

ECONOMICS (P220)

BACKGROUND TO THE SUBJECT OF ECONOMICS

The paper code for the subject is P220.

The subject consists of two papers i.e. Economics paper one (P220/1) and Economics paper two (P220/2).

ECONOMICS PAPER ONE (P220/1)

This paper tests the candidates' understanding of the basic economic principles.

The questions set in this paper are open and usually demand for answers which can apply in any country. The questions usually end with the phrase "in an economy".

ECONOMICS PAPER TWO (P220/2)

This paper tests the candidates' understanding of the application of the economic principles.

This paper concentrates on examining economics as it applies to Uganda in particular.

When answering questions in paper 2;

- Pay a lot of attention to the tense used in the question
- Do not use a speculative language i.e. avoid using words like will and shall.

The duration of each paper is 3 hours.

Each paper has two sections i.e. Section A and Section B.

SECTION A

Section A has one compulsory question having five parts (a – e) each carrying 4 marks making a total of 20 marks.

Answers to this section should be concise and precise.

SECTION B

Section B consists of 6 essay type questions each carrying 20 marks out of which a student is required to attempt only four questions making a total of 80 marks.

THE COURSE OUTLINE (TOPICS TO BE COVERED)

1. Introduction to economics
2. Price theory
3. Production
4. National income
5. Economic growth and development
6. Money and banking
7. Population, labour and wages.
8. Unemployment
9. Structure of Uganda's economy
10. Public finance and fiscal policy
11. International trade
12. Inflation
13. Economic development planning

INTRODUCTION TO ECONOMICS

Economics centers on how human beings can make the best use of the available scarce resources to satisfy the competing ends (needs). Economics deals with the ways in which production and distribution change over time. Therefore it is the use

(allocation) and organization of resources that constitute the subject matter of economics.

DEFINITION OF ECONOMICS

There are many definitions of economics as put forward by different economists among which are the following;

1. Professor Alfred Marshal defines economics as a study of mankind in an ordinary business way of life. This means that the subject is concerned with the study of how man lives, moves and thinks in an ordinary business way of life.
2. Professor A.C. Pigou defines economics as a means of how to increase production in order to raise people's standards of living.
3. The classical economists led by Adam Smith define economics as the science of accumulation of wealth. This means that economics as a subject is concerned with the way people and the nation become rich. However, this definition has been criticized for being narrow because it does not address the main problem facing man i.e. scarcity of resources.
4. Economist Lionel Robbins said in 1935 that "Economics is a social science that studies human behaviour as a relationship between ends and scarce means which have alternative uses.

NOTE

By the term ends, we refer to human needs (endless desires of man)

By the term scarce means, we refer to inadequate resources.

WHY ROBBINS DEFINITION IS PREFERRED

Robbins definition is the most widely acceptable definition of economics because it carries three main important factors in economic analysis i.e. key economic issues facing man and countries.

1. It recognizes that human needs are unlimited (endless)

2. The resources to satisfy the unlimited human wants are scarce.
3. The scarce resources have got alternative uses and thus there is need to make the right choices when allocating resources.

The definition also recognizes economics as a social science i.e. it deals with that part of economic activity which is concerned with the satisfaction of the material needs.

ECONOMICS AS A SCIENCE AND SOCIAL SCIENCE

Economics has elements that make it a science discipline and these include;

- It is based on facts in real life.
- It is research based i.e. it makes experiments to prove certain things.
- It develops theories, principles and laws.
- It makes scientific observations.

Economics also has elements which qualify it to be a social science. These include;

- It is based on value judgement i.e. peoples' opinions
- It is dynamic i.e. it changes depending on the social and political conditions.
- It is based on human reasoning and human satisfaction.

ASSUMPTIONS IN ECONOMICS

It is not possible to isolate the problems in an economy. Economists make assumptions to enable them study the behaviour of an aspect/ phenomenon and hence draw conclusions or predictions whenever there is a change in one variable. Economists use the term **"Ceteris paribus."** This is a Latin word which stands for **"other factors held constant."**

ECONOMIC CONCEPTS

1. ECONOMIC THEORY

This is a body of concepts and principles which help us understand/explain and make predictions in economics. It is divided into two major parts;

a) Microeconomics.

Microeconomics is a branch of economics that deals with the economic behaviour of small units. The prefix **micro** comes from the Greek word "**Mikros**" which means **small**. So microeconomics deals with the behaviour of individual economic agents like consumers, producers and resource owners.

b) Macroeconomics.

Macroeconomics is the branch of economics that studies the economy as a whole. It assumes that the economy is a single functioning unit and any decision made affects all economic units. It deals with the behaviour of economic aggregates such as unemployment, inflation, aggregate demand and supply, national income, public finance and fiscal policy, economic development planning, etc.

2. STATEMENTS IN ECONOMICS

a) POSITIVE STATEMENT

In economics, a positive statement concerns what "**is**", "**was**" or "**will be**" and contains no indication of approval or disapproval. (What should be). Positive statements are testable or at least it is possible to imagine facts that disapprove them. Examples of positive statements include;

- i. The moon is made of black and gold cheese. (This is empirically false but is still a positive statement as it is a statement about what is and not what should be.
- ii. The price of sugar is high compared to what it was last year.
- iii. If the government raises the tax on beer, this will lead to a fall in the profits of brewers.

b) NORMATIVE STATEMENT

A normative statement expresses a value judgement about whether a situation is subjectively desirable or undesirable. It concerns **"What ought to be."** Normative statements are characterized by the modal verbs **"should", "would" or "could"**. Examples of normative statements include;

- i. The world would be a better place if the moon were made of green cheese.
- ii. The price of milk should be Shs. 1500 a gallon to give daily farmers a higher living standard.
- iii. The government should increase the minimum wage to Shs. 500,000 to reduce poverty.

3. THE THREE FUNDAMENTAL (BASIC) ECONOMIC PRINCIPLES (PROBLEMS)

a) Scarcity

Scarcity refers to the limited supply of economic resources in relation to peoples' requirements/wants e.g. there is scarcity of land, scarcity of trained labour, scarcity of trained entrepreneurs, scarcity of capital, etc.

The problem of scarcity is considered to be the most fundamental problem and it gives rise to the other two.

b) Choice

Choice is defined as the making of the best decision out of the available alternatives.

Because of scarcity of resources, man must make a scale of preference.

A scale of preference is a list of wants arranged starting with the most pressing needs and ending with the least pressing ones.

When the consumer chooses the first item, second, third and so on, he is said to be

making a choice.

Importance of choice

- ✓ Guides producers on what goods to produce and in what quantity.
- ✓ Guides producers on how to produce various goods and services.
- ✓ Guides producers on how to distribute the goods and services.
- ✓ Guides consumers when making consumption plans.

c) Opportunity cost/ Trade off cost/ Alternative cost/ Real cost

Opportunity cost is the second best alternative foregone when choice is made.

Opportunity cost arises out of scarcity and choice. When a consumer uses a scale of preference to make choice, it implies that he is making a decision to satisfy one set of wants. This necessarily means sacrificing some other set. It is because of the consumer's limited resources (income) that he chooses commodity A and leaves B for the mean time. By making choice therefore, he is sacrificing commodity B for A. It is this sacrifice that is referred to as opportunity cost in economics.

USES/IMPORTANCE OF THE CONCEPT OF OPPORTUNITY COST IN ECONOMICS

- ✓ **It guides producers in resource allocation/ making production decisions.** That is what to produce, when to produce, how to produce, where to produce and for whom to produce.
- ✓ **It helps consumers in making consumption decisions i.e.** consumers choose commodities that yield maximum utility.
- ✓ **The concept is used in pricing factors of production e.g.** workers that a producer cannot do without are paid high wages because they create a heavy opportunity cost when they are missing.
- ✓ **The concept is used when specializing in international trade.** It is used in international trade under the principle of comparative cost advantage whereby a

country specializes in the production of a commodity where it has the least opportunity cost.

- ✓ **It is a basis of economic planning.** Government planners always look at the second best alternative foregone during the planning process. E.g. the government can spend more money on providing basic services like universal education than on recreational facilities like sports stadia.
- ✓ **It helps workers to make employment decisions.** That is whether to work or enjoy leisure.

ASSIGNMENT

Under what circumstances may the opportunity cost principle be applied in economics?

(04 marks)

LIMITATIONS OF THE CONCEPT OF OPPORTUNITY COST

- ✓ It is based on the assumption that producers and consumers are rational which is not always true. Many producers and consumers are not guided by a calculating mind. They simply produce or consume without looking at the opportunity cost.
- ✓ It lacks uniformity because different people have different priorities.
- ✓ Opportunity cost does not have a monetary value and therefore it is very hard to attach a money value to it.
- ✓ Some factors of production are specific in that they cannot be put to alternative uses.
- ✓ The concept assumes perfect markets which not existent in the real world.
- ✓ It is not applicable in situations where factor immobility exists.

RELATIONSHIP BETWEEN SCARCITY, CHOICE AND OPPORTUNITY COST

Due to scarcity of resources, one has to make a choice out of the many alternatives, leaving some needs unsatisfied, hence opportunity cost.

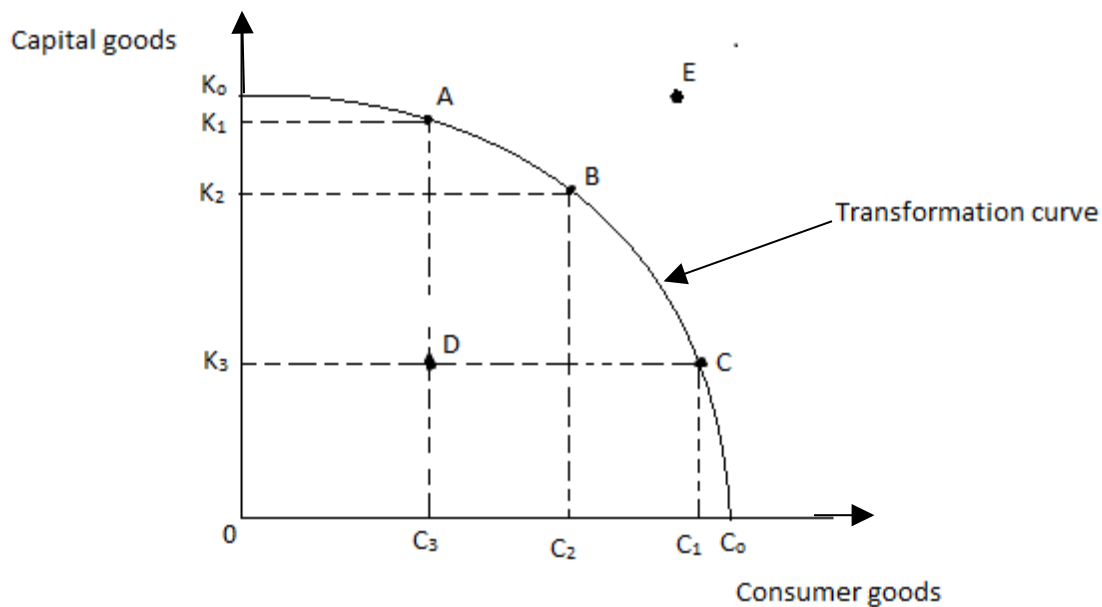
4. THE PRODUCTION POSSIBILITY FRONTIER/ CURVE (PPF/PPC) / TRANSFORMATION CURVE/ OPPORTUNITY COST CURVE

The PPF/C refers to a locus of points showing various combinations of two commodities that can maximumly be produced when all the country's available resources are fully and efficiently utilized.

ASSUMPTIONS OF THE PPF/C

- ✓ Assumes only two commodities being produced e.g. capital goods and consumer goods.
- ✓ Assumes a closed economy.
- ✓ Assumes full employment of resources.
- ✓ Assumes constant technology.
- ✓ Assumes perfect mobility of factors of production.
- ✓ Producers are assumed to be rational in their production decisions.

ILLUSTRATION OF THE PPF/C



Points along the PPF/C show the maximum amount of both capital goods and consumer goods that can be produced using all the available resources i.e. efficient utilization of resources.

If all resources are devoted to the production of capital goods, the economy/ country will have a maximum of K_0 and no consumer goods.

If all resources are devoted to the production of consumer goods, the economy will have a maximum of C_0 and no capital goods.

However, both commodities are needed in the society thus the society or producer would decide on how much of each commodity is to be produced. The society can either produce at point A (more capital goods and less consumer goods) or at point C (more consumer goods and less capital goods) or at point B (same amount of capital goods and consumer goods).

Along the PPF/C, society can produce more of one good but only by reducing the amounts produced of the other good. For example moving from point A to C, more consumer goods are produced but the amount produced of capital goods is reduced. A movement from one point to another along the PPF creates opportunity cost.

A point inside the PPF/C (Point D) represents under utilization of resources (excess capacity).

A point outside the PPF/C (point E) is desirable but unattainable because of scarcity of resources.

NOTE

Movement of the PPF/C outwards illustrates economic growth and better utilization of resources.

USE OF THE PPF/C TO EXPLAIN THE BASIC ECONOMIC PRINCIPLES

The PPF/C can be used to explain the concepts of scarcity, choice and opportunity cost.

a) Scarcity

Since resources are scarce, man is forced to produce along the PPF/C. man cannot produce beyond the PPF/C using the available resources and at constant technology.

b) Choice

A choice has to be made concerning how much of each commodity is to be produced. The society can decide to produce only capital goods or only consumer goods or a combination of the two.

c) Opportunity cost

Along the PPF/C, if society chooses to produce at point A rather than point B, then the value of the combination at point B becomes the opportunity cost.

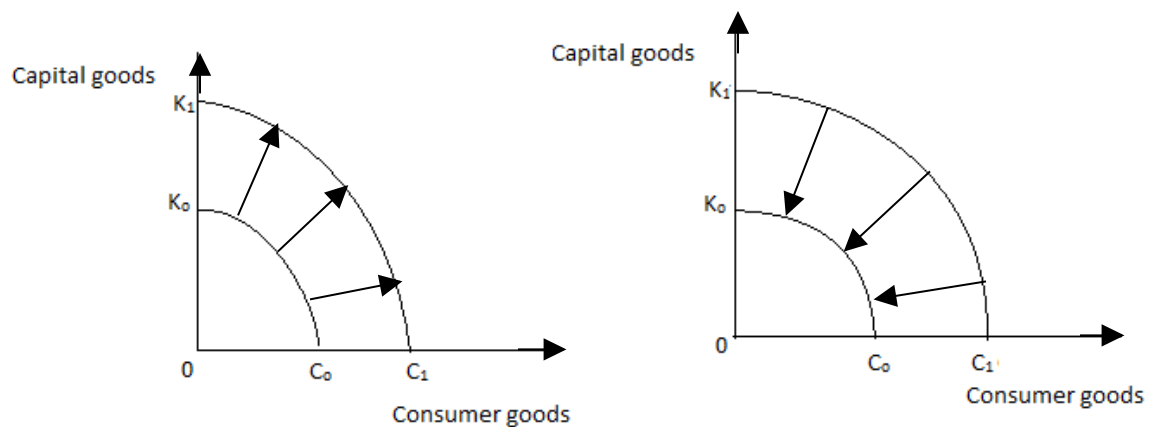
NOTE

For uses of the PPF/C, refer to the uses of the opportunity cost concept.

A SHIFT IN THE PPF/C

The PPF/C can either shift to the left (inwardly) or to the right (outwardly).

ILLUSTRATION



a) outward shift of the PPF

b) Inward shift of the PPF

Such a shift is caused by a change in factors that favour/disfavour production of both capital goods and consumer goods.

CAUSES OF THE PPF TO SHIFT OUTWARDS (Part a))

- ✓ Discovery of new natural resources e.g. oil deposits.
- ✓ Improvement in technology.
- ✓ Improvement in entrepreneurship skills.
- ✓ The economy becoming open leading to capital inflow.
- ✓ An increase in the size of the labour force.
- ✓ Improvement in the skills of workers/ increase in the efficiency of workers
- ✓ Increase in the level of capital stock.
- ✓ Political climate becoming favourable
- ✓ Improvement in the existing infrastructures.

CAUSES OF THE PPF TO SHIFT INWARDS (Part b))

- ✓ Depletion/ exhaustion of natural resources
- ✓ Decline in the level of technology.
- ✓ Reduced entrepreneurship ability
- ✓ Increased capital outflow.
- ✓ Decrease in the size of the labour force.
- ✓ Decrease in the skills of workers/decrease in workers efficiency

- ✓ Decrease in the level of capital stock.
- ✓ Political climate becoming unfavourable.
- ✓ Destruction of the existing infrastructures.

NOTE

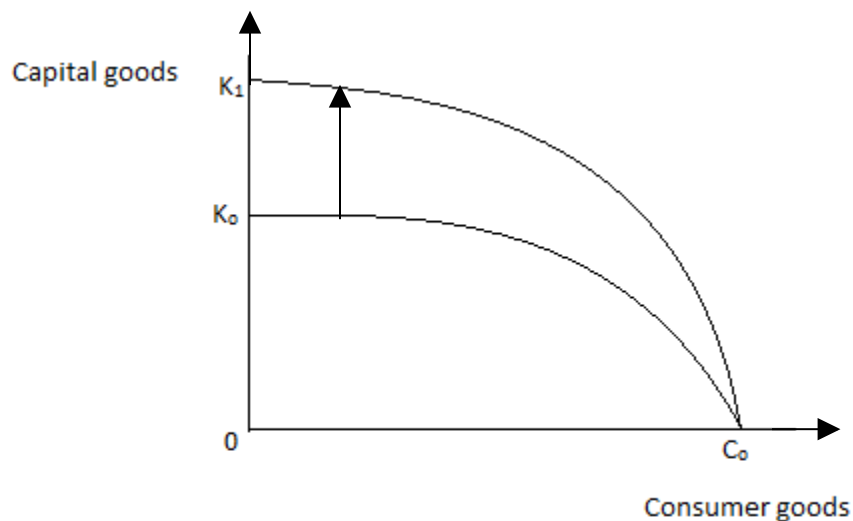
For factors that cause a shift in the PPF, begin with the word “change” in all your points.

Assignment

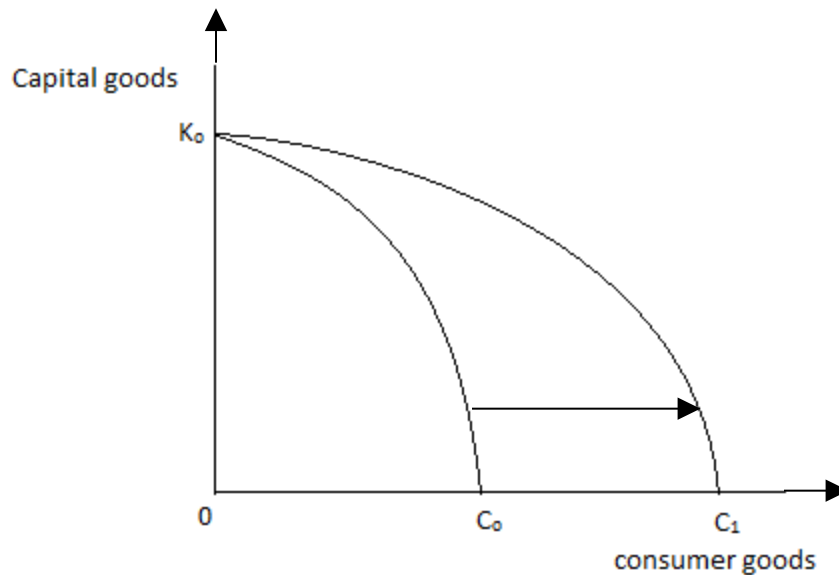
Outline any four factors that make the PPF to shift.

ROTATION OF THE PPF

This is caused by a change in factors that favour production of only one commodity. For example if the above mention factors such as technology, natural resource, etc change in favour of capital goods , the PPF will rotate as shown in the diagram below.



On the other hand if the factors change in favour of consumer goods, the PPF will rotate as shown in the diagram below.



5. RESOURCES

These are goods/ inputs out of which man produces goods and services to satisfy his wants.

OR

Resources are tangible and intangible things including human labour that man makes use of to satisfy his unlimited wants.

Examples of human resources include labour and entrepreneur.

Resources are also known as factors of production, factor inputs or means of production.

Resources can either **be renewable** or **non-renewable**.

Renewable resources are those resources which can be regenerated e.g. forests.

Non-renewable resources are those resources which cannot be regenerated e.g. minerals.

6. GOODS/ COMMODITIES

These are tangible items which satisfy human wants directly like clothes.

TYPES OF GOODS

a) **Producer/ capital/ goods/ goods of second order.**

These are goods used by producers to transform raw-materials into finished goods. These goods are used in the production of other goods. They satisfy human wants indirectly for example factory machines, buildings, raw materials, ovens, blender.

b) **Consumer/ final goods/ goods of first order.**

These are goods which are meant for final use by the final consumer and are capable of providing direct satisfaction to man's wants E.g. salt, soap, foodstuffs, books, clothes, cars, computer.

c) **Intermediate goods.**

These are goods which are produced but have not reached their final stage of production. That is they still need more processing in order to obtain a final good e.g. sugar canes are intermediate goods in the making of sugar, sugar in the making of sweets, wheat flour in the making of bread.

d) **Durable goods.**

These are goods which are capable of giving a long term service e.g. buildings, furniture, machines, television set, computers.

e) **Perishable goods.**

These are goods whose capacity to satisfy human wants ends after a short period of time i.e. they go bad after a short period of time e.g. vegetables, bread, meat, chapatti, milk.

f) Private goods.

Are those enjoyed solely/ exclusively by an individual such that one's consumption excludes others. A non owner must always seek permission from the owner before using the good E.g. personal cars, clothes, houses, laptops, textbooks, radio.

Characteristics of private goods

- ✓ They are excludable i.e. owners prevent those who have not paid for it from using the good/ no free – riders.
- ✓ There is rivalry in their consumption i.e. consumption by one necessarily prevents that of another.
- ✓ They involve direct payment to be consumed.
- ✓ They are scarce which causes competition for them

g) Public goods.

Are those which when provided, usually by the state, for a particular individual or group of individuals become available for others to use at zero or no extra costs and consumption by one person does not reduce the amount available for other users.

Examples of public goods include public roads, national defence, law and order, street lights, public clocks, public schools, public hospitals.

Characteristics of public goods

- ✓ Non-exhaustibility. Consumption by one person does not reduce the amount available for other users.
- ✓ Non-excludability. It is difficult to stop a person from consuming public goods or from getting the benefits of public goods.

- ✓ Non-divisibility (Indivisible). They are equally available to all individuals in the society.
- ✓ Usually provided by the state.
- ✓ They are indirectly paid for i.e. through taxes.
- ✓ No competition for them (There is non-rivalry in their consumption).

h) Free/ natural/ original goods.

Are those which exist in natural abundance and are enough for everyone to consume as much as they want at zero cost. E.g. rain water, sunshine, moonlight, soil, air, etc.

Characteristics of free goods

- ✓ They are provided by nature
- ✓ They are in abundant supply.
- ✓ They are consumed at zero cost.
- ✓ They provide utility.

i) Economic goods.

Are goods that are scarce and for one to consume them, a cost has to be incurred.

OR

Are goods that arise out of scarcity and choice.

Any commodity which is paid for is an economic good e.g. clothes, vehicles, pens.

Characteristics of economic goods

- ✓ They are relatively scarce.
- ✓ They provide satisfaction/ utility
- ✓ They command a price/ be marketable/ have a monetary value.

- ✓ They have opportunity cost.
- ✓ Their ownership is transferable

j) Merit goods.

Are those whose consumption is deemed intrinsically desirable and are meant to improve the quality of life of the people and their consumption should be encouraged. Examples of merit goods are safe water, health care and education.

k) Demerit goods.

These are goods considered to be socially undesirable and reduce the quality of life of individuals and the society at large e.g. cigarettes, alcohol, pornographic materials.

l) Normal goods.

These are goods whose demand increases as the consumer's income increases. E.g. first hand cars, first hand shoes, first hand suits.

m) Inferior goods.

Are those whose demand reduces as the income of the consumer increases e.g. cassava and beans, second hand clothes, second hand computers, second hand shoes.

OR

Are goods with negative income elasticity of demand.

n) Giffen goods.

Are those whose demand increases with the price and take a big percentage of the budget/ income of the low income earner e.g. the basic foodstuffs.

OR

Are goods with positive price elasticity of demand consumed by low income earners.

OR

Are goods with positive elasticity of demand and negative income elasticity of demand consumed by low income earners.

Examples of Giffen goods are basic foodstuffs like bananas, maize flour, bread, bread, cassava, potatoes etc.

NB

All giffen goods are inferior but not all inferior goods are giffen.

o) Superior goods/ articles of ostentation/ luxuries/ status symbols.

These are goods that are desirable only when they are expensive and people buy them show their class or to impress/ attract the attention of others for example golden earrings, sports cars, perfumes, golden watches, expensive phones, etc. The demand for superior goods increases as the price increases.

p) Necessities/ essential goods.

These are goods that that a consumer cannot do without for example food, shelter, water, clothing, soap, fuel. The demand for necessities first increases when there is an increase in the consumers' income up to a certain point beyond which further increase in income does not affect the quantity demanded. (Quantity demanded remains constant).

q) Complementary goods.

These are goods where the quantity demanded of one commodity varies inversely as the price of the other commodity. (As the price of one commodity goes up, the demand for the other falls).

OR

Complementary goods are goods that are consumed together.

Examples include cars and fuel, guns and bullets, tooth brush and tooth paste, etc.

r) **Substitute goods.**

These are goods where the quantity demanded of one commodity varies directly as the price of the other commodity. (As the price of one goes up, the demand for the other also rises).

OR

Substitute goods are goods which can be used for the same purpose.

OR

Substitute goods are goods which can be used interchangeably.

Examples include Colgate and fresh-up, tea and coffee, Omo and Nomi, etc.

7. **SERVICES**

These are intangible items that are helpful in making our lives comfortable and useful e.g. medical services, teaching services hair dressing services, banking services.

OR

These are intangible items used to facilitate the production of goods and services.

They can be classified as;

a) **Personal services.**

These are provided by individuals directly e.g. pastors, doctors, services of a teacher, etc.

b) **Commercial services**

These are services provided by institutions and are related to aids to trade e.g. insurance companies, communication networks, banking services, transport services, etc.

8. HUMAN WANTS/ NEEDS

These are desires of man which are satisfied by consuming goods and services.

They can also be defined as biological, physical and cultural needs of an individual or society.

They can be categorized as;

a) **Basic needs/ wants.**

These are necessities of life without which life would hardly exist. E.g. shelter, food, water and clothes.

b) **Secondary needs.**

These are needs that are required to make life comfortable. E.g. television sets, cars, air conditioners, etc.

c) **Material needs/ wants.**

These are desires which are satisfied through consumption of tangible/ physical goods e.g. desire for clothes, food, houses, chair, phone, etc.

d) **Immaterial needs.**

These are desires satisfied by consumption of services e.g. entertainment, security, health care, knowledge, etc.

e) **Private wants.**

These are desires of individuals and are always satisfied using personal resources e.g. the desire for eye glasses, wheel chair by a lame person, phone, etc.

f) **Public wants/ needs.**

These are collective needs of society which are satisfied by public goods and service e.g. the desire for public health centres, public schools, public roads, national defence, etc.

g) **Satiable wants.**

These are wants which can be satisfied by the available resources at a given period of time e.g. one's desire to quench thirst is satisfied by water for some hours.

h) **Insatiable wants.**

These are wants which cannot be satisfied using the available resources in a short period of time. Such wants cannot be satisfied because of the limited resources e.g. the desire for money and knowledge.

FEATURES/ CHARACTERISTICS OF HUMAN WANTS

- ✓ Human wants are unlimited i.e. they are endless e.g. man's desire for education, security, leisure is unlimited.
- ✓ They are dynamic, i.e. they keep changing from time to time depending on the prevailing social, political and economic conditions.
- ✓ They are varied, i.e. they are many and of different types e.g. spiritual, biological, physical, etc.
- ✓ They are competitive in nature, i.e. individuals always compete for the limited resources in order to satisfy the unlimited needs.
- ✓ They are recurrent (insatiable) i.e. there is a continuous need to satisfy wants from time to time/ they are hardly satisfied once and for all/ it is impossible to satisfy human wants. E.g. one's desire to quench thirst re-occurs.

- ✓ They are complementary, i.e. they are jointly satisfied e.g. one's desire for a car calls for other desires like buying fuel and car service.

9. WEALTH

Is a stock of productive goods/ assets which satisfy private and social needs of people.

OR

Wealth is the stock of assets and other resources existing in an economy at a given time which are used to generate more income.

FEATURES/CHARACTERISTICS OF WEALTH

- ✓ It is relatively scarce.
- ✓ It creates utility/ provides satisfaction
- ✓ It's ownership is transferrable
- ✓ It has a monetary value/ commands a price.
- ✓ Can be used to produce more wealth.

TYPES OF WEALTH

1. Personal wealth.

These are assets that are owned by an individual and they are used to satisfy the individual owner, e.g. personal clothes, furniture, books, vehicle, house, land, cattle.

2. Business wealth.

These are assets that are owned by a business firm with a view of making profits

e.g. company vehicles, raw-materials, commercial buildings, industrial machines, generator and furniture.

3. **Social/ public/ collective wealth.**

These are assets that are owned by the state/government and are collectively used by all members of the society, e.g. public roads, schools, hospitals, public springs/ wells, street lights.

10. **ECONOMIC QUESTIONS**

An economy or an individual is faced with a number of economic questions. These include;

a) **What to produce.**

Since resources or factors of production are scarce, a choice of what is to be produced must be made. Some societies would prefer to have more food, clothing and medical care while others would prefer more schools, roads and other forms of infrastructures.

b) **When to produce.**

That is choosing to produce now for present consumption or in the future. Most people prefer to consume now than postponing it for tomorrow. **"A bird in hand is better than a thousand in the bush."** A situation in which present consumption is preferred to future consumption is termed as **"positive rate of time preference"** while a situation in which future consumption is preferred to present consumption is termed as **"negative rate of time preference."**

c) **Where to produce.**

This concerns the location of the business. That is whether to produce near the source of raw materials or near the market or anywhere without considering any pull factor. A low cost locality is where the industry is usually located.

d) How to produce.

This concerns the method of production. That is whether to use capital intensive or labour intensive technology. In a country like Uganda where labour is abundant and cheaper than capital, more labour is used to produce goods and services. In contrast, developed countries have vast capital equipment and therefore use capital intensive methods at different production levels.

e) For whom to produce.

This concerns the nature of the consumers who are to consume the products. That is whether to produce for the rich or the poor, male or female, young, adults or old people and so on.

f) How much to produce.

This depends on the demand for the commodity and the objective of the firm. The more the demand for the commodity, the more quantities producers are likely to produce and put on the market. Also if the objective of the firm is to maximize sales, more is produced than when the firm's objective is to maximize profits.

11. ECONOMIC SYSTEMS

An economic system is an organization of ownership, allocation and distribution of resources in a given country. The above fundamental economic questions are answered differently depending on the type of economic system. There are three basic types of economic systems which exist in the world today and these are;

a) Free enterprise/free market/laissez faire/unplanned/ capitalist economy

b) Centralized/command/planned/socialist economy

c) Mixed economy.

THE FREE ENTERPRISE ECONOMY

Is an economic system where resources are owned, allocated and distributed by private individuals through market forces of demand and supply with little or no government intervention.

CHARACTERISTICS/ FEATURES OF THE FREE ENTERPRISE ECONOMY

- ✓ Resources are owned by private individuals.
- ✓ The price is determined by the market forces of demand and supply.
- ✓ The production of commodities depends on demand.
- ✓ Producers aim at profit maximization and consumers aim at utility maximization.
- ✓ There are many buyers and sellers in the market.
- ✓ There is reliance on price mechanism in the allocation of resources.
- ✓ There is limited or no government intervention especially in resource allocation and decision making.
- ✓ Characterized by self interest.
- ✓ There is freedom of choice. Producers are not forced to produce certain commodities and consumers are not forced to consume what they do not want.
- ✓ Existence of high levels of competition amongst producers and consumers in both factor and commodity markets respectively.

MERITS OF THE FREE ENTERPRISE ECONOMY

1. There is limited wastage of resources since production is according to demand.
2. Encourages exploitation of idle resources. This results into creation of more

employment opportunities.

3. Provides an incentive to economic growth. The private ownership of resources facilitates the exploitation and utilization of resources in an economy. This increases the production of goods and services hence economic growth.
4. Leads to production of better quality products due to competition in production.
5. Promotes efficient allocation of resources due to competition and the profit motive of producers.
6. Encourages creativity and innovativeness due to competition in production.
7. Encourages the growth of entrepreneurship due to the urge to earn high profits.
8. Consumers enjoy goods at lower prices due to benefits of competitive production. This leads to better standards of living.
9. Avoids administrative costs by the government because of automatic allocation of resources by the invisible hand.
10. There is low bureaucracy in decision making. This reduces wastage of time and delays because production decisions are quickly made without consulting government offices.
11. Promotes consumer sovereignty. This is because consumers are given freedom to decide on what is to be produced and consumed.
12. Provides a variety of goods and services due to a large number of producers.

DEMERITS OF THE FREE ENTERPRISE ECONOMY

1. Distorts consumer choices due to persuasive advertisement.
2. Subjects the economy to economic instabilities such as inflation, instability in

balance of payments due to absence of government interference.

3. Leads to unemployment and underemployment due to closure of some weak firms.
4. Monopoly is likely to develop with its negative consequences especially exploitation of consumers. Monopolistic firms restrict output and charge high prices with an aim of maximizing profits.
5. Worsens income and wealth inequalities due lack of a regulatory body. Resource owners tend to accumulate a lot of wealth while the poor grow poorer.
6. Leads to wastage of resources through excessive advertisement and duplication of goods and services.
7. Does not provide public goods such as defence, justice and sewage collection and merit goods like education, public health and safe water. This mainly because it would be impossible to charge them prices since "free riders" are not excluded in their consumption.
8. Some resources may be over exploited leading to their quick depletion and others may remain idle.
9. Production of goods and services is in favour of the rich (luxury goods) than the poor (necessities). As a result, cheap goods disappear from the market.
10. Results into production and consumption of harmful but profitable goods like alcohol, cigarettes.
11. Does not respond to rapid/ sudden structural changes like flooding, famine, earthquakes which require proper government planning.
12. There is divergence between private benefits and social costs. Under free enterprise economy, private benefits overweigh public benefits. In trying to achieve private benefits, social costs rise e.g. pollution, deforestation, exhaustion of resources, etc.

NOTE

The government intervenes in a free market economy through its policies which include the following;

- ✓ Taxation
- ✓ Subsidization of producers
- ✓ Price legislation (maximum or minimum price)
- ✓ Government planning
- ✓ Rationing of consumers (government provides scarce resources to consumers)
- ✓ Wage determination (minimum wage)
- ✓ Formation of consumer associations through which the government sensitizes people about their rights.

THE COMMAND/COMMUNISM/ CENTRALLY PLANNED/ SOCIALIST ECONOMY

Is an economic system where resources are owned, allocated and distributed by the central authority on behalf of the citizens.

The government creates a department called the central planning authority and this department makes decisions on ownership, control and allocation of resources.

Examples of countries that are largely socialist include Russia, China, North Korea, East Germany, Cuba.

FEATURES OF THE COMMAND ECONOMY

- ✓ Economic or productive resources are owned by the state i.e. the state owns all the natural resources and businesses in the country.
- ✓ The economic or productive resources are publicly owned. The productive resources belong to everyone in the country and are used with the guidance of

the government.

- ✓ Prices are determined by the state that is by either setting a minimum price to benefit producers or a maximum price to benefit consumers.
- ✓ The main aim of production is to maximize peoples' welfare. The government does not aim at making profits but producing goods and services that improve peoples' welfare.
- ✓ Decisions pertaining to economic activities such as resource exploitation are handled by a central planning authority and therefore some resources are reserved for future use.
- ✓ Self reliance is always the major goal of the government whenever economic resources are being designed.
- ✓ There is limited competition in production because the government is not profit motivated and consumers have to wait for what the government is to provide.
- ✓ Extensive planning by the central authority is done. The government is in charge of planning for everything.

MERITS OF THE COMMAND ECONOMY

1. Income is fairly distributed since resources are publicly owned.
2. Resources are not wasted since there is effective planning for the economy. Scarce resources can therefore be effectively utilized.
3. It eliminates the inefficiencies that tend to result from meaningless competition.
4. Private monopolies are controlled by the state. This helps to protect the consumers from being exploited in form of high prices charged by private monopolists.

5. People's welfare is improved since emphasis in production is on welfare and not commercial gains.
6. It ensures that adequate resources are devoted to production of public and merit goods.
7. The system can cope with rapid structural changes such as drought, famine, floods, earthquakes, etc through proper planning by the central planning authority.
8. The system caters for the unprivileged groups of people in the society such as the lame and the poor hence equal distribution of opportunities.
9. It controls the production of harmful products in the economy. The government is in position to regulate the production of such commodities like alcohol, cigarettes through taxation.
10. Some key areas like production of fire arms cannot be left in the hands of private individuals. This is because it may cause insecurity in the country hence a need for a planned economy.
11. More employment opportunities are provided as the government tries to improve welfare and even out income distribution.

DEMERITS OF THE COMMAND ECONOMY

1. Many officials are required to estimate wants and to direct factors of production accordingly. This results into high costs.
2. It is hard to accurately estimate peoples' needs since there are many. This leads to wastage of resources due to poor judgement of wants and some needs may remain unsatisfied.
3. Bureaucracy and red tape which are associated with the system lead to delay in production and planning. This makes development to move at a slow pace.

4. There is inefficiency in production due to absence of stiff competition.
5. The quality of final goods and services produced is low due to lack of competition.
6. Limited variety of goods is produced as government's interest is in provision of necessities of life. This limits the choice of consumers and they may be forced to consume goods which are not of their choice.
7. The system is a disincentive to private or individual initiative due to state ownership of resources. I.e. what belongs to the state is no man's resource.
8. The system is associated with limited inventions and innovations due to absence of competition.
9. The system is associated with high levels of corruption and embezzlement of government funds. This is because the sector cannot supervise all the sectors effectively.
10. It leads to imbalance in regional resource allocation and development. This is due to state influence in resource distribution basing on political support.
11. It leads to budgetary deficits in the economy. This is due to high administrative costs and subsidization of parastatals which are not economically productive.
12. It is difficult to coordinate all the economic activities at the same time. This is because the government has a lot of responsibilities.

ASSIGNMENT

Present the advantages of capitalism over socialism.

MIXED ECONOMY

Is one where resources are owned, allocated and distributed by both the state and the private individuals (market forces of demand and supply).

FEATURES OF A MIXED ECONOMY

- ✓ Ownership of resources is both by the state and private individuals. Some productive resources like land and industries belong to the government while others are privately owned.
- ✓ Economic decisions are made by both the state and private individuals.
- ✓ Production is both for profit and welfare maximization. The state produces goods to improve peoples' welfare while private individuals produce to maximize profits.
- ✓ Resource allocation is by both the market forces of demand and supply and the central planning authority.
- ✓ There is co-existence of both the private and public sector.
- ✓ There is existence of indicative planning. Indicative planning is one where the government draws plan targets and provides (conducive) political, social and economic policies to guide the private sector but it does not participate in plan implementation.
- ✓ Regulated competition in production and consumption. The government uses its authority to check on competition between firms.

MERITS OF A MIXED ECONOMY

1. Limited resource wastage due to regulated competition.
2. Better quality products are produced because of competition between the private and public sectors.

3. Production of a wide variety of products by both the private and public sectors
4. Reduced income inequalities due to state control.
5. Individuals' self interests are regulated e.g. over exploitation of resources and consumer exploitation.
6. It increases employment opportunities due to existence of both the private and public sectors.
7. The public sector provides essential goods and services that the private sector would not provide.
8. There is economic stability due to government intervention.
9. Increased rate of economic efficiency in production due to competition and planning.
10. The taxes got from the private sector can generate income for the government to fulfill its obligations.

DEMERITS

1. In most cases, the private sector suffers from restrictions and taxes imposed by the state yet the public sector is subsidized thus the ground for competition is not leveled.
2. Where the private sector is dominant, the consumers are exploited by the profit motivated producers. The producers can also influence government decisions politically and economically.
3. An inefficient public sector is a big burden to the government since the government incurs losses, experiences corruption and nepotism. If the public sector is kept on going by the state through subsidies which increase its expenditures, it will lead to public debts and an increased debt burden.

THE ROLE OF GOVERNMENT IN A MIXED ECONOMY

NB:

In economics, we look at the **role of.....**from a **functional perspective** i.e. in this particular case, we focus on what the government does or what it puts in place in a mixed economic system. Hence the role (functional work) of government in a mixed economy is thus;

1. **Enacting and enforcing laws that govern trade or business activities.** The government creates a set of laws for example the law of contract, consumer protection laws, Sale of goods Act, Food and drugs Act, etc. such laws help in regulating the way commercial activities are to be conducted in an economy.
2. **Supplementing and modifying the price mechanism.** The government in a mixed economy may intervene in the working of price mechanism through measures like price controls, taxation and subsidization. For example, legislation of maximum price by the government helps in protecting consumers from being exploited by producers through over charging.
3. **It reduces or checks income inequality.** The government uses policies like progressive taxation, supporting small and medium scale enterprises, diversification of the economy, etc to create a fair distribution of income among people in an economy. Fair distribution of income promotes savings and investment.
4. **Ensuring macro-economic stability.** The government is in charge of fighting inflation by regulating the volume of money in circulation. It also ensures that the exchange rates are stable in order to promote international trade. Macro-economic stability is important because it promotes investment which gives rise to production of more goods and services.
5. **Providing essential goods and merit goods to the public at affordable prices.** The government in a mixed economy provides merit goods such as safe water, health care (immunization programmes) and education usually at subsidized costs. E.g. The government of Uganda is currently providing universal primary and secondary education in government – aided schools.

6. **It checks social costs (negative externalities) in a country.** The government uses environment protection laws to check or reduce the degradation or pollution of the environment. It ensures that there is proper treatment and disposal of industrial waste, garbage. By controlling the social costs, the government is able to improve the quality of life of the people.
7. **Ensuring that political stability prevails in an economy.** By promoting political stability, there is assured security of life and property of people. This stimulates investment both in the public and private sector.
8. **It levies taxes to generate revenue to finance her development programmes or activities.** The government is able to finance its capital and re-current expenditure by using the revenue generated from taxes levied on incomes of individuals, goods, profits of companies, etc.
9. **Undertaking strategic ventures which cannot be left in the hands of private investors.** Such ventures include the manufacturing of ammunitions, printing of the national currency, etc.
10. **Undertaking projects that require large initial capital which the private investors are unable to raise.** Such projects include construction of hydro – electric power generating dams, construction of roads and rail lines, etc. By financing such projects, the government directly supports the activities of the private sector.
11. **Influencing the location of industries in particular areas.** This is achieved by gazetting land for industrial activities such that the areas become industrial estates. For example Namanve industrial estate which was gazetted by the government of Uganda.
12. **Supporting up-coming investors by providing investment incentives such as tax holidays and subsidies.** These investment incentives help investors to incur lower costs of production. This increases production by private investors in a mixed economy.

- 13. Formulating/ laying down plans to be followed by the private sector or private investors and the public sector.** For example, the **Plan for Modernization of Agriculture** (PMA) which was designed by the government of Uganda requires participation of both the public and private sector in the economy for its effective implementation.
- 14. Providing and maintaining the physical infrastructure in an economy (roads, rail lines, power dams).** Such infrastructure greatly supports the production process leading to increased output in terms of goods and services. The production of more goods and services gives rise to economic growth.
- 15. Ensuring creation of more employment opportunities for its people.** In a mixed economy, government sets up and runs public enterprises that operate alongside private enterprises. Private and public investment expands and more jobs are created. The employed people earn income to buy basic needs of life and this improves their standard of living.