to charge different prices in the different market places or transfer of goods from one market to another is difficult
- **There should be different elasticity** of demand in the different markets.
- **Ignorance among customers** about other markets
- **The seller or producer** must be a monopolist or the market must be imperfect.
- **Personal services** that can be resold or transferred e.g. medical Doctor, teacher, entertainment etc.

- **Product differentiation**; artificial differences made on similar products by a way of branding, trademarks.
- **Low transport costs also lead to monopoly power** in that goods can be transferred from one market to another without affecting their prices.
- **No government interference**

(c) (i) What is meant by Gross National Product?

Gross national product (GNP) refers to the money value of all final goods and services produced by nationals of a country (living within and abroad) during a given period of time.

(ii) Given that Gross Domestic Product at factor cost is 2500 million shillings, net income from abroad is 800 million shillings and depreciation of capital equipment is 50 million shillings. Calculate the Net National Product. (2marks)

Net National Product = GDP – depreciation

= (GDP+ Net Y from abroad) – depreciation

= 2500 + 800 – 50

= 3250 million shillings

(d) What is the role of informal sector in your country?

The informal economy consists of **independent, self-employed small-scale producers and distributors of goods and services**. Workers in this sector are for the most part not covered by the country's labour laws and regulations.

Role of informal sector

- Creation of employment opportunities
- Reduction of foreign exchange outflow
- Production of affordable goods
- Produce for local market
- Provides skill development as it encourages training of labour market
- Development of entrepreneurship skills
- Contributes revenue through taxation
- Promotes technological advancement
- Enhances fair distribution of income
- Widens consumer's choice by increasing variety of products.

(e)(i) What is meant by efficiency of labour? (1mark)

Efficiency of labour implies **the quality and quantity of goods and services which can be produced within a given time and under certain conditions**. In other words, productive capacity of a worker is termed as efficiency of labour.

(ii) Factors affecting efficiency of labour in Uganda

- The degree of specialization
- Level of skills/technical knowledge
- The working conditions
- The health conditions of a worker

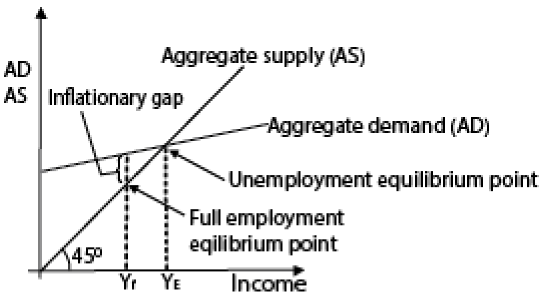
- Degree of expertise
- Workers attitude and level of commitment towards work
- Availability of fringe benefits offered
- Motivation and Incentives/ Wage level
- Resourcefulness of a worker,
- sense of responsibility/judgement of a worker
- age
- disability
- weather conditions for instance hot weather reduces ability to work on a farm
- Availability of technology and other equipment: High technology will increase the efficiency of Labour.
- **Efficiency management**
- **Security of job**

(f) Mention any four structural adjustment conditionality of International Monetary Fund (IMF) that your country has implemented (4marks)

- Privatization
- Economic liberalization
- Reduction of government expenditure
- Investment policy i.e. encouragement of foreign investors through provision of conducive investment climate-low taxes.
- Devaluation
- Cost – sharing
- Agricultural modernization
- Retrenchment
- Improvement in tax collection by Uganda Revenue Authority (URA)
- Trade liberalization
- Forex liberalization

(g)(i) What is inflationary gap(1mark)

Inflationary gap is the amount by which the actual aggregate demand exceeds 'aggregate supply at level of full employment'.



The diagram above shows that the bigger the inflationary gap, the smaller the level of national income since income increases from Y_f to Y_E. Also,

Inflationary gap causes a rise in price level which is called **inflation and leads to an increase in employment and income.**

(ii) How is inflationary gap in an economy be closed?

Decrease aggregate demand through

- Reductions in government spending
- Increasing taxes
- Reduction of exports
- Price control
- interest rate increases
- improvement of investment climate
- strict income and wage control

(h)(i) Define the term "invisible export" (1mark)

Invisible exports are non-tangible goods (service) that are sold by one country to another e.g. insurance, tourism, shipping, etc.

(ii) What are the components of your country's export-import trade?

Uganda export

- agricultural primary products e.g. cotton, coffee, tea
- non-traditional export like vanilla, sim-sim, etc.
- services like tourism, electricity to Rwanda and Kenya
- Export e.g. manpower
- Horticulture

Uganda imports

- Petrol and petroleum products
- Manufactured products capital and consumer goods
- Services like banking, insurance
- Technology
- Manpower
- Service

(i)(i) Distinguish between cash ratio and liquid ratio

Cash ratio is the proportion or percentage of the commercial bank deposits kept in cash form to meet the day demands of their customers and other obligations which exclude lending out as loans to borrowers.

Liquid ratio refers to the proportion of the total deposits of commercial banks which is kept in cash form of in form of assets that can easily be converted into cash e.g. bank drafts, cheques, etc.

Liquid ratio = Liquid assets/total assets.

(ii) Calculate the credit created where initial deposit amount to 10,000 shillings, cash ratio 5%and four banks are involved

Banks	New deposit	Cash ratio	Loans
1	10.000	(5/100) x 10,000 = 500	9500
2	9500	(5/100) x 9500 = 475	9025
3	9025	(5/100) x 9025 = 451.25	8573.75
4	8773.75	(5/100) x 8573.75 = 428.69	8145.06

Total deposit = 10,000 + 9500 + 9025 + 8573.75 + 8145.06 = 37,098.75shillings

(j) Mention four factors responsible for lax revenue in your country.

- High levels of tax evasion and avoidance
- Political interference
- Low tax base
- Low levels of taxable income
- Large Informal sector
- A big subsistence sector
- Corruption
- Low tax education
- Political instability

SECTION B

2(a) Examine the causes of agricultural price fluctuations in your country. (12 marks)

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

(b) What are effects of agricultural price fluctuation in your country?

- Leads to unstable export earnings

- Unstable terms of trade since the cost of imports remain constant
- Leads to fluctuating government revenue
- Make planning agriculture difficult leaving it to mere speculation
- Encourages rural-urban migration search of job with stable income
- Reduced employment in agricultural sector case of fall in prices
- Reduced production because price fluctuation discourage investment in agriculture
- Income inequality rises because some become rich others poor due to agricultural price fluctuations.
- Make it hard to pay back agricultural loans
- Make it hard for banks to avail agro based loans

3.(a) Define the term investment

An investment is the purchase of goods (e.g. capital goods, human capital (skills))that are not consumed today but are used in the future to generate wealth.

(b) Examine the factors influencing 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.
- **Population growth;** high population provide market and labour required for investment

4. To what extent is an inward-looking industrial development strategy ideal for your country?

Inward-looking industrial development strategy or import substitution industrial strategy is would be ideal for Uganda because

- Reduces its foreign dependency through the local production of industrialized products and leads to self-sustenance of economy.
- It yield steady flow of income since prices of industrial products tend to be stable
- Improves skills and marginal productivity
- It provides market for agricultural products
- Reduces balance of payment position since it reduces proportion of imports
- Improves terms of trade because it promotes exportation
- It encourages development of infrastructure such as roads, schools, hospitals, etc.
- Provide government revenues through taxation
- Industries in rural areas reduce rural-urban migration
- Promotes efficient utilization of local resources
- Creates employment
- Promotes customers choice through a variety of products

Demerits of inward-looking industrial development strategy

- It leads to unemployment due to use of capital intensive techniques of production
- Encourage profit repatriation since most factory owners are foreigners
- It promotes monopolistic tendencies as industries are expensive to start
- Leads to wastage of resources due to limited domestic consumer market
- Due to high production costs it leads to cost push inflation
- High protectionism leads to inefficiency of domestic industries and inferior goods and services
- Protectionism is very expensive to implement
- Encourage use of imported inputs leading to imported inflation
- Low standards of living due to limited variety
- It leads to rural-urban migration

5(a) What is meant by a subsistence wage?

A subsistence wage is a wage that provides only the bare necessities of life.

(b) Account for the existing differences in wages in your country?

- **Difference in talents** (natural ability) those who are naturally talented e.g. footballers, musicians usually earn higher wages than their counterparts that are not talented.
- **Differences in opportunities:** people with good paying jobs earn more than others with low paying jobs
- **Differences in elasticity of demand;** inelastic labour attracts higher wages than elastic labour
- **Level of education and training;** highly educated and well- trained people tend to earn more than those with low education and training e.g. Doctors versus nurses.
- **Differences in physical and mental abilities;** the mentally sound and physically strong tend to have ability and willingness to work and hence have higher incomes compared to those that are insane and physically weak
- **Differences in infrastructure distribution**. Area with even distribution of infrastructure tend to have higher incomes than others with under developed infrastructures

- **Differences in age, sex, tribe and race;** labour discrimination is based on these factors are used to determine individual wages.
- **Risks of jobs;** people in risky jobs earn bigger wages
- **Difference in number of hours worked;** those who work long hours are paid more than those that work a few hours
- **Differences in mobility of factors of production**; mobile factors of production can easily move from areas of low payment to areas of high wages unlike immobile factors of production.
- **Influence of trade unions.** Strong and sound trade unions agitate for favorable conditions of work.
- **Political stability;** areas that are politically stable attract investment than those that are unstable.
- **Government policy;** government tend to favor some parts of the country when allocating resources. These get higher incomes
- **Globalization** – Lesser-skilled Ugandan workers have been losing ground in the face of competition from workers in Asia and neighboring countries.
- **Skills/expertise and responsibility–** The rapid pace of progress in information technology has increased the relative demand for higher-skilled workers.
- **Social norms** –CEO pay is very much higher than a normal worker

6(a) Explain the Keynesian theory of unemployment (4marks)

The Keynesian theory states that **unemployment caused by a lack of aggregate demand in the economy**

Due to low demand for final products, firms reduce their output, income level fall, investment is discouraged and thus less labour and capital are employed.

According Keynes, this unemployment can be solved by increasing aggregate demand by

- Reducing taxes to raise disposable income
- Using expansionary policies
- Increasing government expenditure
- Subsidization of consumer

(b) To what extent is the this theory relevant to developing countries

To a greater extent, this theory is irrelevant to developing countries because

- **It is one sided**. it is mainly concerned with demand deficiency yet unemployment in LDCs is basically from supply side hence inapplicable.
- **It assumes full employment**. The theory is only applicable under conditions of full employment of resources, which condition do not exist in LDCs since there is excess capacity.
- **It considers industrialized economies**. The theory is mainly concerned with industrialized economies like Britain and yet LDCs are agrarian economies.
- **It can be inflationary.** As a solution to unemployment, Keynes prescribes policies, which raise the levels of aggregate demand such as increase in money supply which is always inflationary.
- **The theory is based on a highly monetized industrial economy**. LDCs are basically subsistence where production is intended for producer's own consumption.
- **The theory is drawn basing on the existence of a strong private sector** in LDCs is weak.
- **The theory is based on a well-functioning product, money and factor markets** which is not the case in LDCs.

- **The theory is based on assumption that firms respond quickly and effectively to change in demand**. Firms in LDCs due to structural difficulties tend not to respond quickly and effectively to demand.
- **Keynes based his theory on investment** multiplier as a major contributor to employment. In LDCs, it is export multiplier that contributes more employment than investment multiplier.
- **The theory of unemployment was based on a closed economy**. LDCs economies are open in that they have trade interactions with others.
- However to small extent the Keynesian theory is relevant in LDCs because
- In LDCs, the element of industrialization exist, hence the theory applies.
- Use of **expansionary monetary policies** increase purchasing power has tended to increase employment level in LDCs.
- **Measures to stabilize export earnings** through IMF compensatory arrangements to ensure stable export market reduces the rate of unemployment.
- **Since investment climate affects employment,** then it is true that improved investment in LDCs will expand employment hence relevancy of the theory.
- The supply of co-operant factors e.g. labour can increase in the long run.
- **A fall in demand can lead to unemployment** hence the applicability of the theory.

7(a) Examine the causes of inflation in your country.

- **Excessive government expenditure** and much money that is not by supply of goods has given rise to price increase lead to demand pull inflation
- **Increasing population growth rate** which increases the demand for goods and services and increase in prices
- **Increase in wages;** persistent lead to increase in money supply in the circulation workers' purchasing power, demand and inflation
- **Frequent devaluation.** This leads to high costs of imports and import inflation.
- **Political instability** leads to low investment and output causing demand pull inflation
- **Shortage of foreign exchange** causes reduction in imports and scarcity of goods leads demand pull inflation
- **Influence of trade unions.** Trade unions ask for higher wages that cause high cost of production leading cost push inflation
- **Monopoly tendency.** Monopolist lower their output in order to charge high prices leading to profit push inflation
- **Underdeveloped infrastructure.** Poor road network for example limits movement of goods and service causing scarcity in areas where goods are highly demanded leading to high prices
- **Reduced taxes.** Low taxes on income increase the level of disposable income which leads to increase in demand of goods and services resulting in high prices.
- **International crisis** such as that between Russia and Ukraine in 2022 leads scarcity of imported goods and services causing a rise in prices
- **Speculation**
- **Increase in prices** of fuel lead to increase in costs of transport causing inflation.
- **Rise in taxes,** leads to cost push inflation.

(b) Why may a low rate of inflation in an economy desirable

- **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.
- **Stimulates labour mobility and labour efficiency**

8(a) Define the term “public finance”. (4marks)

Public finance is a branch of macro-economic which deals with the government income and expenditures to achieve national development.

(b) What is the role of public finance in your country

- It **influences the level of investment.** The government may reduce taxes and increase subsidies in a given sector to raise level of investment
- To **reduce income inequality** especially through progressive taxes
- To raise **government revenue** to infrastructural development
- To **control inflation**
- To **discourage consumption of harmful products** such as drugs, tobacco and alcohol.
- To **increase the level of unemployment** by creating employment opportunities and subsidizing projects that create employment opportunities
- To promote **industrialization of self-sustenance** of a country
- To build necessary **infrastructure for development** and facilitate economic growth.
- **Save people from disaster** such as floods, hurricanes, fire etc.
- To **manage public debts**
- To **ensure security for** the country.
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Thank you

Dr. Bbosa Science